NEW YORK STATE BAR ASSOCIATION

Section Chair

**Karen Gilbreath Sowell, Esq.**

Ernst & Young LLP

Washington, DC

NYSBA

# Tax Section

## Summer Meeting

The Press Hotel

Portland, Maine

June 22 – 24, 2018

Attendance at this meeting offers ***up to*** 7.5 NY MCLE credit hours in Professional Practice for experienced attorneys.

This program is co-sponsored by
The New York Bar Foundation

NYSBA

THE NEW YORK BAR FOUNDATION

# *Summer Meeting*
## *NotePad*

**Tax Section**

June 22-24, 2018

**The Press Hotel**

Portland, Maine

**Thank You!** This program is made possible by the generous donation of time and expertise by members and volunteers. Thank you to our volunteers—and to you, for choosing NYSBA Programs.

NYSBA

# ACCESSING THE ONLINE ELECTRONIC COURSE MATERIALS

All program materials will be distributed exclusively online in PDF format. It is strongly recommended that you save the course materials in advance in the event that you will be bringing a computer or tablet with you to the program.

Printing the complete materials is not required for attending the program.

To access the complete set of course materials, please insert the following link into your browser's address bar and click 'enter' **www.nysba.org/TAXSU18Materials**

This hard copy NotePad is provided to all attendees at the live program site. It contains lined paper for taking notes on each topic, speaker biographies and any power point presentation slides received prior to printing.

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- NYSBA cannot guarantee that free or paid WI-FI access will be available for your use at your program location.

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# MCLE INFORMATION

Program Title: **Tax Section Summer Meeting**

Dates: June 22-24, 2018 Location: The Press Hotel, Portland, Maine

Evaluation: https://nysba.co1.qualtrics.com/jfe/form/SV_8oje5okQtRgd4Pj

This evaluation survey link will be emailed to registrants following the program.

Total Credits: **Up to 7.5 New York CLE credit hours**

**Credit Category:**
7.5 Areas of Professional Practice

This course is approved for credit for experienced attorneys only. This course is not transitional and therefore will not qualify for credit for newly admitted attorneys (admitted to the New York Bar for less than two years).

## Attendance Verification for New York MCLE Credit

In order to receive MCLE credit, attendees must:

1) **Sign in** with registration staff

2) Complete and return a **Verification of Presence form** (included with course materials) at the end of the program or session. For multi-day programs, you will receive a separate form for each day of the program, to be returned each day.

**Partial credit for program segments is not allowed.** Under New York State Continuing Legal Education Regulations and Guidelines, credit shall be awarded only for attendance at an entire course or program, or for attendance at an entire session of a course or program. Persons who arrive late, depart early, or are absent for any portion of a segment will not receive credit for that segment. The Verification of Presence form certifies presence for the entire presentation. Any exceptions where full educational benefit of the presentation is not received should be indicated on the form and noted with registration personnel.

## Program Evaluation

The New York State Bar Association is committed to providing high quality continuing legal education courses, and your feedback regarding speakers and program accommodations is important to us. Following the program, an email will be sent to registrants with a link to complete an online evaluation survey. The link is also listed above.

# Additional Information and Policies

Recording of NYSBA seminars, meetings and events is not permitted.

## Accredited Provider

The New York State Bar Association's **Section and Meeting Services Department** has been certified by the New York State Continuing Legal Education Board as an accredited provider of continuing legal education courses and programs.

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Attorneys who wish to apply for credit outside of New York State should contact the governing body for MCLE in the respective jurisdiction.

## MCLE Certificates

MCLE Certificates will be emailed to attendees a few weeks after the program, or mailed to those without an email address on file. **To update your contact information with NYSBA**, visit www.nysba.org/MyProfile, or contact the Member Resource Center at (800) 582-2452 or MRC@nysba.org.

## Newly Admitted Attorneys—Permitted Formats

In accordance with New York CLE Board Regulations and Guidelines (section 2, part C), newly admitted attorneys (admitted to the New York Bar for less than two years) must complete **Skills** credit in the traditional live classroom setting or by fully interactive videoconference. **Ethics and Professionalism** credit may be completed in the traditional live classroom setting; by fully interactive videoconference; or by simultaneous transmission with synchronous interactivity, such as a live-streamed webcast that allows questions during the program. **Law Practice Management** and **Areas of Professional Practice** credit may be completed in any approved format.

## Tuition Assistance

New York State Bar Association members and non-members may apply for a discount or scholarship to attend MCLE programs, based on financial hardship. This discount applies to the educational portion of the program only. Application details can be found at www.nysba.org/SectionCLEAssistance.

## Questions

For questions, contact the NYSBA Section and Meeting Services Department at SectionCLE@nysba.org, or (800) 582-2452 (or (518) 463-3724 in the Albany area).

# SCHEDULE OF EVENTS

## Friday, June 22

**4:00 – 6:00 pm** **Registration** – Press Hotel Art Gallery

**6:00 – 7:00 pm** **Welcome Reception** – Composing Room

**Dinner** on your own
See page 7 for restaurant recommendations

## Saturday, June 23

**8:00 – 9:30 am** **Continental Breakfast** – Editorial Room/Art Gallery

**8:00 am – Noon** **Registration** – Composing Room Foyer

**9:00 am – Noon** **GENERAL SESSION** – Composing Room

**9:00 – 9:10 am**

**Tax Section Welcome**
**Karen Gilbreath Sowell, Esq.**
**Tax Section Chair**
Ernst & Young LLP
Washington, DC

**NYSBA Welcome**
**Michael Miller**
**President, New York State Bar Association**
Albany, NY

**9:10 – 10:30 am**

### Are You Feeling GILTI, or Just BEAT? Some [Unintended?] Intersections of the New International Tax Rules

Join us to discuss the frustrating fracas of international tax reform, where new acronyms are layered on top of vintage rules. The panel will cover puzzling issues involving foreign tax credits, previously-taxed income, basis, expense allocation and more. We will also consider how this fabulous new world applies to consolidated groups and partnerships.

*Panel Chair:*

**Kimberly S. Blanchard, Esq.**
Weil, Gotshal & Manges LLP
New York City

*Panelists:*

**Marjorie A. Rollinson, Esq.**
Associate Chief Counsel (International)
Internal Revenue Service
Washington, DC

**Stephen E. Shay, Esq.**
Harvard University
Boston, MA

**Jose E. Murillo, Esq.**
Ernst & Young LLP
Washington, DC

**William L. McRae, Esq.**
Cleary Gottlieb Steen & Hamilton LLP
New York City

**10:30 – 10:45 am** **Coffee Break**

**10:45 am – Noon**

### A Token Gesture: Tax Considerations for Cryptocurrencies and Utility Tokens

This panel will focus on the tax consequences to both issuers and purchasers of cryptocurrencies and utility tokens. We will discuss the new meaning of forks (they are not just for eating) and SAFEs (they are not just for protecting your will).

*Panel Chair:*

**John T. Lutz, Esq.**
McDermott Will & Emery LLP
New York City

*Continued on Next Page...*

## Saturday, June 23 *continued*

**10:45 am – Noon** **A Token Gesture** *continued...*

***Panelists:***

**Karl T. Walli, Esq.**
Senior Counsel, Office of Tax Policy
U.S. Department of the Treasury
Washington, DC

**Lisa M. Zarlenga, Esq.**
Steptoe & Johnson
Washington, DC

**Edward E. Gonzalez, Esq.**
Skadden, Arps, Slate, Meagher & Flom LLP
New York City

**Noon – 1:30 pm** **State & Local Tax Committees Luncheon and CLE (Registered Attorneys Only):**
**PREREGISTRATION *IS REQUIRED.*** CLE program runs from 12:15 - 1:30 pm.

**2018-2019 New York State Budget Bill: What's In, What's Out & What it All Means?**

This panel will discuss certain provisions of the 2018-2019 New York State enacted budget, as well as proposals that were not enacted. We will explore how these developments may impact the landscape of state and local taxation in New York State and City, including how the enacted budget provisions may result in lack of clarity, areas of controversy, planning opportunities, traps for the unwary, new administrative guidance, and future legislative action.

***Panel Chair:***

**Jack Trachtenberg, Esq.**
Deloitte Tax LLP
New York City

***Panelists:***

**Megan L. Brackney, Esq.**
Kostelanetz & Fink, LLP
New York City

**Paul R. Comeau, Esq.**
Hodgson Russ LLP
Buffalo

**Leah S. Robinson, Esq.**
Mayer Brown LLP
New York City

**OPTIONAL GROUP WALKING TOURS:**

**2:00 – 5:00 pm** **THE CULINARY PALETTE – ARTS & CULTURE WALKING TOUR**

Portland is steeped in rich local and maritime history. Join Maine Foodie Tours as we uncover the storied past of the city - sampling imaginative local dishes and confections enroute to visiting local art galleries and exploring the city's cultural and historical highlights. Tour starts at the US Customs House, 312 Fore St., and concludes at the Portland Museum of Art, 7 Congress St. **$85 per person includes VIP admission to Portland Museum of Art that may also be used on Sunday. Preregistration required.**

**2:00 – 3:30 pm** **GREATER PORTLAND LANDMARKS TOUR: THE GATEWAY TO COMMERCE & INDUSTRY IN PORTLAND**

Congress Street forms the commercial and transportation spine of the Portland peninsula. Ironically, the street was once far beyond the borders of the waterfront settlement at the foot of India Street. Business and commercial activity spread toward Congress from the waterfront; a transition accelerated by the Great Fire of 1866. By the 1900's, Congress Street was the commercial center of the city - new offices replaced older commercial buildings; the first skyscraper was finished in 1910. Learn about the history of the area, its industries and its current revitalization. **Meet in Press Hotel Lobby at 1:50 pm to depart for tour. $10 per person. Preregistration required.**

**6:30 – 10:00 pm** **OFFSITE RECEPTION & DINNER AT BRICK SOUTH, THOMPSON'S POINT**

Transportation provided to and from venue. Meet in hotel lobby; bus will make two runs to venue – departures at 6:15 and 6:25 pm. For those driving, directions will be provided.

## SCHEDULE OF EVENTS

### Sunday, June 24

**7:30 – 9:30 am** **Continental Breakfast** – Art Gallery

**8:00 – 9:00 am** **Executive Committee Breakfast Meeting** – Editorial Room

**8:00 am – Noon** **Registration** – Composing Room Foyer

**9:15 am – Noon** **GENERAL SESSION** – Composing Room

**9:15 – 10:30 am** **Relearning Corporate Transactions**

This year's "usual corporate panel" is not about reorganizations or spin-offs, but will discuss how corporate transactions will adapt to a new menu of good and bad ideas.

***Panel Chair:***

**William D. Alexander, Esq.**
Skadden, Arps, Slate, Meagher & Flom LLP
Washington, DC

***Panelists:***

**Tijana J. Dvornic, Esq.**
Wachtell, Lipton, Rosen & Katz LLP
New York City

**Kathleen L. Ferrell, Esq.**
Davis, Polk & Wardwell LLP
New York City

**John J. Merrick, Esq.**
Senior Level Counsel to the Associate Chief Counsel
(International)
Internal Revenue Service
Washington, DC

**10:30 – 10:45 am** **Coffee Break**

**10:45 am – Noon** **Aggregate vs. Entity Theory after TCJA**

Discussion on the manner in which various provisions of the TCJA address partnerships using an entity approach, an aggregate approach or a hybrid of both approaches.

***Panel Chair:***

**Michael B. Shulman, Esq.**
Shearman & Sterling LLP
New York City

***Panelists:***

**Andrew W. Needham, Esq.**
Cravath, Swaine & Moore LLP
New York City

**Amanda H. Nussbaum, Esq.**
Proskauer Rose LLP
New York City

**Krishna P. Vallabhaneni, Esq.**
Deputy Tax Legislative Counsel
U.S. Treasury Department
Washington, DC

**Meeting Adjourns**

NEW YORK STATE BAR ASSOCIATION

# Lawyer Assistance Program 800.255.0569


## Q. What is LAP?

**A.** The Lawyer Assistance Program is a program of the New York State Bar Association established to help attorneys, judges, and law students in New York State (NYSBA members and non-members) who are affected by alcoholism, drug abuse, gambling, depression, other mental health issues, or debilitating stress.

## Q. What services does LAP provide?

**A.** Services are **free** and include:

- Early identification of impairment
- Intervention and motivation to seek help
- Assessment, evaluation and development of an appropriate treatment plan
- Referral to community resources, self-help groups, inpatient treatment, outpatient counseling, and rehabilitation services
- Referral to a trained peer assistant – attorneys who have faced their own difficulties and volunteer to assist a struggling colleague by providing support, understanding, guidance, and good listening
- Information and consultation for those (family, firm, and judges) concerned about an attorney
- Training programs on recognizing, preventing, and dealing with addiction, stress, depression, and other mental health issues

## Q. Are LAP services confidential?

**A.** Absolutely, this wouldn't work any other way. In fact your confidentiality is guaranteed and protected under Section 499 of the Judiciary Law. Confidentiality is the hallmark of the program and the reason it has remained viable for almost 20 years.

**Judiciary Law Section 499 Lawyer Assistance Committees Chapter 327 of the Laws of 1993**

Confidential information privileged. The confidential relations and communications between a member or authorized agent of a lawyer assistance committee sponsored by a state or local bar association and any person, firm or corporation communicating with such a committee, its members or authorized agents shall be deemed to be privileged on the same basis as those provided by law between attorney and client. Such privileges may be waived only by the person, firm or corporation who has furnished information to the committee.

## Q. How do I access LAP services?

**A.** LAP services are accessed voluntarily by calling **800.255.0569** or connecting to our website **www.nysba.org/lap**

## Q. What can I expect when I contact LAP?

**A.** You can expect to speak to a Lawyer Assistance professional who has extensive experience with the issues and with the lawyer population. You can expect the undivided attention you deserve to share what's on your mind and to explore options for addressing your concerns. You will receive referrals, suggestions, and support. The LAP professional will ask your permission to check in with you in the weeks following your initial call to the LAP office.

## Q. Can I expect resolution of my problem?

**A.** The LAP instills hope through the peer assistant volunteers, many of whom have triumphed over their own significant personal problems. Also there is evidence that appropriate treatment and support is effective in most cases of mental health problems. For example, a combination of medication and therapy effectively treats depression in 85% of the cases.

## Personal Inventory

Personal problems such as alcoholism, substance abuse, depression and stress affect one's ability to practice law. Take time to review the following questions and consider whether you or a colleague would benefit from the available Lawyer Assistance Program services. If you answer "yes" to any of these questions, you may need help.

1. **Are my associates, clients or family saying that my behavior has changed or that I don't seem myself?**
2. **Is it difficult for me to maintain a routine and stay on top of responsibilities?**
3. **Have I experienced memory problems or an inability to concentrate?**
4. **Am I having difficulty managing emotions such as anger and sadness?**
5. **Have I missed appointments or appearances or failed to return phone calls? Am I keeping up with correspondence?**
6. **Have my sleeping and eating habits changed?**
7. **Am I experiencing a pattern of relationship problems with significant people in my life (spouse/parent, children, partners/associates)?**
8. **Does my family have a history of alcoholism, substance abuse or depression?**
9. **Do I drink or take drugs to deal with my problems?**
10. **In the last few months, have I had more drinks or drugs than I intended, or felt that I should cut back or quit, but could not?**
11. **Is gambling making me careless of my financial responsibilities?**
12. **Do I feel so stressed, burned out and depressed that I have thoughts of suicide?**

## There Is Hope

**CONTACT LAP TODAY FOR FREE CONFIDENTIAL ASSISTANCE AND SUPPORT**

The sooner the better!

**1.800.255.0569**

NEW YORK STATE BAR ASSOCIATION

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☐ As a NYSBA member, **PLEASE BILL ME $25 for Tax Section dues.** (law student rate is $12.50)

☐ I wish to become a member of the NYSBA (please see Association membership dues categories) and the Tax Section. **PLEASE BILL ME for both.**

☐ I am a Section member — please consider me for appointment to committees marked.

Name ______________________________

Address ______________________________

______________________________

City ____________ State ____ Zip ____________

The above address is my ☐ Home ☐ Office ☐ Both

Please supply us with an additional address.

Name ______________________________

Address ______________________________

City ____________ State ____ Zip ____________

Office phone ( ______ ) ______________________

Home phone ( ______ ) ______________________

Fax number ( ______ ) ______________________

E-mail address ______________________________

Date of birth ______ /______ /______

Law school ______________________________

Graduation date ____________

States and dates of admission to Bar: ______________

*Please return this application to:*
**MEMBER RESOURCE CENTER,**
New York State Bar Association, One Elk Street, Albany NY 12207
Phone 800.582.2452/518.463.3200 • FAX 518.463.5993
E-mail mrc@nysba.org • www.nysba.org

# Join a Tax Section Committee(s)

Please designate in order of choice (1, 2, 3) from the list below, a maximum of three committees in which you are interested. You are assured of at least one committee appointment. All appointments are made as space availability permits.

___ Bankruptcy and Operating Losses (TAX1100)
___ Compliance, Practice and Procedure (TAX1300)
___ Consolidated Returns (TAX1400)
___ Corporations (TAX1500)
___ Cross-Border Capital Markets (TAX4100)
___ Cross-Border M&A (TAX4500)
___ Diversity (TAX4300)
___ Employee Benefits (TAX2600)
___ Estates and Trusts (TAX1700)
___ Financial Instruments (TAX1800)
___ "Inbound" U.S. Activities of Foreign Taxpayers (TAX3700)
___ Individuals (TAX2100)
___ Investment Funds (TAX4200)
___ New York City Taxes (TAX2400)
___ New York State Taxes (TAX2500)
___ "Outbound" Foreign Activities of U.S. Taxpayers (TAX2000)
___ Partnerships (TAX2800)
___ Pass-Through Entities (TAX2900)
___ Real Property (TAX3100)
___ Reorganizations (TAX3200)
___ Securitizations and Structured Finance (TAX4000)
___ Spin Offs (TAX4600)
___ Tax Exempt Entities (TAX3500)
___ Treaties and Intergovernmental Agreements (TAX4700)

## 2018 ANNUAL MEMBERSHIP DUES

Class based on first year of admission to bar of any state.
Membership year runs January through December.

| ACTIVE/ASSOCIATE IN-STATE ATTORNEY MEMBERSHIP | |
|---|---|
| Attorneys admitted 2010 and prior | $275 |
| Attorneys admitted 2011-2012 | 185 |
| Attorneys admitted 2013-2014 | 125 |
| Attorneys admitted 2015 - 3.31.2017 | 60 |
| **ACTIVE/ASSOCIATE OUT-OF-STATE ATTORNEY MEMBERSHIP** | |
| Attorneys admitted 2010 and prior | $180 |
| Attorneys admitted 2011-2012 | 150 |
| Attorneys admitted 2013-2014 | 120 |
| Attorneys admitted 2015 - 3.31.2017 | 60 |
| **OTHER** | |
| Sustaining Member | $400 |
| Affiliate Member | 185 |
| Newly Admitted Member* | FREE |

**DEFINITIONS**

Active In-State = Attorneys admitted in NYS, who work and/or reside in NYS
Associate In-State = Attorneys not admitted in NYS, who work and/or reside in NYS
Active Out-of-State = Attorneys admitted in NYS, who neither work nor reside in NYS
Associate Out-of-State = Attorneys not admitted in NYS, who neither work nor reside in NYS
Sustaining = Attorney members who voluntarily provide additional funds to further support the work of the Association
Affiliate = Person(s) holding a JD, not admitted to practice, who work for a law school or bar association
*Newly admitted = Attorneys admitted on or after April 1, 2017

NYSBA

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# ARE YOU FEELING GILTI, OR JUST BEAT? SOME (UNINTENDED?) INTERSECTIONS OF THE NEW INTERNATIONAL TAX RULES

**Presented By:**


**Kimberly S. Blanchard, Esq. , Panel Chair**
Weil, Gotschal & Manges LLP
New York City

**Marjorie A. Rollinson, Esq.**
Associate Chief Counsel (International)
Internal Revenue Service
Washington, DC

**Jose E. Murillo, Esq.**
Ernst & Young LLP
Washington, DC

**Stephen E. Shay, Esq.**
Harvard University
Boston, MA

**William L. McRae, Esq.**
Cleary Gottlieb Steen & Hamilton LLP
New York City

**Report No. 1388**

# NEW YORK STATE BAR ASSOCIATION TAX SECTION

## REPORT ON SECTION 965

**February 6, 2018**

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# I. Introduction

## A. Background

This Report[1] ("Report") makes recommendations for guidance addressing the application of section 965[2], as amended by "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," P.L. 115-97 (the "Act"). This Report also addresses Notice 2018-07 (issued December 29, 2017)[3] and Notice 2018-13 (issued January 19, 2018) (the "Notices"). Each of the Notices announced that the Department of the Treasury (the "Treasury") and the Internal Revenue Service (the "Service") intend to issue regulations for determining amounts required to be included in gross income by United States shareholders under section 951(a)(1) pursuant to section 965.

We commend Treasury and the Service for taking these thoughtful and significant first steps in providing guidance under section 965. In this Report, we suggest some improvements and recommend areas in which we believe additional guidance is required.

## B. Overview of New Section 965

Section 965 requires U.S. shareholders that own 10 percent of the voting stock of controlled foreign corporations ("CFC") and all foreign corporations in which a domestic corporation owns a 10 percent voting interest to include in their income their shares of the undistributed post-1986 earnings and profits of such corporation, as specially determined. It is clear from the statutory framework that the objective of section 965 is that a U.S. shareholder's share of such undistributed earnings be included in income but it is also clear that it was only intended to be included in income once. Although section 965 provides a number of detailed rules to assist in its operation, the drafters appeared to have expected that the mechanics of the Subpart F regime would fill in many of the gaps.[4] Unfortunately, the Subpart F regime cannot fill many of the gaps due to the specialized nature of many of the provisions of section 965 and what appears to be the implicit assumption

[1] The principal drafters of this Report were Edward Gonzalez, Brian Krause, and Jay Cosel, with contributions from William Alexander, Neil J. Barr, Kimberly S. Blanchard, Andrew H. Braiterman, Loren R. Lembo, Jeffrey Maddrey, Michael Mollerus, Yaron Z. Reich, Michael Schler, Karen G. Sowell, Shun Tosaka, and Gordon E. Warnke. This Report reflects solely the views of the Tax Section of the New York State Bar Association ("NYSBA") and not those of the NYSBA Executive Committee or the House of Delegates.

[2] Unless otherwise indicated all section references are to the Internal Revenue Code of 1986, as amended (the "Code") and the Treasury Regulations issued thereunder.

[3] 2018-4 I.R.B. 317, modified by, Notice 2018-13, to be published in 2018-06 I.R.B.

[4] For example, the Subpart F regime is an income inclusion regime whereas section 965 provides for both an income inclusion and a deduction.

of the drafters that the ownership of a "specified foreign corporation" would remain static during the inclusion year.

Consequently, as described below, section 965 raises many interpretative issues. Unlike other provisions of the Act, section 965 generally has an impact that is short-lived because taxpayers' income inclusions pursuant to the statute will occur exclusively in 2017 and 2018. Immediate guidance from Treasury and the Service is, nevertheless, critical because of the impact that these rules have on taxpayers' 2017 and 2018 financial statements. Given the uniqueness of section 965, and its short-lived nature, we urge Treasury and the Service to exercise their regulatory authority to fill the interpretative gaps in a manner consistent with the legislative intent to subject the income to tax only once at the favorable corporate rates specified in the statute.

## II. Need for Guidance Providing for Simplifying Conventions Generally

Section 965 requires taxpayers to obtain a substantial amount of information from specified foreign corporations, including the foreign corporation's "accumulated post-1986 deferred foreign income" (hereinafter referred to as "deferred E&P") as of the November 2, 2017 and December 31, 2017 measurement dates and the corporation's foreign cash position as of three different dates. Many taxpayers are required to gather information relating to their specified foreign corporations ("SFCs")[5] for periods that pre-date their ownership of such SFCs in order to comply with section 965.

In some cases, foreign corporations and their U.S. shareholders will have maintained similar information for purposes of complying with the Code's international provisions as in existence prior to the Act (including the Subpart F regime, the passive foreign investment company rules, and the deemed-paid foreign tax credit). In other cases, however, section 965 compliance requires a completely new and potentially daunting administrative burden for taxpayers. The difficulties are compounded by the fact that SFCs, particularly those that are not controlled by U.S. shareholders, may be quite reluctant—or even completely unwilling—to assist their U.S. shareholders in this task, particularly in the time frame required in order to comply with section 965.[6]

5 "Specified foreign corporation" is generally defined to mean any CFC or any foreign corporation (other than a non-controlled passive foreign investment company) that has a U.S. shareholder that is a domestic corporation. § 965(e).

6 The Act's repeal of section 958(b)(4) results in even more U.S. taxpayers, including individuals, that are 10% U.S. shareholders of majority foreign-owned foreign corporations being subject to the transition tax. As in effect prior to repeal, section 958(b)(4) provided that subparagraphs (A), (B), and (C) of section 318(a)(3) were not to be applied so as to consider a United States person as owning stock which is owned by a person who is not a United States person. The subparagraphs of section 318(a)(3) generally attribute stock owned by a person to a partnership, estate, trust, or corporation in which such person has an interest (so-called "downward attribution"). For example, stock of a corporation owned by a person that owns 50 percent or more in value of the stock of another corporation is treated as owned by such other corporation.

In recognition of the administrative burdens posed by section 965, section 3.02 of Notice 2018-13 announced that Treasury and the Service intend to issue regulations providing that taxpayers may make an election to determine an SFC's deferred E&P as of a measurement date using an "alternative method." The purpose of the alternative method is to eliminate the need for taxpayers to determine an SFC's deferred E&P as of a date that does not fall on the last day of a month. An SFC (other than an SFC with a 52-53 week taxable year) would thus be permitted to do an interim closing of the books on October 31, 2017, rather than on November 2, 2017, compute a daily earnings amount for the stub period through October 31, and add two days' worth of earnings and profits to the earnings and profits as of October 31 in order to determine the SFC's earnings and profits as of November 2, 2017.

Recommendations

We believe Section 3.02 of Notice 2018-13 represents a significant first step in easing the compliance challenges that section 965 presents for taxpayers. Nevertheless, we suggest that Treasury and the Service issue further guidance that makes additional simplifying conventions available to taxpayers.

With respect to SFCs that were not either CFCs or "section 902 corporations" within the meaning of section 909(d)(5) under pre-Act law (*i.e.*, SFCs that may not have had any reason for determining earnings and profits under U.S. federal income tax principles or furnishing their U.S. shareholders with any information), taxpayers should be able to determine deferred E&P and cash positions as of the various dates required under section 965 based on financial statements and statements of retained earnings that are filed with a governmental entity or audited by an independent accountant. In many cases, we believe this is the only information regarding their SFCs to which minority U.S. shareholders will have any access.

We believe additional conventions should also be available for measuring deferred E&P in order to avoid potential distortionary effects of determining deferred E&P as of a mid-year date. These are discussed below.

## III. Need for Guidance Regarding Measurement of Post-1986 Earnings and Profits and Deficits

### A. Mid-Year Measurement Dates

Pursuant to section 965(a), an SFC's deferred E&P is required to be determined on November 2, 2017 and December 31, 2017. An SFC with deferred E&P on at least one of the measurement dates is treated as a "deferred foreign income corporation" ("DFIC"). A DFIC's Subpart F income is increased by the greater of the two amounts in its last taxable year beginning before January 1, 2018.

As other commenters have pointed out, the requirement to measure a foreign corporation's earnings and profits on a date that does not correspond to the end of the corporation's taxable or fiscal year will cause distortionary effects in many cases.[7] It also represents a substantial compliance burden for taxpayers.

Taxpayers often have significant items of expense for the year that do not arise until at or close to the end of the year. Accordingly, the deferred E&P of a DFIC as of the November 2 measurement date may overstate earnings and be inconsistent with economic reality, because it includes income accrued through that date with respect to the measurement year, but not the deductions that are properly allocable against the income.[8] For example, foreign income taxes are generally not treated as accruing until the end of a corporation's foreign tax year.[9] Depending upon the jurisdictions in which a DFIC operates, foreign income taxes may constitute a very substantial expense. This expense clearly relates to income that is earned over the DFIC's foreign tax year, and in other contexts Treasury and the Service have provided rules apportioning foreign taxes between periods falling within the same tax year in order to achieve a proper matching of income with the associated foreign taxes.[10] Another potential mismatch occurs in the case of DFICs that pay a significant portion of annual compensation in the form of bonuses that do not become fixed until sometime in December (after the November 2 measurement date).

The "alternative method" proposed in Notice 2008-13 does not address this issue.

<u>Recommendations</u>

7 *See* Letter to Department of the Treasury from The Securities Industry and Financial Markets Association (Dec. 22, 2017), 2018 TNT 2-8.

8 In the case of foreign income taxes that may not accrue until year-end, this problem is compounded by section 78, which would effectively require a U.S. shareholder to include in income an amount equal to its indirect foreign credits related to its section 965 inclusion, even though a portion of the underlying foreign income taxes did not reduce the deferred E&P.

9 For an accrual method taxpayer, a foreign tax liability accrues when the "all events" test is satisfied. *See* Reg. §1.446-1(c)(1)(ii). To satisfy the all events test, in general, a liability must have arisen in fact; the amount of the liability must be susceptible to reasonably accurate determination; and economic performance must have occurred. *See* § 461(h); Treas. Reg. § 1.446-1(c)(1)(ii). In the case of a foreign income tax liability, however, economic performance occurs when the requirements of the all events test other than economic performance (*i.e.*, payment) are met. Treas. Reg. § 1.461-4(g)(6)(iii)(B).

10 *See* Treas. Reg. § 1.338-9(d) (allocating foreign taxes of a target in a stock sale in connection with which a section 338 election is made if the foreign taxable year of target does not close on the acquisition date); Treas. Reg. § 1.901-2(f)(4) (allocating foreign taxes of a partnership or disregarded entity that is a foreign taxpayer in cases where a change in ownership occurs during the entity's foreign taxable year and such taxable year does not close as a result of such change).

We recommend that Treasury and the Service issue guidance permitting taxpayers to use a ratable allocation of the earnings and profits for the entire year or other reasonable method in order to calculate earnings and profits on the measurement dates, in order to mitigate the distortionary effects of an interim closing approach and ease the administrative burden on taxpayers. The ratable allocation method should exclude income or loss from extraordinary transactions, which can be taken into account in the appropriate period.

This recommendation is consistent with other areas of U.S. federal income tax law. For example, Treasury Regulation section 1.1502-76(b) provides that items (other than extraordinary items) may be ratably allocated between a separate return and the consolidated return when a corporation joins or leaves a consolidated group based on a day count.

Alternatively, some other rules need to be adopted to permit items of expense that accrue at year end but relate to the entire year to be taken into account, particularly with respect to the November 2 date. For example, the alternative method of Notice 2018-13 could be retained but with the additional feature that items that accrue at year-end[11] (and were not taken into account in closing of the books) are allocated over the measurement period. We believe it is especially important to address the treatment of foreign income taxes, which represent a substantial expense for many DFICs and should be treated as accruing with the related income for this purpose.

**B. Sales, Redemptions and Distributions During the Transition Year**

Section 965(d)(3) provides that the deferred E&P of SFCs are determined "… without diminution by reason of dividends distributed during the taxable year … other than dividends distributed to another specified foreign corporation" (the "no-diminution" rule). This provision presents a number of issues because parties could have undertaken transactions both before and after any meaningful details regarding tax reform were known and the consequences as a result of section 965 may be very different from those that they reasonably anticipated.

*Example 1.*

(i) Facts. USP owns CFC 1, which as of December 31, 2016 had $50 post-1986 earnings and profits, $20 of which was previously taxed income within the meaning of section 959 ("PTI"), and $50 of cash. The equity of CFC 1 had a fair market value of $100 and USP had a tax basis of $20 in the stock of CFC 1. CFC 1 had a December 31 tax year. In February 2017, CFC 1 distributed all of its cash of $50 to USP and in March 2017, USP entered into a binding agreement to sell the stock of CFC 1 to USCo, an unrelated U.S. corporation, for $50. The transaction closed in June

[11] As mentioned above, foreign taxes do not generally accrue until the end of a foreign corporation's tax year, which may differ from its tax year for U.S. federal income tax purposes.

2017. CFC 1 earned an additional $10 of E&P in 2017, none of which was Subpart F income as defined in section 952.

(ii) Analysis. Under the law in effect at the time of the transactions, USP expected to recognize dividend income of $30 and gain of $50 from the sale of the CFC 1 stock, $10 of which would be treated as a dividend from CFC 1 under section 1248(a). USCo expected that it would not recognize any income on account of CFC 1's pre-acquisition E&P and that CFC 1 would have $10 of PTI attributable to USP's section 1248(a) amount.

Under section 965(a), it appears that USCo is required to include in income $40 of CFC 1's deferred E&P, because it is the owner of the CFC 1 stock on December 31, 2017 and the amount of CFC 1's deferred E&P is generally determined without reduction for distributions made during its 2017 tax year (subject to application of section 965(f), discussed below). However, it appears that USP is also required to include in income that $40 of E&P as a result of the February 2017 dividend distribution and the section 1248(a) amount recognized on the sale of the CFC 1 stock. The $40 of E&P would not be attributable to PTI described in section 959(c)(2) by reason of section 965(a) with respect to USP, protected by the gain-reduction rule set forth in the Notices (discussed below), because USP was not the U.S. shareholder of CFC 1 on December 31, 2016 that recognized the section 965(a) inclusion. Note that the deferred E&P inclusion would be more distortive if the distribution to USP had been, in whole or in part, a distribution of property that triggered gain under section 311(b). It should also be noted that this treatment will create a built-in loss with respect to the stock of CFC 1 held by USCo because USCo can never get the cash that was distributed to USP.

Section 965(f) could be used as a basis for reducing USCo's section 965(a) inclusion. Under section 965(f), a U.S. shareholder's section 965(a) inclusion is reduced based on distributions made by the SFC during the inclusion year to shareholders that were not U.S. shareholders on the last date of the year under principles similar to section 951(a)(2). We note, however, that section 951(a)(2) requires pro-rating distributions made during the year to other shareholders based on their holding period during the year. Because section 965(a) requires multiple years of income to be recognized, this pro rata allocation method could still result in an acquirer of SFC shares recognizing a section 965(a) inclusion on E&P that accrued before its holding period started that was previously distributed to other shareholders. In the case of USCo, it would still have a $20 section 965(a) inclusion because it owned the CFC 1 stock for half the year. Alternatively, in light of the fact that section 965(d)(3) requires that only periods during which a foreign corporation was an SFC be taken into account, it might be possible to argue that in this context the principles of section 951(a)(2) should be interpreted as allowing a proration between shareholders over the period that the entity was an SFC.

Similar issues could arise with respect to redemptions during the inclusion year, particularly redemptions that are treated as dividends under section 301. In such cases, the remaining

U.S. shareholder may have to include in income the redeemed shareholder's share of the deferred earnings.

Recommendation

As an initial matter, there should be clarification of how the seller in Example 1 or a redeemed shareholder should be treated. Does section 965(a) alter their treatment or is section 965(a) solely affecting the treatment of the taxpayer who holds the SFC shares on the last day of the inclusion year? We believe that the most appropriate rule is that the no-diminution rule under section 965(d)(3) was only intended to be factored in computing deferred E&P and should not affect the treatment of transactions during the inclusion year for former shareholders of the SFC.

With respect to the holders of the shares of the SFC at the end of the inclusion year, there are a number of potential solutions to the over-inclusion issue. None of the potential solutions are perfect from the standpoint of both solving the issue and clearly coming within the applicable statutory language. We believe that the purpose of the no-diminution rule was to prevent taxpayers from engaging in transactions that could reduce the deferred E&P. Based on this likely motivation, we believe that some of the over-inclusion issues could be solved by providing that if the stock purchase involves a qualified stock purchase under section 338, the no-diminution rule would not apply to pre-sale distributions paid to the selling shareholders. Situations involving a qualified stock purchase are less likely to be motivated solely by tax planning and the terms would be arm's length. Similarly, distributions prior to sales between unrelated parties, but which involve sales of less than 80% of the stock, could also be given effect. It is also possible to limit this special rule to transactions occurring before the date of the first release of the text of section 965.

In cases involving related parties, such as a redemption, a possible solution is to permit a reduction of E&P by the redeemed shareholder's allocable share of E&P based on their relative stock ownership. In such a case, the reduction of E&P would not be the full amount that is treated as a dividend under section 301, but the U.S. shareholder at the end of the inclusion year would not be including in its income another shareholder's E&P, which it could never get.

### C. Application of E&P Deficit Rules to SFCs with PTI and E&P Deficits

Section 3.01 of Notice 2018-13 contains rules for determining whether an SFC is a DFIC or an E&P deficit foreign corporation. This determination is significant because if the SFC is an E&P deficit foreign corporation, then its E&P deficit will be available to reduce its U.S. shareholders' income inclusion under section 965 with respect to other SFCs of the U.S. shareholder. Example 2 of Notice 2018-13 illustrates that when the same SFC has PTI and a deficit in E&P described in section 959(c)(3), the deficit is required to be netted against the PTI. Specifically, in the example FS has 100u of PTI and an E&P deficit of 90u. The example concludes that the 100u of PTI and the 90u E&P deficit are netted, resulting in FS having positive E&P of 10 and not qualifying as an E&P deficit foreign corporation.

Recommendation

Under Notice 2018-13, assuming an identical amount of positive non-PTI E&P in its DFICs, a U.S. shareholder of an SFC with PTI and an E&P deficit will pay more transition tax than a U.S. shareholder of an SFC with no PTI and the same sized E&P deficit. It will also pay more transition tax than a U.S. shareholder whose PTI is in an SFC with positive non-PTI E&P.[12] The methodology of the Notice can create significant and unjustified differences between similarly situated taxpayers based merely on the existence and location of PTI among affiliated SFCs. It is also inconsistent with the result that would have been obtained if affiliated SFCs were treated as a single corporation, which is a base of comparison that Treasury utilized to determine the appropriate treatment of intercompany payables and receivables among affiliated SFCs in Notice 2018-07. Had Treasury issued this guidance last November, the result could have easily been avoided had the SFC with the E&P deficit and PTI merged with a DFIC before the E&P measurement dates. The result could also have been avoided had an SFC with an E&P deficit distributed its PTI to its U.S. shareholders prior to the E&P measurement dates.

Congress specifically excluded PTI from the definition of "accumulated post-1986 deferred foreign income," which reflects an intent to exclude PTI from the computation of deferred E&P under section 965. Congress granted Treasury broad authority under section 965 to issue "necessary or appropriate" regulations.[13] Section 965 itself does not define "deficit," and we urge Treasury to exercise its regulatory authority to exclude PTI from this calculation as well.[14]

[12] It appears that in this situation the deficit is not required to be allocated against the PTI in the DFIC.

[13] We note that Treasury and the Service may be assuming by negative inference that the definition of "post-1986 earnings and profits" for purposes of section 965 includes earnings attributable to PTI, because the definition in section 965(d)(2) of "accumulated post-1986 deferred foreign income" provides that "post-1986 earnings and profits" are reduced by the amount of a DFIC's PTI and effectively connected income. A more natural reading of the term "post-1986 earnings and profits," however, excludes PTI altogether, because section 965(d)(3) is based almost verbatim on section 902(c), which has always reduced post-1986 undistributed earnings and profits by PTI. Significantly, such a reading is specifically mandated by the longstanding regulation interpreting that same language. *See* Treas. Reg. § 1.902-1(a)(9).

Thus, it is at least equally reasonable to conclude that the reference to PTI in section 965(d)(2) is intended to clarify and resolve any ambiguity regarding whether PTI (and ECI) is to be subjected to additional tax under section 965. Given the clear policy objectives of section 965 described above and the ambiguous, at best, statutory scheme, and in light of Treasury's and the Service's interpretation of section 902(c), Treasury and the Service should consider exercising their regulatory authority (as they did under section 902(c)) to exclude PTI from all relevant computations under section 965.

[14] Notice 2018-13 does not address whether the PTI and E&P deficit in FS continue to be available after they are netted for purposes of determining whether FS is a DFIC or E&P deficit foreign corporation. We believe that they should continue to be available and that Treasury should confirm that in regulations.

### D. Hovering Deficits and Related Foreign Income Taxes

Section 3.03 of Notice 2018-13 states that Treasury and the Service intend to issue regulations "clarifying that all deficits related to post-1986 earnings and profits, including hovering deficits, are taken into account for purposes of determining the post-1986 earnings and profits (including a deficit) of" an SFC. We believe this is an appropriate result, clearly contemplated by the legislative history of section 965. In its discussion of deficits, the Conference Report includes the following passage:

> For example, assume that a foreign corporation organized after December 31, 1986 has $100 of accumulated earnings and profits as of November 2, 2017, and December 31, 2017 (determined without diminution by reason of dividends distributed during the taxable year and after any increase for qualified deficits), which consist of $120 general limitation earnings and profits and a $20 passive limitation deficit, the foreign corporation's post-1986 earnings and profits would be $100, even if the $20 passive limitation deficit was a hovering deficit. Foreign income taxes related to the hovering deficit, however, would not generally be deemed paid by the U.S. shareholder recognizing an incremental income inclusion. However, the conferees expect the Secretary may issue guidance to provide that, solely for purposes of calculating the amount of foreign income taxes deemed paid by the U.S. shareholder with respect to an inclusion under section 965, a hovering deficit may be absorbed by current year earnings and profits and the foreign income taxes related to the hovering deficit may be added to the specified foreign corporation's post-1986 foreign income taxes in that separate category on a pro rata basis in the year of inclusion.[15]

Recommendation

While section 3.03 of Notice 2018-13 allows taxpayers to take hovering deficits into account in determining deferred E&P, it is silent on the treatment of related foreign income taxes that are otherwise suspended under Treasury Regulation section 1.367(b)-7(d)(2)(ii). We recommend that Treasury and the Service consider issuing guidance on the treatment of such foreign income taxes. In general, we believe that it may be appropriate to treat those taxes as being included in a DFIC's post-1986 foreign income tax pool. Allowing these taxes to be claimed as credits in connection with the transition tax is consistent with treating the separate corporations

[15] H.R. Rep. No. 115-466, at 490 (footnotes omitted).

that engaged in a section 381 transaction giving rise to a hovering deficit as a single DFIC—if foreign operations had historically been conducted in a single DFIC rather than through two or more separate corporations, then there would be neither a hovering deficit nor any suspended foreign income taxes.

### E. Potential Double Counting of Earnings and Profits of SFCs With Inclusion Years Ending November 30, 2018

Section 3.02 of Notice 2018-07 provides rules that would seem to obviate most issues related to double counting of E&P. One exception, however, may be distributions by a first-tier November 30 SFC to its U.S. shareholder occurring between November 2 and December 1, 2017 (because such distributions occur after the November 2 measurement date, and thus may not reduce the section 965 inclusion, but prior to the SFC's inclusion year, and thus would seem not to be PTI).

Recommendation

We recommend that Treasury and the Service consider issuing guidance regarding the proper treatment of distributions by November 30 SFCs occurring between November 2, 2017 and December 1, 2017, either by treating such distributions as PTI, or by providing that the deferred E&P as of November 2, 2017 is reduced by such distributions, to the extent necessary to prevent double counting.

## IV. Need for Guidance Regarding Measurement of Cash Position

### A. Notional Cash Pooling Arrangements

#### 1. Cash Pooling Arrangements Generally

Corporate groups frequently take a centralized approach to managing the deployment of cash within the group and to hedging risks associated with the group's treasury and finance functions. In a cash pooling arrangement, the treasury center, typically together with a third-party financial institution, centrally manages the group's cash. In all pooling arrangements, the participating group members will typically each enter into a separate account agreement with the financial institution operating the pool. In addition, the participating members typically enter into an agreement among themselves specifying the key terms of the pooling arrangement, including the frequency of sweeps and the mechanism for calculation and payment of interest among the participating members.

There are two basic types of cash pooling arrangements: (i) physical cash pooling and (ii) notional cash pooling. There are some differences between these two types of arrangements.

In a physical cash pooling arrangement (also sometimes referred to as a zero balance arrangement, or a cash sweep), several group members will open accounts with the same financial institution. At pre-established frequent intervals (usually daily, although in some cases weekly, monthly or quarterly intervals might be used), the bank automatically moves cash from the accounts of group members that have positive account balances to the account of the treasury center (this account is sometimes called the pool leader's account or the header account). The bank then automatically moves cash from the header account into the accounts of group members that have negative account balances. If, after this process, the header account has a positive balance, the financial institution pays interest on that balance; or, if the header account balance is negative, the treasury center is charged interest. These cash movements typically are automated rather than manual, as automation provides significantly greater efficiency and limits possibilities for error.

The second basic type of cash pooling arrangement is often referred to as notional or virtual cash pooling. Such an arrangement resembles physical cash pooling, in that participating group members typically all establish accounts with the same financial institution, and the treasury center acts as the pool leader. However, in a notional pooling arrangement, cash is not swept out of, or deposited into, any group member's account by the financial institution. Each group member retains its own account relationship with the bank and its own deposit or overdraft balance. On each measurement date, the financial institution determines whether each group member has a positive or negative balance in its account and aggregates the account balances. If the aggregate is positive, then the financial institution pays the treasury center an amount of interest on that positive amount; if the aggregate is negative, then the treasury center must borrow either from the financial institution or from some other corporation in the group (*e.g.*, the parent) in order to increase the negative amount to zero. Absent such borrowing, participants in the pooling arrangement with negative balances generally cannot have an aggregate negative balance in excess of the aggregate positive balance of those participants with positive balances.

Group members participating in notional pooling may separately account for the absence of interest payable to the financial institution on members' negative account balances; the absence of interest receivable from the financial institution on members' positive account balances; and payments of interest to, or by, the pool header on the notional aggregate balance. Therefore, the total amount of interest income and expense recorded by participants in physical and notional pools should be similar; any variance should be attributable to differences between the interest rates paid/charged by the financial institutions and the transfer pricing policies implemented by group members, rather than to the difference in counterparty described above.

### 2. General Treatment of Cash Pools for U.S. Federal Income Tax Purposes

Physical and notional pooling arrangements are economically similar insofar as each pool member has the right to access cash on a demand basis as needed. Nevertheless, the overall amount of liquid assets (*i.e.*, net cash) held by a group of related corporations is the same regardless of whether they are members of a physical or notional pooling arrangement. Nevertheless, because of the formal structure of the rights and obligations under each arrangement, the characterization of physical and notional pooling arrangements for U.S. federal income tax purposes may be different.

For U.S. federal income tax purposes, a physical cash pooling arrangement like the one described above is typically viewed as creating loans to the treasury center from the other group members with positive balances, and from the treasury center to the group members with negative account balances. Interest typically is accrued on these loans. Loans are repaid automatically through the sweep mechanism as cash becomes available to the borrower, with balances shifting each time a periodic sweep occurs.

In a notional pooling arrangement, the parties to the relationship for U.S. federal income tax purposes might be viewed as including the facilitating financial institution. Because group members typically each continue to have their own individual overdrafts and deposits directly with the bank, it could be argued that notional pooling should be treated for U.S. and foreign tax purposes as loans from the financial institution operating the pool to group members that have negative account balances, and to the financial institution from group members that have positive account balances. For purposes of the section 385 regulations, Treasury and the Service have indicated that they generally view notional cash pooling arrangements as in substance loans directly between and among the affiliated group members, rather than loans between the members and the financial institution, in circumstances where the financial institution is merely acting as an intermediary administrative clearing house to facilitate cash movements among members of the affiliated group.[16]

### 3. Application of Section 965(c)(3) and Notice 2018-07

Section 965(c)(3)(B)(ii) provides that the "aggregate foreign cash position" of a specified foreign corporation includes that corporation's "net accounts receivable." Notice 2018-07 recognizes that if there are accounts receivable or short-term obligations between related SFCs, this may "inflate the aggregate foreign cash position of a U.S. shareholder relative to the actual aggregate amount of liquid assets (other than the intercompany receivables) owned by the specified foreign

[16] T.D. 9790 (October 21, 2016) ("For example, a notional cash pool in which the cash received by a nonmember cash pool provider from expanded group members is required to equal or exceed the amount loaned to expanded group members will generally be treated as a loan directly between expanded group members, even though the interests may be in form documented as debt between an expanded group member and a nonmember facilitator").

corporations of the United States shareholder." The Notice then goes on to reason that intercompany receivables would inflate the measure of liquid assets because "if the specified foreign corporations were treated as a single corporation, the liquid assets of the specified foreign corporations would have been reduced."

To address this concern, Notice 2018-07 takes the position that receivables and payables between SFCs that are related within the meaning of section 954(d)(3) will be disregarded. Specifically, the Notice clarifies that for purposes of applying section 965(c)(3)(B)(ii), Treasury and the Service "intend to issue regulations providing that, with respect to a United States shareholder, any receivable or payable of a specified foreign corporation from or to a related specified foreign corporation will be disregarded to the extent of the common ownership of such specified foreign corporations by the United States shareholder."[17]

We agree with the underlying policy position of Notice 2018-07, which is that the appropriate measure of liquid assets for purposes of computing the aggregate foreign cash position under section 965(c)(3) should be based on the total net liquidity of an affiliated group of SFCs. We believe that those policies apply equally to both physical cash pooling and notional cash pooling and thus they should be treated in the same manner for purposes of section 965. The reasoning can be illustrated with the following example.

*Example 2.*

US1 is a U.S. corporation that is the 100% owner[18] of five specified foreign corporations: CFC1, CFC2, CFC3, CFC4, and CFC5. CFC1, CFC2, CFC3, and CFC4 are operating companies that participate in a pooling arrangement with CFC5, which is a corporate treasury center dedicated to the management of any cash pooling arrangement. Without regard to any pooling arrangement, the cash balance of each CFC would be as follows:

- CFC1: $100
- CFC2: $50
- CFC3: ($50) (*i.e.*, it has a cash deficit)
- CFC4: ($25)

[17] Notice 2018-07 § 3.01(b).

[18] We have used a single U.S. shareholder with 100% ownership for ease of illustration. The underlying analysis and policy rationale should not be different in cases where there are multiple U.S. shareholders and/or unrelated owners. We also note that in general, it is typical for all members of a cash pooling arrangement (whether physical or notional) to be part of the same controlled group of corporations (as such term is used in section 1563(a)).

- CFC5: $0 (*i.e.*, it is solely a treasury center and so would not exist without a pooling arrangement)[19]

Regardless of whether CFCs 1-5 are participants in a physical or notional pooling arrangement, the net liquid assets held by US1's CFCs is $75.

In a physical cash pooling arrangement, CFCs 1-4 would be treated as having receivables from (or payables to) CFC5 of $100, $50, ($50), and ($25), respectively. Under Notice 2018-07, these would all be disregarded. CFC5 would have a cash balance with the financial institution of $75 (*i.e.*, cash pooled from CFC1 and CFC2, less cash advanced to CFC3 and CFC4). Therefore, the aggregate foreign cash position of US1 would be $75.

Under the policy rationale of the Notice, the result should be identical under a notional pooling arrangement.[20] However, if the notional pooling balances would otherwise be treated as receivables/payables directly between the financial institution and CFCs 1-4, CFC5 would not, in this example, have a receivable or payable with the financial institution (setting aside any interest paid or other extraneous transactions). In that case, as currently promulgated, Notice 2018-07 would not permit US1 to reduce the cash position of CFC1 and CFC2 by the cash deficits of CFC3 and CFC4. Therefore, US1 would have an aggregate foreign cash position of $150, which overstates the liquid assets of its group of CFCs.

<u>Recommendation</u>

We request that Treasury clarify that both physical cash pooling and notional cash pooling arrangements will be treated in a similar manner under section 965. We believe that a straightforward allocation approach can be used to achieve the policy objectives of Notice 2018-07. Under this approach, where related-party SFCs are participants in a notional cash pooling arrangement, SFCs that have positive cash balances would reduce their aggregate foreign cash position in respect of any negative balances of related-party SFC's that are participants in the pooling arrangement. The net positive cash balance of the SFC pool participants would then be allocated pro rata to each SFC in proportion to such SFC's share of the positive balances in the pool.

Applying this approach to the example above, the net positive cash balance of the participants in the pooling arrangement is $75 (*i.e.*, 100 + 50 - 50 - 25). That $75 net positive balance would be allocated between CFC1 and CFC2—the only entities with positive balances—based on each such entity's proportionate share of the gross positive balances of such pool participants.

[19] The treatment of CFC5 as a dedicated treasury center entity is solely for ease of illustration. We do not believe that the analysis should be different if CFC5 had its own operations and cash balance.

[20] An SFC's cash position should be the same whether it participates in a notional cash pooling arrangement or a physical cash pooling arrangement.

CFC1 would thus be allocated a positive cash balance of $50 (*i.e.*, $75 x (100 ÷150)). And CFC2 would be allocated $25 (*i.e.*, $75 x 50 ÷ 150).

We believe that this approach is consistent with the approach in Notice 2018-07 as it applies to physical cash pooling arrangements, is consistent with the treatment of notional cash pooling under section 385, and is consistent with the policy of avoiding double counting of liquid assets when determining the aggregate foreign cash position for purposes of section 965(c)(3).

### B. Definition of "Accounts Payable"

Notice 2018-13's definition of "accounts payable" likely creates unfavorable results for a wide variety of taxpayers, raising significant policy questions as well as factual difficulties.[21] Section 3.04(a) of the Notice provides that "the term 'accounts payable' means payables arising from the purchase of property described in section 1221(a)(1) or 1221(a)(8) or the receipt of services from vendors or suppliers." Section 1221(a)(1) describes inventory, while section 1221(a)(8) describes supplies. Noticeably and surprisingly absent is any reference to payables arising from property described in Section 1221(a)(2) (depreciable property or real property used in a trade or business), or any reference to payables accrued to license intellectual property. To illustrate the scope of this extremely limited definition, accounts payable incurred by a manufacturer (i) to acquire equipment, (ii) to license intellectual property rights or (iii) to pay employees would all fail to qualify as "accounts payable."

These results are particularly surprising when one realizes that cash payments for any of the foregoing items would clearly reduce the "cash position" under section 965(c)(3)(B). No explanation is provided for why a purchase of supplies is viewed as creating an account payable while a license of IP is not. Similarly, it is challenging to explain why a purchase of machinery should be regarded differently from a purchase of inventory. The Notice articulates a rationale of trying to measure liquidity; whether liquidity is impacted by a purchase of inventory versus a purchase of equipment, for example, would seem irrelevant.[22]

[21] We note that section 965(c)(3)(C)(ii) refers to a "corporation's accounts payable (determined consistent with the rules of section 461)." The meaning of the parenthetical is not entirely clear. Section 461 and the Treasury Regulations thereunder are timing provisions, but do not expressly refer to accounts payable. The parenthetical may simply mean that only accounts payable that have accrued in accordance with section 461 principles are taken into account. We do believe, however, that the inclusion of the parenthetical supports the argument that "accounts payable" should not be construed narrowly for purposes of section 965(c).

[22] In addition to the foregoing, this definition appears to depart from existing guidance on what constitutes an "account payable" for U.S. federal income tax purposes. For example, Rev. Proc. 99-32 defines the payable/receivable that may be created via a transfer pricing adjustment as an "account payable" and an "account receivable," fostering a rationale of allowing cash payments to match transfer pricing adjustments without incremental tax consequences. Under Notice 2018-13, however, accounts payable created by virtue of such

Recommendation

We recommend that Treasury and the Service further consider the appropriate definition of "accounts payable".

### C. Treatment of Non-Corporate Entities as SFCs

Section 965(c)(3)(E) provides that an entity (other than a corporation) is required to be treated as an SFC of a U.S. shareholder for purposes of determining such U.S. shareholder's aggregate foreign cash position if any interest in the entity is held by an SFC of the U.S. shareholder, and the entity would be an SFC of the U.S. shareholder if it were a foreign corporation.

Under this rule, certain partnerships in which SFCs own interests will themselves be treated as SFCs for purposes of determining the relevant U.S. shareholders' aggregate foreign cash positions. Notably, however, rather than functioning as a look-through rule that treats an SFC as owning its allocable share of the liquid assets of a partnership in which the SFC owns an interest, section 965(c)(3)(E) instead simply treats a partnership as an SFC. As a consequence, under the plain text of the statute, a U.S. shareholder would be required to take into account not only the cash position of a partnership that is attributable to an SFC's interest in the partnership, but also the cash position that is attributable to any interest in the partnership held by the U.S. shareholder itself.

*Example 3. Partnership Owned by U.S. Shareholder and its SFC.*

USP, a domestic corporation, owns 100% of CFC 1. USP owns 5%, and CFC 1 owns 95%, of PRS, a foreign partnership. PRS's cash position as of each of the relevant measurement dates is $100.

Under section 965(c)(3)(E), PRS is treated as an SFC because if PRS were a corporation, it would be 100% owned (directly and indirectly) by USP. In the absence of any guidance to the contrary, the full $100 of cash held by PRS would be taken into account by USP in determining its aggregate foreign cash position.

As a policy matter, a U.S. shareholder's allocable share of the cash position of a partnership should not be taken into account in determining the shareholder's aggregate foreign cash position. The purpose of measuring a U.S. shareholder's aggregate foreign cash position is to impose the

adjustments would not be "accounts payable" for purposes of assessing liquid assets under section 965(c)(3). We can discern no rationale for distinguishing between account payables based on the asset that gave rise to the account payable. Forcing taxpayers to make such distinctions will potentially impose onerous requirements on taxpayers.

transition tax at a higher rate on the portion of a foreign corporation's deferred E&P that is attributable to liquid assets.[23] Accordingly, only liquid assets that are held by foreign corporations—directly, or indirectly through a partnership—should be taken into account.[24]

Importantly, the Conference Report states that the conferees anticipate that Treasury and the Service will issue guidance addressing the application of section 965(c)(3)(E) in these circumstances.[25]

Recommendation

We recommend that Treasury and the Service issue guidance providing that a U.S. shareholder's share of the cash position of a non-corporate entity that is treated as an SFC pursuant to section 965(c)(3)(E) is disregarded. Under this principle, in Example 3 above, USP would take into account $95 of the cash of PRS in determining its aggregate foreign cash position, and not the full $100.

We also recommend that Treasury and the Service issue guidance clarifying that the term "entity" in section 965(c)(3)(E) does not include an entity that is disregarded as an entity separate from its owner for U.S. federal income tax purposes (a "DRE"). For purposes of applying section 965(c), we believe DREs should simply be disregarded and liquid assets held by a DRE should be considered as being held directly by the entity's owner.

## V. Need for Guidance Regarding PTI and Basis Adjustments

Section 965 gives rise to a number of issues regarding distributions made by DFICs during and after their inclusion year and basis adjustments that are made in connection with U.S. shareholders' inclusions under section 951(a)(1) pursuant to section 965. We believe section 3.03 of Notice 2018-07 and section 4 of Notice 2018-13 address several of these issues and commend Treasury and the Service for their efforts. Nevertheless, additional guidance is needed to clarify a

[23] *See* Senate Budget Committee Explanation, p. 358;

[24] There may be partnerships that are jointly owned by U.S. shareholders and their SFCs and to which the relevant SFC has contributed a disproportionate share of cash and cash equivalents compared to the U.S. shareholder (which may have contributed operating assets, for example). In situations where the SFC's contribution of liquid assets was undertaken with a principal purpose of reducing its cash position, the anti-abuse rule in section 965(c)(3)(F) permits the Service to disregard the transfer. Outside this context, in non-abusive transactions in which an SFC has contributed liquid assets to a bona fide partnership in exchange for a partnership interest, we do not believe it is generally appropriate to "trace" specific partnership property back to the contributing SFC.

[25] *See* H.R. Rep. No. 115-466, at 492.

few remaining interpretative questions and correct certain adverse consequences arising from the application of section 965.

Generally, section 961 provides rules for adjusting a U.S. shareholder's basis in stock of SFCs[26] and other property to account for inclusions pursuant to section 951(a) and distributions of PTI. Section 961(a) provides for positive basis adjustments to account for inclusions in gross income under section 951(a), while section 961(b)(1) provides for negative basis adjustments to reflect distributions of PTI. To the extent the amount of a distribution of PTI exceeds the U.S. shareholder's basis in the SFC stock, the U.S. shareholder is required to recognize gain under section 961(b)(2).[27]

A U.S. shareholder's pro rata share of the increase in Subpart F income of an SFC required by section 965(a) is included in the gross income of the U.S. shareholder for its taxable year in which or with which the taxable year of the SFC beginning before January 1, 2018 ends.

Thus, for a December 31 DFIC, a U.S. shareholder with respect to such DFIC included an amount in income under section 951(a)(1) pursuant to section 965 for its taxable year that included December 31, 2017. The deferred E&P that gave rise to this inclusion became PTI on December 31, 2017, and the distribution of this PTI results in the application of section 961(b).

Section 965(b)(1) provides that, if a taxpayer is a U.S. shareholder with respect to at least one DFIC and at least one E&P deficit foreign corporation,[28] then the portion of deferred E&P which would otherwise be taken into account under section 951(a)(1) by a U.S. shareholder with respect to each DFIC is reduced by the amount of such U.S. shareholder's aggregate foreign E&P deficit that is allocated to such DFIC.

Section 965(b)(4)(A) states:

> For purposes of applying section 959 in any taxable year beginning with the taxable year described in [section 965(a)], with respect to any United States shareholder of a deferred foreign income corporation, an amount equal to such shareholder's reduction under [section 965(b)(1)] which is allocated to such deferred foreign income corporation under this subsection shall be treated as an amount

[26] Although section 961 refers to CFCs, section 965(e)(2) provides that, for purposes of sections 951 and 961, an SFC shall be treated as a CFC for purposes of taking into account Subpart F income of such corporation for purposes of section 965(a) (and for purposes of applying section 965(f)).

[27] § 961(b)(2); Treas. Reg. § 1.961-2(c).

[28] Under section 965(b)(3)(B), "E&P deficit foreign corporation" means, with respect to any taxpayer, any SFC with respect to which such taxpayer is a U.S. shareholder, if, as of November 2, 2017, (i) such specified foreign corporation has a deficit in post-1986 earnings and profits, (ii) such corporation was an SFC and (iii) such taxpayer was a U.S. shareholder of such corporation.

> which was included in the gross income of such United States shareholder under section 951(a).

Thus, under section 965(b)(4)(A), the amount by which a shareholder reduces its section 951(a)(1) inclusion with respect to a DFIC as a result of the allocation of a deficit is treated as PTI. Section 965(b)(4)(A) does not, however, by its terms expressly treat the allocation of a deficit as an amount which was included in income under section 951(a) for purposes of applying section 961(a). Thus, section 965(b) may have the effect of creating PTI in DFICs that is not matched by corresponding basis adjustments. Consequently, as illustrated in Example 5 and Example 6 below, the operation of section 965(b) may result in a U.S. shareholder being in a position where it is not possible to make a distribution from a foreign subsidiary without triggering unfavorable U.S. federal income tax consequences, including during tax years following the inclusion year when the participation exemption under section 245A is applicable.

Under section 959(e), distributions made during the taxable year are generally treated as first made from PTI and thereafter from E&P that is not PTI. Accordingly, distributions made by a December 31 DFIC during its tax year that ended December 31, 2017 in many cases are retroactively treated as distributions of PTI. If the U.S. shareholder did not have sufficient basis in the stock of the DFIC at the time of the distribution, then the U.S. shareholder would have recognized gain under section 961(b)(2). As a result, the E&P that was distributed may have been subject to U.S. federal income tax at rate of up to 50.5%, *i.e.*, the section 965(a) inclusion at the 15.5% effective rate and the section 961(b)(2) gain at the 35% corporate rate in effect in 2017. In light of the fact that section 965(a) was introduced in November and enacted at the end of December, the taxpayer may have reasonably expected that under the law in effect at the time of the distribution, the distribution would be treated as a dividend (and not a distribution of PTI), and that foreign tax credits would be available.

For a November 30 DFIC, a U.S. shareholder with respect to such DFIC will include an amount in income under section 951(a)(1) pursuant to section 965 for its taxable year that includes November 30, 2018. The deferred E&P that gives rise to such inclusion will constitute PTI when distributed, with the distribution resulting in the application of section 961(b). Accordingly, if the U.S. shareholder does not have sufficient basis in its stock of the DFIC at the time of the distribution, then the U.S. shareholder would recognize gain under section 961(b)(2).

As discussed above, one important Congressional purpose in enacting section 965 was to encourage U.S. multinationals to repatriate heretofore untaxed foreign earnings and to do so as soon as possible, including during the inclusion year. The statute on its face, however, may discourage repatriations before the last day of a DFIC's taxable year if a U.S. shareholder does not have basis in its DFIC stock that is sufficient to offset distributions occurring on an earlier date. The rule in section 3.03 of Notice 2018-07 attempts to resolve this issue. It provides that if a U.S. shareholder receives distributions from a DFIC during the inclusion year that are attributable to

PTI described in section 959(c)(2) by reason of section 965(a) ("Section 965 PTI"), the amount of gain recognized by the U.S. shareholder with respect to the stock of the DFIC under section 961(b)(2) will be reduced (but not below zero) by the "section 965(a) inclusion amount"[29] (the "gain-reduction rule"). Notice 2018-07 does not expressly apply the gain-reduction rule to distributions to a U.S. shareholder from an entity (an "upper-tier entity") that is not a DFIC (for instance, an E&P deficit foreign corporation) that has received distributions from a DFIC (a "lower-tier DFIC") attributable to Section 965 PTI. Notice 2018-07 could, moreover, be interpreted to provide that even when the upper-tier entity is a DFIC, the amount of gain recognized by the U.S. shareholder that is reduced by reason of the gain-reduction rule is limited solely to the section 965(a) inclusion amount of the U.S. shareholder with respect to the upper-tier entity, rather than also including the section 965(a) inclusion amount with respect to the lower-tier DFIC from which such upper-tier entity has received distributions attributable to Section 965 PTI.

Notice 2018-13 addresses some of these issues. It states that Treasury and the Service intend to issue regulations providing that the gain-reduction rule will also apply to distributions received from a DFIC through a chain of ownership described in section 958(a).[30] Specifically, Section 4 of Notice 2018-13 states that such regulations will provide that if a U.S. shareholder receives distributions through a chain of ownership described under section 958(a) from a DFIC during the inclusion year that are attributable to Section 965 PTI, the amount of gain recognized under section 961(b)(2) by the U.S. shareholder with respect to the stock or property of any entity in the ownership chain described in section 958(a) through which the distribution is made will be reduced (but not below zero) by the section 965(a) inclusion amount of the U.S. shareholder with respect to such DFIC. The gain-reduction rule will apply similarly to reduce the amount of gain that would otherwise be recognized under section 961(c) by any CFC in the ownership chain described in section 958(a) through which the distribution is made to a U.S. shareholder for purposes of determining the amount included under section 951(a)(1) in the gross income of the U.S. shareholder.

<u>Recommendation</u>

While the Notices address many of the issues raised by distributions made by DFICs during their inclusion year, we believe further guidance is necessary.

[29] The term "section 965(a) inclusion amount" is defined as the portion of the section 965(a) earnings amount that is taken into account under section 951(a)(1) by a U.S. shareholder with respect to each DFIC reduced by the amount of such U.S. shareholder's aggregate foreign E&P deficit that is allocated to such DFIC under section 965(b)(2) (the "Section 965 inclusion amount"). Notice 2018-13, § 4, <u>modifying</u> Notice 2018-07 § 3.03.

[30] *See* Notice 2018-13, § 4.

### A. PTI Ordering Rule and Timing of Basis Adjustments

Section 4 of Notice 2018-13 only applies to distributions "that are attributable to" a U.S. shareholder's Section 965 PTI. It is not clear under this Notice how to determine what portion, if any, of a distribution is "attributable to" Section 965 PTI if the distributing DFIC also earns, or otherwise has, other Subpart F income during the inclusion year.

To achieve the section 965 policy objective of encouraging U.S. multinationals to repatriate untaxed foreign earnings, distributions received by a U.S. shareholder from a DFIC during the inclusion year should first be treated as attributable to Section 965 PTI and then to other Subpart F income.

*Example 4.*

(i) Facts. USP, a domestic corporation that is a calendar year taxpayer, owns all of the stock of CFC, a DFIC with an inclusion year that ends on November 30, 2018. The functional currency of CFC is the U.S. dollar. USP's adjusted basis in the stock of CFC is zero. CFC has deferred E&P of $100 as of December 31, 2017 (the applicable measurement date). USP therefore has a section 965(a) inclusion amount of $100 with respect to CFC on November 30, 2018. On March 1, 2018, CFC earns $30 of Subpart F income (as defined in section 952) which will be included in the gross income of USP under section 951(a) in its taxable year ending December 31, 2018. On March 15, 2018, USP causes CFC to make a cash distribution of $100 to USP.

(ii) Analysis. Under Treasury Regulation section 1.961-1(a)(1),[31] the increase to USP's tax basis in its CFC stock for its section 965(a) inclusion and other Subpart F income earned during the inclusion year may not be effective until November 30, 2018, the last day of the CFC's taxable year. In such case, on March 15, 2018, the date of the distribution, USP's basis in the CFC stock would be zero, and absent the application of the Notices' gain-reduction rule, USP would recognize $100 of gain as a result of the distribution.

Since neither of the Notices nor section 965 include an ordering rule, it is not clear how the distribution received by USP on March 15, 2018 should be treated. One possibility is that it should be sourced first from Section 965 PTI to the extent thereof, and then from non-Section 965 PTI (*i.e.*, the PTI attributable to the $30 of Subpart F income earned during CFC's inclusion year).

[31] Treasury Regulation section 1.961-1(a)(1) provides, in pertinent part, that "[t]he basis of a United States shareholder's… [s]tock in a controlled foreign corporation… shall be increased under section 961(a), *as of the last day in the taxable year of such corporation on which it is a controlled foreign corporation*, by the amount required to be included with respect to such stock or such property in such shareholder's gross income under section 951(a) for his taxable year in which or with which such taxable year of such corporation ends." (Emphasis added.) This regulation has created some uncertainty as to whether the basis increase would be available for mid-year distributions of E&P that subsequently become PTI.

Alternatively, it could be sourced first from non-Section 965 PTI, or proportionately from both Section 965 PTI and non-Section 965 PTI.

If the distribution is first treated as being attributable to Section 965 PTI, then the gain-reduction rule would apply to the entire $100 distribution. Under this scenario, USP would not recognize any taxable gain as a result of the distribution.

If, on the other hand, any part of a distribution is treated as being attributable to the $30 of Subpart F income earned during the inclusion year, then the gain-reduction rule would not apply to that portion of the distribution and the distribution may result in USP recognizing gain pursuant to section 961(b)(2).[32]

Recommendation

We recommend that guidance be issued that clarifies that distributions received by a U.S. shareholder from a DFIC, either directly or through a chain of ownership, during an inclusion year are first treated as attributable to Section 965 PTI and then to non-Section 965 PTI. We also recommend that guidance be issued clarifying that to the extent gain under section 961(b)(2) is reduced by the section 965(a) inclusion amount, such amount is excluded from the calculation of the basis increase under section 961(a).

As an alternative to the gain-reduction rule, we recommend that Treasury and the Service consider an ordering rule for basis adjustments due to section 965 inclusions and distributions as follows.

Treasury and the Service could replace the gain-reduction rule with basis adjustment rules analogous to the rules applicable in the S corporation or partnership context. Similar to the basis adjustment rules under section 961, section 1367(a) provides that the basis of a shareholder's stock in an S corporation is increased by the shareholder's pro rata share of the income of the S corporation and is decreased (but not below zero) by distributions made to the shareholder. Generally, a shareholder recognizes gain to the extent a distribution exceeds the shareholder's basis in its stock.[33] For purposes of determining whether a distribution exceeds basis, section 1368(d)(1) and

32 Under section 959 and the applicable regulations, the $30 portion of the distribution treated as attributable to the current year Subpart F income, however, would otherwise be excludable from USP's gross income when distributed because such amount represents earnings and profits attributable to amounts which are included in USP's gross income for the taxable year of the distribution under section 951(a). § 959(a); Treas. Reg. § 1.959-1(b) Example.

33 § 1368(b)(2).

applicable regulations further provide that a shareholder of an S corporation increases its basis in its S corporation stock for its share of income before taking distributions into account.[34]

Similarly, section 705(a) provides that a partner's basis in its partnership interest is increased by the partner's distributive share of partnership income and is decreased (but not below zero) by distributions by the partnership. To the extent that the amount of money distributed to a partner exceeds the partner's basis in its partnership interest, the partner recognizes taxable gain. Under the partnership rules, advances or drawings of money or property against a partner's distributive share of income are treated as current distributions made on the last day of the partnership taxable year with respect to such partner.[35] By treating such distributions of money as occurring on the last day of the partnership taxable year, income allocations to the partner will increase the partner's basis in its partnership interest before taking the distribution of money into account.

In lieu of the gain-reduction rule, we recommend that Treasury and the Service consider adopting a basis adjustment ordering rule analogous to the S corporation rule and provide that a U.S. shareholder of a DFIC takes into account its section 965(a) inclusion amount for purposes of adjusting its basis in its DFIC stock before taking into account any distributions from the DFIC during the inclusion year. In the alternative, Treasury and the Service could adopt a rule similar to the partnership rule and provide that Section 965 PTI distributions are treated as current distributions made on the last day of the DFIC's taxable year. Under either alternative, a U.S. shareholder would get the benefit of increasing its basis in the DFIC stock for its section 965(a) inclusion amount before taking the Section 965 PTI distribution into account and thereby avoid recognition of gain to the extent of the basis increase.

### B. PTI Adjustments in Excess of Basis Increases May "Trap" Earnings and Profits

Under the Notices, the "section 965(a) inclusion amount" means the portion of the deferred E&P that is taken into account under section 951(a)(1) by a U.S. shareholder with respect to each DFIC *reduced* by the amount of such U.S. shareholder's aggregate foreign E&P deficit that is allocated to such DFIC under section 965(b)(2). As described above, under section 965(b)(4)(A), the amount by which a shareholder reduces its section 951(a)(1) inclusion with respect to a DFIC as a result of the allocation of a deficit is treated as PTI. Nevertheless, section 965(b)(4)(A) does not provide for a corresponding increase in basis under section 961(a).

If a U.S. shareholder's inclusion amount with respect to a DFIC is reduced by an E&P deficit allocated from another SFC, a distribution by such DFIC of all of its E&P may exceed the

[34] § 1368(d)(1); Treas. Reg. § 1.1368-1(e)(2).

[35] Treas. Reg. § 1.731-1(a)(1)(ii).

U.S. shareholder's section 965(a) inclusion amount, resulting in taxable gain to the U.S. shareholder. Such gain would not be subject to the gain-reduction rule.

*Example 5.*

(i) Facts. USP, a domestic corporation, owns all of the stock of CFC1 and all of the stock of CFC2, each with an inclusion year ending December 31, 2017. The functional currency of CFC1 and CFC2 is the U.S. dollar. As of December 31, 2016, CFC1 did not have any E&P described in section 959(c)(1) or (c)(2), and USP's adjusted basis in the stock of CFC1 was zero. As of each of the measurement dates, CFC1 has post-1986 E&P of $100. CFC2 is an E&P deficit foreign corporation with a specified E&P deficit of $50. On July 1, 2017, USP caused CFC1 to make a cash distribution of $100 to USP that USP anticipated would be treated as a dividend from CFC1's E&P described in section 959(c)(3).

(ii) Analysis. Although USP reasonably anticipated that the July 1 distribution by CFC1 would be treated as a dividend (and would allow USP to claim indirect foreign tax credits in accordance with section 902), the subsequent enactment of section 965 alters USP's tax treatment. Under section 965(a), CFC1's Subpart F income is increased by its deferred E&P of $100 for its 2017 tax year. USP's section 965(a) inclusion amount is $50, determined by reducing its section 951(a)(1) inclusion of $100 by the E&P deficit allocated to it in the amount of $50. Under section 965(b)(4), USP has a PTI account of $100 with respect to CFC 1.

The July 1, 2017 distribution by CFC1 is retroactively recharacterized as a distribution of $100 of PTI. Under the gain-reduction rule, the amount of gain recognized by USP with respect to its CFC1 stock under section 961(b)(2) will be reduced (but not below zero) by $50, USP's section 965(a) inclusion amount. Accordingly, USP is required to recognize $50 of taxable gain as a result of CFC1's distribution.

*Example 6.*

(i) Facts. The facts are the same as in Example 5 above, except that CFC1 did not make any distributions during 2017.

(ii) Analysis. As of January 1, 2018, CFC1 has $100 of PTI and $0 of E&P described in section 959(c)(3). USP's adjusted basis in its CFC1 stock is $50, because it was increased by the amount of USP's section 951(a)(1) inclusion with respect to CFC1. Distributions by CFC1 occurring after December 31, 2017 are not subject to the Notices' gain-reduction rule, since the gain-reduction rule only applies to distributions during a DFIC's inclusion year.

It may not be possible for USP to receive any future distributions from CFC1 without triggering unfavorable U.S. federal income tax consequences. Because CFC1 has $100 of PTI but USP has only $50 of basis in its CFC1 stock, and distributions made by a CFC during its taxable year are generally treated as first made from PTI, the first $50 of distributions from CFC1 would result in USP recognizing gain under section 961(b)(2).

Significantly, this situation persists even if CFC1 has earnings following its inclusion year, the distribution of which would qualify for the 100% dividends-received deduction under section 245A. Because distributions by CFC1 will be treated as first made from PTI, the first $50 distributed by CFC1 will result in USP recognizing taxable income on a dollar-for-dollar basis. Effectively, post-2017 E&P will be "trapped" by the PTI.

Recommendation

We recommend that Treasury and the Service consider issuing guidance that would allow U.S. shareholders to repatriate Section 965 PTI in full without triggering taxable gain under section 961(b)(2), including by applying the gain-reduction rule to the full extent of a U.S. shareholder's section 951(a)(1) inclusion of deferred E&P (without reduction for any deficit allocated against the inclusion pursuant to section 965(b)). Because it is common for U.S. shareholders to own foreign corporations with substantial deficits in earnings and profits, we believe that a regime that creates PTI that is not matched by corresponding basis adjustments will impede the repatriation of deferred E&P as well as future earnings in many cases, and will also have unduly harsh—and what at the time may have been unforeseeable—consequences for taxpayers that received distributions in 2017 prior to the introduction of the new legislation.

On the other hand, adopting this approach could potentially be viewed as overly generous. Many aspects of section 965, including section 965(b), seem to be premised (at least in part) on the principle that U.S. shareholders that divided foreign operations among multiple corporations should be treated similarly to U.S. shareholders that consolidated their foreign operations in a single corporation (a "one-CFC" approach).

Returning to Example 5 and Example 6 above, if CFC 1 and CFC 2 had been combined into a single corporation, USP would have included the same net $50 of deferred E&P in income pursuant to section 951(a)(1), and would have adjusted its basis in the stock of its CFC by $50 under section 961(a) as a result of the inclusion. Thus, absent further transactions affecting its tax position, USP would not have sufficient basis in its CFC stock to receive a $100 distribution without triggering gain. On the other hand, a single CFC would only have had $50 of PTI, rather than the $100 of PTI that is created in CFC1 in the examples; consequently, unlike the examples, post-inclusion year foreign earnings would not be "trapped" behind $50 of excess PTI and could be repatriated tax-free with the benefit of section 245A.

One alternative for addressing these issues that we recommend Treasury and the Service consider would be providing rules that permit taxpayers to appropriately utilize basis in the stock of E&P deficit foreign corporations in order to offset section 961(b)(2) gain resulting from distributions of Section 965 PTI. For example, the gain-reduction rule could be expanded so that it also operates to reduce section 961(b)(2) gain by the basis in the stock of an E&P deficit foreign corporation to the extent a deficit of such E&P deficit foreign corporation was allocated to reduce the taxpayer's section 951(a)(1) inclusion in respect of the relevant DFIC. This is consistent with a "one-CFC" approach; if CFC1 and CFC2 in Example 5 and Example 6 were a single CFC, then USP's basis in the combined entity would generally be equal to its aggregate basis in the stock of CFC1 and CFC2. In order to address the issue of "trapped" PTI illustrated in Example 6, if Treasury and the Service were to adopt such a rule, it should apply to DFICs' inclusion year as well as succeeding tax years in order to avoid the "trapped" E&P issue illustrated by Example 6.

### C. Effective Date of Gain-Reduction Rule

The gain-reduction rule applies to a "U.S. shareholder that receives a distribution during the inclusion year," but the Notices state that the implementing regulations will be "effective beginning the first taxable year of a foreign corporation (and with respect to United States shareholders, the taxable years in which or with which such taxable years of the foreign corporation ends)" to which section 965 applies. Under this effective date provision, distributions made during December 2017 by a November 30 SFC to a December 31 U.S. shareholder would not be entitled to the gain-reduction rule, notwithstanding that the U.S. shareholder received the distribution during the SFC's inclusion year.

Recommendation

We recommend that guidance be issued clarifying that distributions made to a U.S. shareholder during the inclusion year are within the scope of the effective date provisions of the Notices and any regulations promulgated pursuant thereto.

## VI. Need for Guidance Regarding Election Under Section 965(n)

### A. Clarification of Section 965(n)(1)(A)

Section 965(n)(1) provides that if a United States shareholder of a DFIC makes an election for the taxable year described in section 965(a), then the section 965(a) inclusion amount (plus the section 78 gross-up amount with respect thereto and after taking into account the participation exemption deduction under section 965(c)) shall not be taken into account (A) in determining the amount of the "net operating loss deduction under section 172 of such shareholder for such taxable year" or (B) in determining the amount of taxable income for such taxable year "which may be reduced by net operating loss carryovers or carrybacks to such taxable year under section 172."[36]

[36] We note that the references to "taxable year" in section 965(n)(1) are somewhat ambiguous. Section 965(n)(1) first refers to "the taxable year described in subsection (a)." The only reference to a taxable year

Clause (B) is clearly meant to permit a taxpayer to elect to exclude the section 965(a) inclusion amount (plus the section 78 gross-up amount with respect thereto and after taking into account the participation exemption deduction under section 965(c)) in determining the amount of net operating loss carryovers and carrybacks from other taxable years to the inclusion year. However, the use of the term "net operating loss deduction" in clause (A) makes the intended effect and purpose of clause (A) unclear. Section 172(a) states that "for purposes of this subtitle" the term "net operating loss deduction" means the deduction allowed by section 172(a). Section 172(a) permits a deduction for the taxable year in an amount equal to the aggregate of (i) the net operating loss carryovers to such year, and (ii) the net operating loss carrybacks to such year. (By contrast, section 172(c) defines the term "net operating loss" for purposes of section 172 as the excess of the deductions allowed by chapter 1 over gross income, computed with the modifications specified in section 172(d).)

If the term "net operating loss deduction" as used in clause (A) means the amount of the deduction, in the inclusion year, equal to the aggregate net operating loss carryovers and carrybacks from other taxable years to the inclusion year, then clause (A) has exactly the same effect as clause (B), and thus is superfluous. There is absolutely no indication that Congress intended this result. Although there is nothing in the legislative history that explicitly describes the purpose of section 965(n),[37] we believe that the purpose of section 965(n) is to permit a taxpayer to elect to have taxable income in the inclusion year at least equal to its aggregate section 965(a) inclusion amount (plus the section 78 gross-up amount with respect thereto and after taking into account the participation exemption deduction under section 965(c)), the tax on which could then be reduced by allowable foreign tax credits. In the absence of section 965(n), a taxpayer's aggregate section 965(a) inclusion amount (plus the section 78 gross-up amount with respect thereto and after taking into account the participation exemption deduction under section 965(c)) might be reduced, in whole or in part, by either a current year net operating loss (computed without regard to section 965) or one or more net operating loss carryovers or carrybacks. Either would prevent the taxpayer from utilizing, in whole or in part, foreign tax credits which would otherwise be allowable in the absence of such net operating losses (which foreign tax credits, given the participation exemption deduction in section 245A and other changes made by the Act, might never be used in the future). In light of this purpose, it should make no difference whether the net operating loss at issue is a

in section 965(a) is to the "last taxable year of a [DFIC] which begins before January 1, 2018." The later references to "taxable year" in section 965(n)(1)(A) and (B), however, only make sense as references to the taxable year of the U.S. shareholder of such DFIC. Congress presumably meant to refer to the taxable year of the U.S. shareholder of such DFIC in which the U.S. shareholder has a section 965(a) inclusion amount with respect to which DFIC. We assume for purposes of this discussion that this is in fact how section 965(n) should be interpreted and applied, although clarification to that effect would be welcome.

[37] H.R. Rep. No. 115-466, at 486.

current year net operating loss (computed without regard to section 965) or a net operating loss carryforward or carryback.

Recommendation

We recommend that Treasury issue guidance that provides that, if a taxpayer makes the election under section 965(n)(1) with respect to a taxable year, the amount described in section 965(n)(2) shall not be taken into account in determining the amount of the net operating loss under section 172 of such shareholder for such taxable year.

### B. Consolidated Groups

The consolidated return rules adopt the principles of section 172. A consolidated net operating loss ("CNOL") occurs when the aggregate of the members' deductions exceeds their income.[38] A CNOL can be carried back or carried forward, subject to limitations.

On its face, the election in section 965(n) does not seem applicable to consolidated groups because the CNOL is determined at the group level, and carried over at the group level, rather than by any particular member of the group has a section 951(a)(1) inclusion pursuant to section 965.

Recommendation

We recommend that Treasury and the Service issue guidance providing that a consolidated group is permitted to make an election under section 965(n), which election would exclude the impact of section 965 on the members of the consolidated group from the calculation of the CNOL and in determining the amount of consolidated taxable income which may be reduced by a CNOL carryover or carryback.

## VII. Need for Guidance Regarding Treatment of Individuals Who Are Subject to the Transition Tax

Under section 965(c), a U.S. shareholder of a DFIC is allowed a deduction in the taxable year in which it is required to include amounts in gross income under section 951(a)(1) pursuant to section 965. The deduction is intended to result in a 15.5% rate of tax on deferred E&P that is attributable to the cash position, and an 8% rate of tax on all other earnings.[39] The amount of the deduction is the sum of the "15.5 percent rate equivalent percentage" of the inclusion amount that is attributable to the aggregate foreign cash position, plus the "8 percent rate equivalent percentage" of the portion of the inclusion amount (if any) that exceeds the aggregate foreign cash

[38] *See* Treas. Reg. § 1.1502-21(e).

[39] H.R. Rep. No. 115-466, at 491.

position. The "15.5 percent rate equivalent percentage" and the "8 percent rate equivalent percentage" are calculated based on the corporate tax rate.

Because the deduction is calculated in the same manner for individual taxpayers, it results in individuals being subject to the transition tax at higher effective tax rates, as illustrated by the following examples.[40]

*Example 7. Tax Rate Imposed on Corporate Taxpayer's Deferred E&P Attributable to Cash*

USP owns 100% of the stock of CFC 1. Both are calendar year taxpayers. CFC 1 is the only DFIC in which USP owns an interest. On December 31, 2017, USP has a section 951(a)(1) inclusion pursuant to section 965 of $100. CFC 1's cash position is $100 on each of the relevant measurement dates; accordingly, USP's aggregate foreign cash position is $100.[41]

Under section 965(c), USP is entitled to a deduction of $55.71 (*i.e.*, $100 x (35% - 15.5%) ÷ 35%). USP has a gross income inclusion of $100 and an offsetting deduction of $55.71, resulting in net income of $44.29. Imposing the 35% corporate tax rate on this amount results in a tax liability of $15.50—equivalent to taxing the full $100 of deferred E&P at a 15.5% rate. If CFC 1's inclusion year ended on November 30, 2018 instead of December 31, 2017, so that USP's inclusion is in 2018 when the corporate tax rate is 21%, then USP would be entitled to a deduction of $26.19 (*i.e.*, $100 x (21% - 15.5%) ÷ 21%), again resulting in an effective tax rate of 15.5%.

*Example 8. Tax Rate Imposed on Individual Taxpayer's Deferred E&P Attributable to Cash*

The facts are the same as in Example 7, above, except that individual A, a U.S. citizen, owns 100% of the stock of CFC 1. Assume that in 2017, A is subject to the highest marginal U.S. federal income tax rate applicable to individuals, 39.6%.

Pursuant to section 965(c), A is entitled to a deduction in the same amount as USP, *i.e.*, $55.71. Subjecting Individual A's net income of $44.29 (*i.e.*, $100 - $55.71) to income tax at the 39.6% rate results in a U.S. federal income tax liability of $17.54. Thus, A's effective U.S. federal income tax rate on A's inclusion of CFC 1's deferred E&P is 17.54%, rather than 15.5%.[42] The rate disparity is exacerbated if the inclusion year of CFC 1 ends on November 30, 2018, because the difference between the corporate and individual rates is even more pronounced in 2018. If

[40] Significantly, while the transition tax applies to individual U.S. shareholders and corporate U.S. shareholders alike, individuals are not entitled to the benefits of the Act's transition to a quasi-territorial system. *See* § 245A.

[41] In the interest of simplicity, Examples 7–9 ignore the potential availability of indirect foreign tax credits.

[42] Individual A may also be subject to the Medicare tax of 3.8% on this net income.

CFC 1 had a November 30 taxable year, A would be subject to an effective U.S. federal income tax rate of 27.31%, rather than 15.5%, on A's inclusion in 2018.

The Conference Committee recognized this anomaly. The Conference Report states:

> The use of rate equivalent percentages is intended to ensure that the rates of tax imposed on the deferred foreign income is similar for all U.S. shareholders, regardless of the year in which section 965 gives rise to an income inclusion. Individual U.S. shareholders, and the investors in U.S. shareholders that are pass-through entities generally can elect application of corporate rates for the year of inclusion.[43]

At the end of the passage cited above, the Conference Report includes a footnote which states: "Sec. 962 allows individuals to make the election for a specific taxable year, subject to regulations provided by the Secretary." It is not clear whether by the reference to section 962 Congress intended to incorporate only the corporate rate election of section 962(a) or all of section 962.

Generally, a section 962 election is available to individuals who are U.S. shareholders of foreign corporations and are required to include amounts in gross income under section 951(a). The election can be made each year.[44] An election pursuant to section 962 has a number of consequences. First, the electing individual's gross income inclusions under section 951(a) are subject to U.S. federal income tax at corporate rates.[45] In addition, the election allows the individual to benefit from the indirect foreign credit under section 960 (which is otherwise unavailable to non-corporate U.S. shareholders).

For purposes of applying section 962, the corporate tax rate applies (i) to all amounts required to be included in the individual's gross income under section 951(a) for the taxable year, plus (ii) all amounts which would be required to be included in his gross income under section 78 for such taxable year with respect to the amounts referred to in clause (i) if such shareholder were a domestic corporation.[46] For purposes of section 962, the amount that is subject to taxation at the

[43] H.R. Rep. No. 115-466, at 491.

[44] *See* Section 962(a).

[45] Section 962(a)(1).

[46] Treas. Reg. § 1.962-1(b).

corporate tax rate cannot be reduced by any deduction of the U.S. shareholder even if his deductions exceed his gross income.[47]

The applicability of the corporate tax rate and the availability of indirect foreign tax credits are generally favorable tax consequences for an individual that makes the election under section 962. A section 962 election also involves unfavorable consequences. Section 962(d) overrides the normal application of section 959, by providing that when earnings and profits attributable to amounts that were included in income and subject to a section 962 election are distributed, those earnings and profits are required to be included in gross income to the extent they exceed the amount of U.S. federal income tax paid on such earnings and profits.[48] Additionally, under section 961(a), the increase in CFC stock basis that a U.S. shareholder ordinarily receives in respect of a section 951(a)(1) inclusion is limited for an individual who makes a section 962 election to the amount of U.S. federal income taxes the individual pays with respect to the section 951(a)(1) inclusion. The general effect of section 962 is to put the individual taxpayer in roughly the same position with respect to Subpart F income subject to the election as if the individual owned its CFC stock indirectly through a U.S. corporation that has a section 951(a)(1) inclusion in respect of such stock.

Thus, a section 962 election has the potential to result in double taxation of earnings and profits. Moreover, contrary to the statement in the Conference Report, a section 962 election may not result in deferred E&P being subject to the same 15.5% and 8% tax rates that are imposed on actual corporate taxpayers. While a section 962 election may have seemed a simpler way to create parity between corporations and individuals, it was not designed for the provisions of section 965. The following example illustrates these issues.

*Example 9. Consequences of Section 962 Election*

The facts are the same as in Example 8 above, except that individual A elects the application of section 962 in 2017. In addition, CFC 1 distributes $100 to A on January 1, 2018.

In 2017, Individual A has a gross income inclusion of $100 under section 951(a)(1) pursuant to section 965, and is entitled to a deduction of $55.71 pursuant to section 965(c). Under one interpretation of section 962(a)(1), it seems A would be subject to the 35% corporate tax rate on the $100 inclusion, prior to any available deduction, and the application of section 962 would not alter the treatment of the deduction to which A is entitled pursuant to section 965(c). Accordingly, assuming that A is able to offset other taxable income with the $55.71 deduction, the tax benefit

[47] Treas. Reg. § 1.962-1(b).

[48] Treasury Regulation section 1.962-3 contains detailed ordering rules on the allocation of distributions from a CFC among the various earnings and profits accounts in cases where a U.S. shareholder has made a section 962 election.

of the deduction would be $22.06 (*i.e.*, 39.6% x $55.71). Netting this tax benefit against the $35 of tax liability imposed on A's income inclusion, A's effective tax rate on the $100 of deferred E&P of CFC 1 would be 12.94%, rather than the 15.5% rate that applies to corporate taxpayers.

This interpretation of section 962 is clearly inconsistent with the legislative history of section 965, which suggests that Congress intended for the same effective tax rates to apply to individuals and corporations. Section 962 was enacted as part of the original Subpart F regime, and was tailored for net income inclusions since that is how Subpart F operates. The interplay of section 962 with section 965 raises an interpretative question: because section 965 operates by requiring a U.S. shareholder to include an amount in gross income, but permits a deduction that partially offsets the gross income inclusion in order to reach the effective tax rate that was intended to apply by Congress, should section 962, alternatively, be interpreted as applying to A's <u>net</u> inclusion of $44.29 so that the cash tax liability of A is equivalent to the tax liability of a corporation?[49]

Turning to A's tax treatment in 2018, when Individual A receives a distribution of $100 of Section 965 PTI, A would be required to include a portion of the distribution in income, because, under section 962(d), the amount of Section 965 PTI would be excluded from gross income only to the extent of the amount of tax paid by A in respect of his inclusion in 2017. Thus, depending upon which of the two interpretations of section 962(a) set forth above is correct, either $65 (*i.e.*, $100 - $35) or $84.50 (*i.e.*, $100 - $15.50) of the distribution would be included in A's gross income. In any case, A's aggregate U.S. federal income tax liability in 2017 and 2018 combined would, as a result of the application of section 962, exceed what it would have been had A not elected under section 962 (*i.e.*, $17.54, as illustrated in Example 8 above).

Finally, we note that the election under section 962 is generally only available to U.S. shareholders.[50] The passage from the Conference Report excerpted above states: "Individual U.S. shareholders, *and the investors in U.S. shareholders that are pass-through entities* generally can elect application of corporate rates for the year of inclusion." (Emphasis added.) Unless the individual investors that own an interest in a DFIC indirectly through a pass-through entity that is a U.S. shareholder of the DFIC also qualify as U.S. shareholders of the DFIC, however, the election would seem to be unavailable to them.

[49] We note that a similar issue arises in the application of section 962 to individuals' inclusions of global intangible low-taxed income (GILTI) pursuant to section 951A. Although it appears from the language of section 962 and the Treasury Regulations thereunder that the deduction allowed under section 250 does not apply in determining the amount of income subject to taxation at the corporate rate, applying the deduction appears to be more consistent with the statutory scheme of putting the individual U.S. shareholder in the same position as if the individual owned the CFC shares indirectly through a U.S. corporation.

[50] *See* Section 962(a); Treas. Reg. § 1.962-2(a).

*Example 10. Tax Rate Imposed on Investors in a Pass-Through Entity That is a U.S. Shareholder*

The facts are the same as in Example 7, above, except that LLC 1, a Delaware limited liability company treated as a partnership for U.S. federal income tax purposes, owns 100% of the stock of CFC 1. LLC 1, in turn, is owned by a number of U.S. individuals, each of whom owns less than 10% of the interests in LLC 1.

Under the plain language of the statute, it is not clear that the individual members of LLC 1 are eligible to make an election under section 962 because none of them owns a large enough interest in LLC 1 to qualify as a U.S. shareholder of CFC 1. Like individual A in Example 8 above, the members of LLC 1 will be subject to an effective U.S. federal income tax rate of 17.54% on their respective distributive shares of CFC 1's deferred E&P.

<u>Recommendation</u>

We recommend that Treasury and the Service consider what relief can be provided for individuals under the authority granted under section 965(o) so that the taxes paid on the section 965(a) inclusion amount (after taking into account the participation exemption deduction under section 965(c)) are no greater than those of a corporation. We recognize that it may be difficult as a matter of statutory construction to apply section 962 solely to equalize rates on section 965(a) inclusions for individual and corporate taxpayers, as section 962 clearly contemplates providing an individual with an indirect foreign tax credit while providing for a second level of tax on distributions. We believe, however, that it may be possible to interpret the reference to section 962 in the legislative history as only referring to the rate election in section 962(a), which would be consistent with recognizing that section 965 is not an identical regime to Subpart F because it provides for both an income inclusion and a deduction. The desired result would be that individual taxpayers be entitled to treat the full amount of their section 951(a)(1) inclusions as PTI (notwithstanding section 962(d)), and to make adjustments to their basis in their stock in the relevant DFICs in an amount equal to the amount included in gross income under section 951(a)(1) (notwithstanding the special rule in section 961(a) that generally limits basis adjustments for U.S. shareholders that make section 962 elections). The guidance should also ensure that electing individuals are subject to the corporate tax rate on the <u>net</u> amount of their income inclusions in order to achieve parity with corporate taxpayers.

## VIII. Need for Guidance Regarding Section 965(h)(1) Election to Pay Transition Tax Liability in Installments

### A. Treating Taxpayers as Having Made Section 965(h)(1) Elections by Default

Under section 965(h)(1), a U.S. shareholder may elect to pay the net tax liability resulting from the application of section 965 in eight annual installments (the "Section 965(h)(1) Election").

Under the election, the payments for each of the first five years equal 8 percent of the net tax liability, the sixth installment equals 15 percent of the net tax liability, the seventh installment equals 20 percent of the net tax liability, and the eighth installment equals 25 percent of the net tax liability. The timely payment of installments does not incur an interest charge.

Section 965(h)(2) provides that if a Section 965(h)(1) Election is made, then the first installment is required to be paid by the due date (determined without regard to any extension of time for filing the return) for the tax return for the taxable year described in section 965(a) (*i.e.*, the inclusion year for an SFC), and each succeeding installment is required to be paid by the due date for the tax return for the taxable year following the taxable year with respect to which the preceding installment was made. Section 965(h)(5) states that the Section 965(h)(1) Election shall be made not later than the due date for the return of tax for the taxable year described in section 965(a) and shall be made in such manner as the Secretary shall provide.

Because the Section 965(h)(1) Election does not result in any interest charge, we believe most (if not all) eligible taxpayers will desire to make the election. For calendar year corporate taxpayers with income inclusions in 2017, the first installment payment pursuant to a Section 965(h)(1) Election will be due on March 15, 2018. As described above, gathering all of the information necessary to compute the transition tax liability represents a substantial administrative burden for taxpayers. Failure to pay any installment under section 965(h) on a timely basis may trigger an acceleration of the remaining payments.[51]

<u>Recommendation</u>

We recommend that future guidance provide that all eligible taxpayers will be treated as having made a Section 965(h)(1) Election in the absence of an affirmative election to the contrary. Taxpayers that choose not to pay their transition tax liability in installments could "elect out" of this treatment by attaching a statement to their tax returns for the years that includes the relevant section 951(a)(1) inclusions. This approach should also eliminate the administrative burden the Service is otherwise likely to face from taxpayers flooding it with requests for relief for failure to make the election in a timely manner.

### B. Certain Transactions Should Be Treated as Qualifying for the Exception to the Acceleration Rule

Under section 965(h)(3), generally, in the event of certain transactions or occurrences, any remaining transition tax installment payments of a taxpayer that has made a Section 965(h)(1) Election are accelerated and no longer eligible to be made annually over the remainder of the eight year period (the "Acceleration Rule"). The triggers for the acceleration rule are: (1) an addition to

51 *See* section 965(h)(3) discussed *infra*.

tax for failure to pay any installment required under section 965(h) on a timely basis; (2) a liquidation or sale of substantially all the assets of the taxpayer (including in a title 11 or similar case); (3) a cessation of business by the taxpayer; or (4) any similar circumstance.

The acceleration rule does not apply, however, to the sale of substantially all of the assets of a taxpayer to a buyer if the buyer enters into an agreement with the Secretary under which such buyer is liable for the remaining installments as if such buyer were the taxpayer.[52]

Where the acceleration rule applies, the remaining installments are due on the date that the triggering event occurs (or in the case of a title 11 or similar case, the day before the petition is filed).

The transactions Congress included in the Acceleration Rule suggest that Congress was focused on situations where payment of the remaining installments becomes less certain, including as the result of a loss in the credit quality of the U.S. shareholder. By providing the exception for certain dispositions of substantially all of a U.S. shareholder's assets, Congress recognized that, in a situation where a transferee acquires such assets and agrees to "step into the shoes" of the U.S. taxpayer with respect to any remaining installment payments, it is inappropriate to apply the Acceleration Rule.

Against this backdrop, we believe that certain transactions that would otherwise trigger the Acceleration Rule should potentially be viewed as falling under the exception to the rule because there is a successor taxpayer (a "buyer") that is legally liable to make any remaining installment payments and acquires substantially all of the U.S. shareholder's assets.

The first such transaction is the liquidation of a U.S. shareholder that is a member of a consolidated group (other than the common parent).[53] A liquidation[54] generally triggers the Acceleration Rule under section 965(h)(3). Nevertheless, in the case of a liquidation of a member of a consolidated group (other than the common parent), other members of the consolidated group generally receive assets of the liquidating member comprising at least 80% of the net value of its aggregate assets. Pursuant to Treasury Regulation section 1.1502-6, the other members of the consolidated group also remain liable for the U.S. federal income tax liabilities of the liquidating member. The second category of transactions are section 381 transactions where the transferee

52 Section 965(h)(3).

53 The discussion focuses on liquidations of a U.S. shareholder. However, we believe that other intragroup transactions in which substantially all of the relevant U.S. shareholder's assets remain within the consolidated group (such as a merger of a U.S. shareholder into another member of the same consolidated group) should be similarly treated.

54 We refer to actual liquidation of the legal entity, as well as deemed liquidations pursuant to an entity classification election under Treasury Regulation section 301.7701-3.

succeeds to the tax attributes of the transferor and in most cases assumes all of the liabilities of the transferor.

The third category of transactions with respect to which guidance is needed is the application of the Acceleration Rule to transfers of stock of a C corporation in connection with which an election under section 338(h)(10) or section 336(e) is made. Section 338(h)(10) elections are available in connection with certain sales of stock of a domestic C corporation, and section 336(e) elections are available in connection with certain sales and distributions of stock of a domestic C corporation. In the case of both elections, for U.S. federal income tax purposes, a hypothetical new corporation ("new target") is considered to purchase the assets of the existing corporation ("old target") in a taxable transaction, and old target is deemed to liquidate. Significantly, the same legal entity remains in existence following the transaction, and "new target" generally remains liable for the U.S. federal income tax liabilities of "old target."[55]

In considering the Acceleration Rule it should be noted that when the U.S. shareholder is a member of a consolidated group, it is not clear whether the tax liability created by section 965 is the liability of the member or the group as a whole.

Section 108(i)(5)(D) sets forth an acceleration rule that is similar in some respects to the Acceleration Rule in section 965(h)(3) (although section 108(i) addressed the deferral of income inclusions rather than payments of tax, and section 108(i)(5)(D) expressly dealt with partnerships and likely involved companies in some financial difficulties). Treasury Regulation section 1.108(i)-1 provides guidance under section 108(i)(5)(D) which may, in appropriate circumstances, serve as a model for guidance with respect to the Acceleration Rule.

Recommendation

We recommend that guidance be issued providing that certain transactions qualify for the exception to the acceleration rule whereby a successor to a U.S. shareholder that has not made all of its installment payments pursuant to a Section 965(h)(1) Election effectively steps into the shoes of the U.S. shareholder with respect to the remaining installment payments. In many of these circumstances, we do not believe it should be required for the successor to enter into an agreement with the Service to be liable for the predecessor U.S. shareholder's remaining installment payments.

In particular, we recommend that the guidance provide that the Acceleration Rule is not triggered by the liquidation of a U.S. shareholder that is a member of a consolidated group (other than the common parent). Instead, the other members should be responsible for making any remaining installment payments of the U.S. shareholder that liquidated on the same schedule.

55 *See* Treas. Reg. § 1.338-1(b)(3)(i); Treas. Reg. § 1.336-2(f).

Similarly, Treasury and the Service should consider issuing guidance providing that the exception to the Acceleration Rule is available in transactions in which a person acquires substantially all of a U.S. shareholder's assets in connection with either a merger (whether or not it qualifies for tax-free treatment under section 368(a)) or any other asset reorganization described in section 368(a). In a merger, the transferee generally assumes the liabilities of the merged corporation by operation of law, so an express agreement on the part of such transferee to be liable for the remaining section 965(h) installment payments may be superfluous. On the other hand, in asset reorganizations where the U.S. shareholder actually liquidates (or merges into a disregarded entity of the acquiror), it may be appropriate to require that the person acquiring substantially all of the U.S. shareholder's assets enter into such an agreement with the Service.

Guidance should also be provided regarding transactions involving section 338(h)(10) elections or section 336(e) elections in respect of a U.S. shareholder that is a member of a consolidated group. Although these transactions are treated as asset sales for U.S. federal income tax purposes, it is not clear that it is appropriate to trigger the Acceleration Rule because under applicable law both the selling consolidated group and the target potentially continue to be liable for the tax. It is important to provide clarity on whether in such a case the liability remains with the consolidated group, the target, or both. We believe that it might be preferable to have the liability, contrary to the provisions of Treasury Regulation sections 1.338-1(b)(3)(i) and 1.336-2(f), remain with the selling group. Such a result is more consistent with the treatment of these transactions as asset sales. The selling consolidated group is also more aware of the scope of the liability and can continue to make the installment payments.

We note that Treasury Regulation section 1.108(i)-1(b)(2)(ii)(B)(2)(iii) provides for an additional acceleration event, the "net value acceleration rule." We do not believe that in light of the statutory language of section 965(h) it would be appropriate to add such a concept as an additional acceleration event in the context of Section 965(h)(1) Elections. Nevertheless, we believe that satisfying a similar financial requirement may be an appropriate condition to granting additional exceptions to the Acceleration Rule.

In any case, we believe the transactions discussed above do not implicate the concerns underlying the Acceleration Rule, because after the transaction another person (or persons) continues to be legally liable for the U.S. federal income tax liability of the U.S. shareholder and has acquired the assets of the U.S. shareholder, just as a buyer that enters into an agreement with the Service as contemplated by section 965(h)(3) would.

In addition, we recommend that Treasury and the Service issue guidance providing that for purposes of the exception to the triggering rule in section 965(h)(3), an appropriate statement (or form) signed by the buyer and furnished to the Service should ordinarily be treated as an "agreement" with the Service. Because a triggering event generally causes unpaid transition tax installments to become due immediately, a simple and expedient procedure is necessary.

### C. Partners in Partnerships Should Be Eligible to Make Section 965(h)(1) Elections

Section 965 does not address the treatment of partnerships with respect to amounts required to be included in gross income under section 951(a)(1) pursuant to section 965, nor with respect to the election to pay the tax in installments. Section 965 references a "U.S. shareholder" as the person that is required to include the deferred foreign earnings in income and then states that the United States shareholder may elect to pay the tax liability in installments. A partnership is a U.S. shareholder but it is not the actual taxpayer.

In the case of a partnership this presents a number of issues. For example, a Delaware partnership may have an interest in a specified foreign corporation that, as a result of the ownership by the partnership, is a CFC. The partners in the partnership are the taxpayers who must include their pro rata share of the deferred E&P in income. Nevertheless, the U.S. shareholder is the partnership. Thus, there is an unresolved issue of whether the election to pay the tax liability in installments is made by the partner, the partnership, or not at all because the U.S. shareholder is not the party directly liable for the tax. There is nothing in the statute or the legislative history indicating that a taxpayer that has an inclusion amount under section 965 should be disadvantaged because the inclusion flows from its interest in a partnership rather than from direct ownership. Accordingly, the installment election should be made available, directly or indirectly, to a partner in a partnership that is the U.S. shareholder. The next question is whether the election should be made by the partnership or the partner.

Recommendation

The rationale for providing that the partner can make the election with respect to its allocable portion of the inclusion is that the partner is the taxpayer. It is more appropriate for a partner to make the "with and without" calculations because that calculation is supposed to be made by the taxpayer, which the partnership is not. Consideration must also be given to the new partnership audit procedures that ordinarily make adjustments at the partnership level. In this case because the adjustment affects the liability of the person who was a partner at the close of the inclusion year, any increased tax should only be borne by the person who was the partner at the close of the inclusion year; requiring such adjustment to be paid by a person who was not a partner in the inclusion year is inconsistent with the section 965 concept of adjusting the subsequent installments that are to be paid by the taxpayer at the end of the inclusion year. The original taxpayer, and not the partnership or someone who was not a partner during the inclusion year (including a subsequent purchaser of an interest in the partnership), is the appropriate party to comply with adjustments to the installments provided in section 965(h)(4). If the partner is the proper party to make the installment election, consideration must be given to what are the appropriate acceleration events. The major question in this context is whether, in addition to the acceleration events set forth in section 965(h)(3), the sale or disposition of the partnership interest that gives rise to the inclusion should be an acceleration event. We note that the disposition of the shares of the SFC is not otherwise an acceleration event. As noted above, the acceleration events relate to events that could call into question whether the deferred tax liability would be paid and not an issue of the taxpayer's liquidity. Accordingly, we believe that the acceleration events should be limited to the events enumerated in section 965(h)(3). We note, however, that the sale of a partnership interest is an acceleration event for purposes of section 108(i).

## IX. Treatment of Section 965(a) Inclusions by Regulated Investment Companies

Sections 965 expressly deals with the treatment of section 965(a) inclusions by real estate investment trusts but does not address the treatment of regulated investment companies ("RICs"). RICs are subject to similar tests regarding the nature of their income and assets. A section 965(a) inclusion is a specialized item of income which is unlikely to be treated as a dividend. Thus, it is not certain that it would be treated as a dividend or "other income" for purposes of section 851(b)(2)(A). Treasury and the Service have taken the position in Proposed Treasury Regulation section 1.851-2(b)(2)(i) that amounts included in income under section 951(a)(1)(A)(i) are not treated as a dividend or "other income" for purposes of section 851(b)(1)(A) unless the earnings attributed to such amounts are distributed.[56] A RIC may be subject to section 965 with respect to DFICs that it does not control so that it cannot force the payment of a distribution.[57] Thus, it may have a section 965(a) inclusion without receiving any distribution in respect of such income.

Recommendation

Regardless of Treasury's and the Service's position in the proposed regulation, we recommend that Treasury and the Service make clear that section 951(a)(1) inclusion pursuant to section 965 is a dividend or other income with respect to its investment business within the meaning of section 851(b)(2)(A).

## X. Application of Section 958(b)(4) Repeal in Accordance with Congressional Intent

The Act amended the stock ownership attribution rules of section 958(b) so that the stock of a foreign corporation owned by a foreign person is attributed "downward" from a foreign parent to a 50% owned U.S. corporate subsidiary (determined based on value) or to a partnership in which

[56] We have previously recommended in NYSBA Tax Section Report 1359 that section 951(a)(1)(A) inclusions be treated as "other income" under section 851(b)(2)(A).

[57] Note that in the case of a foreign company that is not a CFC, a RIC may hold a more than 10% voting interest without being required to include amounts in its income under section 951.

the foreign corporation owns equity. The effect of this amendment is to turn many foreign companies that were not previously CFCs into CFCs. According to the Conference Report, the amendment was intended to render ineffective "de-control" transactions, in which the foreign parent corporation of a U.S. shareholder of a CFC causes the foreign corporation to lose its CFC status by acquiring more than 50% of the foreign corporation's stock in exchange for the contribution of cash or property.[58] The repeal of section 958(b)(4) applies retroactively to "the last taxable year of foreign corporations beginning before Jan. 1, 2018, and each subsequent taxable year of such foreign corporations," and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.[59] In effect, the amendment is retroactively effective to the first day of the last taxable year that begins before January 1, 2018 (*e.g.*, January 1, 2017 for calendar year foreign corporations and November 30, 2017 for November 30 foreign corporations). As a result, the amendments to section 958(b) will cause additional foreign corporations to be considered SFCs for purposes of section 965.

Section 958(b) was apparently intended to have a more narrow scope than the statutory language suggests. According to the Senate Finance Committee explanation of the Senate bill, it was the intent of Congress that downward attribution should not apply to cause a foreign corporation to be treated as a CFC with respect to a U.S. shareholder that is not related to the U.S. person to whom ownership of the foreign corporation's stock was attributed within the meaning of section 954(d)(3).[60] The Conference Report further confirms that it was the intent of the conferees that the Senate interpretation apply.[61] According to a discussion on the Senate floor that is part of the Congressional Record, a technical amendment was proposed to codify this explanation, but was rejected as unnecessary to reflect the intent of the Senate Finance Committee or the conferees and that "the Treasury Department and Internal Revenue Service should interpret the stock attribution rules consistent with this explanation of the bill."[62]

*Example 11.*

FC, a foreign corporation that is not a CFC, is the 100% owner of US1, a U.S. corporation. FC also owns 50% of the stock of FC2, a foreign corporation that, prior to the repeal of section 958(b)(4), was not a CFC. US2 is a U.S. corporation that is unrelated to FC and US1. US2 owns 10% of the stock of FC2.

[58] H.R. Rep. No. 115-466, at 508.

[59] *Id*.

[60] S. Prt. 115-20, at 378.

[61] H.R. Rep. No. 115-466, at 508.

[62] 207 Cong. Rec. S8110 (daily ed. Dec. 19, 2017) (statement of Sen. Purdue).

Read literally, the amendment to section 958(b) appears to cause FC2 to become a CFC with respect to US2. FC's 50% ownership of the stock of FC2 would be attributed downwards to US1, causing FC2 to become treated as if more than 50% of its stock was owned by U.S. shareholders. However, according to the Congressional Record, it was Congress' intent that FC2 should not be treated as a CFC with respect to US2 because US2 is not related to US1 within the meaning of section 954(d)(3).

Recommendation

The Senate's and Conference Committee's instructions to Treasury and the Service regarding the proper interpretation of amended section 958(b) raises questions as to the role of legislative history when interpreting a statute. Furthermore, it is not clear to us whether the specific grant of regulatory authority in section 965(o) would provide Treasury and the Service with the authority to interpret section 958(b) consistent with the legislative history. We note that narrowing the number of taxpayers subject to section 965 as a result of this retroactive amendment to section 958(b) is desirable given the compliance issues described in this Report. We encourage Treasury and the Service to consider this further, particularly with respect to section 965. We recommend adding clarifying language on this point to any technical corrections bill that is considered by Congress.

**NEW YORK STATE BAR ASSOCIATION TAX SECTION**

**REPORT ON SECTION 163(j)**

**March 28, 2018**

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**REPORT OF THE TAX SECTION OF THE NEW YORK STATE BAR ASSOCIATION ON AMENDMENTS TO SECTION 163(j)**

This report ("**Report**") of the New York State Bar Association Tax Section comments on Section 163(j)[1] as amended by "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," P.L. 115-97 (the "**Act**")[2].

We thank the Department of the Treasury ("**Treasury**") and the Internal Revenue Service (the "**IRS**") for considering our comments on Section 163(j). In this Report, we recommend that Treasury and the IRS issue guidance to address some uncertainties surrounding the application of the statute.

This Report is divided into four parts. Part I summarizes our recommendations for future guidance. Part II describes Section 163(j) as in effect before and after the Act. Part III provides a detailed discussion of our recommendations. Part IV sets forth some additional issues that we have identified, but regarding which we have not yet developed a formal recommendation.

## I. Summary of Recommendations

We recommend that Treasury and the IRS issue guidance providing for the following:

### A. General Recommendations

1. It should be confirmed that "interest" for purposes of Section 163(j) includes any item of income or expense that is treated as interest under the Code. In addition, it should be considered whether administrative guidance (or a statutory amendment) should provide that items economically equivalent to interest will be treated as such for purposes of Section 163(j). Particularly if the government seeks to address this issue through administrative guidance, we recommend that the guidance apply only to a limited set of specifically identified types of transactions (in all of which one party secures the use of funds for a period of time and makes payments that are determined solely or almost solely by reference to the time value of money). Such guidance also should take a symmetrical approach for

[1] Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as amended (the "**Code**") and the Treasury Regulations promulgated thereunder.

[2] The principal drafters of this report are John T. Lutz and Philip Wagman with contributions from William Alexander, Daniel Z. Altman, Kimberly S. Blanchard, Peter H. Blessing, Andrew H. Braiterman, James R. Brown, Robert Cassanos, Peter Connors, Daniel M. Dunn, Timothy J. Devetski, Lucy W. Farr, Phillip J. Gall, Marcy G. Geller, Kevin Glenn, Edward E. Gonzalez, David Hardy, Andrew M. Herman, Monte A. Jackel, Robert Kantowitz, Shane J. Kiggen, Stephen B. Land, John P. MacMaster, Jeffrey Maddrey, Michael T. Mollerus, Richard M. Nugent, Deborah L. Paul, James M. Peaslee, Elliot Pisem, Michael L. Schler, David Schnabel, Peter F. G. Schuur, Michael B. Shulman, David R. Sicular, Eric B. Sloan, Andrew P. Solomon, Karen G. Sowell, Shun Tosaka, Adina T. Wagman, Gordon E. Warnke and Sara B. Zablotney. This report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or House of Delegates.

purposes of identifying income and expenses equivalent to interest under Section 163(j).

2. All interest income of a corporation (other than interest income attributable to a business exempt from Section 163(j)) should be treated as "business interest income" under Section 163(j)(5), and all interest expense of a corporation (other than interest expense attributable to an exempt business) should be treated as "business interest" under Section 163(j)(6). In the case of a noncorporate taxpayer, all interest income other than investment income as defined in Section 163(d) (and interest income attributable to an exempt business) should be treated as "business interest income," and all interest expense other than investment interest under Section 163(d) and personal interest under Section 163(h) (and interest expense attributable to an exempt business) should be treated as "business interest."

3. "Adjusted taxable income" of a corporation should include all items of income and expense that are included in its taxable income, other than those specifically excluded by Section 163(j)(8)(A)(ii), (iii) and (v) (i.e., business interest income, business interest, the net operating loss deduction and, beginning in 2022, deductions for depreciation and amortization) or that are attributable to exempt businesses. In the case of a non-corporate taxpayer, adjusted taxable income should include (a) all of the taxpayer's non-interest income, other than items that are investment income under Section 163(d), are attributable to exempt businesses or (for a taxpayer that is not a business entity) are clearly personal in nature (such as interest income imputed under Section 7872 on a gift loan), and (b) all of the taxpayer's non-interest deductible expenses, other than investment expenses under Section 163(d), expenses attributable to exempt businesses and (for a taxpayer that is not a business entity) specifically enumerated non-business deductions.

4. A framework should be provided for a corporation to allocate interest expense between businesses it conducts that are exempt from Section 163(j), and businesses that are not exempt. Allocation methods based on the relative assets, or the relative income, of these businesses should be considered. If an asset-based or income-based allocation method is adopted, then the government should consider also providing some exceptions from that allocation method, in order to address limited, specific cases where a particular indebtedness is clearly tied to a particular business: for example, where particular debt is taken into account by a regulatory authority that has oversight over a specific business; or where nonrecourse debt is used to finance the acquisition or construction of property that is used in a particular business.

5. Individuals should allocate interest expense between exempt and non-exempt businesses using tracing principles that are consistent with Treasury Regulation Section 1.163-8T.

6. Tracing principles also should generally apply to partnerships, for purposes of allocating a partnership's interest expense between exempt and non-exempt businesses. However, in the case of a partnership whose partners are solely or mainly corporations, it should be considered whether an allocation method should be used which corresponds to the method required for businesses that are directly owned by a corporation.

7. Section 163(j) should be applied to interest expense for which a deduction otherwise would be allowed to the taxpayer in a given year, after having taken into account all the other statutory and regulatory rules that would disallow or defer such deductions.

8. If a loss is allowed under Sections 465 and 469 which consists in part of interest expense, and a deduction for part or all of that interest expense is then disallowed for the year under Section 163(j), then Sections 465 and 469 should be re-applied after Section 163(j), so that the taxpayer is allowed to deduct additional amounts of other items and claim the full amount of loss permitted under Sections 465 and 469.

9. Interest expense that was disallowed under Section 163(j) as in effect before the Act should be carried forward and treated as interest paid or accrued by the taxpayer in the first year new Section 163(j) is effective. However, a corporation that had a carryforward of excess limitation under old Section 163(j) should lose that limitation carryforward, under the new statute.

10. It should be confirmed how the rules for computing a corporation's "adjusted taxable income" under Section 163(j) interact with Section 246(b) and Section 250(a)(2) (both of which limit specific deductions of a corporation by using formulas that are based on the amount of the corporation's taxable income).

B. **Corporate Recommendations**

1. Interest expense disallowed by reason of Section 163(j) should reduce a corporation’s earnings and profits in the year that the interest expense was paid or accrued in accordance with the corporation’s method of accounting.

2. All members of the same consolidated group should be treated as a single taxpayer for Section 163(j) purposes.

3. There should be rules that deal with disallowed business interest expense carryforwards of a corporation that joins a consolidated group, as well as apportionment of a consolidated group's disallowed business interest carryforwards to a corporation that leaves a consolidated group. These rules should generally be similar to the rules that deal with similar issues in the case of net operating loss carryforwards. However, some special rules may be appropriate, in order to deal with issues that could arise when a member

that has operations that generate applicable taxable income but little or no debt (or vice versa) leaves a group.

4. Section 163(j) should not be applied on a group basis to a Section 1504(a) affiliated group that does not file a consolidated return, or to an expanded affiliated group of the type described in the proposed regulations under old Section 163(j). In addition, a partnership among members of a consolidated group should not be treated as a single taxpayer together with the members of the consolidated group, for purposes of applying Section 163(j).

C. **Partnership Recommendations**

1. The character of a partnership's interest income and expense as business interest income and business interest expense should be determined at partnership level.

2. A partnership generally should use tracing principles to divide its interest expense between investment interest and business interest expense (and, as noted in A.6 above, between exempt and non-exempt businesses). Such allocation should not be dependent on whether the partnership distributes the borrowed funds to its partners. As indicated in A.6 above, in the case of a partnership whose partners are solely or mainly corporations, it should be considered whether an allocation method should be used that corresponds to the method required for businesses that are directly owned by a corporation.

3. A partnership’s deductible business interest expense that is taken into account in the partnership’s non-separately stated income for purposes of Section 163(j) should retain its character as interest for all other purposes of the Code.

4. To the extent that a partnership’s business interest income is taken into account in determining the amount of interest expense allowable under Section 163(j) at the partnership level, such business interest income should be included in the partnership’s non-separately stated income for Section 163(j) purposes, so that a partner cannot utilize such business interest income to support an additional interest expense deduction at the partner level.

5. It should be clarified that if a partner has excess business interest expense carryforwards, and the partner is allocated a share of the partnership's "excess taxable income" for a subsequent year, then the partner can only deduct carried forward interest equal to at most 30% (not 100%) of the allocable excess taxable income.

6. A partner should be permitted to utilize its excess business interest expense carryforwards against such partner’s share of the partnership’s business

interest income (net of such partnership's business interest expense) for a subsequent taxable year.

7. If a partnership has interest expense characterized at the partnership level as investment interest, a corporate partner should treat its share of that interest expense as business interest expense that is subject to Section 163(j) at the partner level; and a non-corporate partner should treat its share of the interest expense as subject to Section 163(d).

8. The statutory exemptions of certain businesses from Section 163(j), including the electing real property trade or business exemption, the electing farming business exemption, the utilities business exemption and small business exemption, should be determined at the partnership level. Elections for the first two of these exemptions should be made at the partnership level.

9. If a partner incurs interest expense at the partner level that is allocable, under the allocation principles described above in A.4 and A.5, to the partner's interest in a partnership that conducts an exempt trade or business, then such interest expense should be exempt from Section 163(j).

10. It should be clarified how Section 163(j) applies in the case of a partnership that has special allocations, as well as how Section 743 adjustments and Section 704(c) allocations impact the application of Section 163(j) to partnerships and partners.

## D. International Recommendations

1. Guidance should confirm whether Section 163(j) applies to business interest expense of controlled foreign corporations and passive foreign investment companies, and, if it does, the manner in which it applies. If Section 163(j) applies to CFCs then, when calculating the Section 163(j) limit in connection with determining the amount of a CFC's Subpart F income, the CFC's adjusted taxable income and business interest income should be computed taking into account only items that are Subpart F income, and its business interest expense should be computed taking into account only interest expense which is allocable to Subpart F income.

2. In the case of a foreign corporation that has a U.S. trade or business, Section 163(j) should be applied in order to compute the corporation's liability for corporate net income and branch profits taxes by taking into account only adjusted taxable income and business interest income that are included in the corporation's effectively connected income, and business interest expense that is allocated to effectively connected income pursuant to the regulations under Sections 882 and 884.

## II. Overview of Section 163(j)

### A. Section 163(j) Prior to the Act

In general terms, prior to the Act, Section 163(j) limited the deductibility of interest paid or accrued by a corporate taxpayer[3] to a related person[4] where such interest was exempt (in whole or in part) from U.S. tax.[5] Old Section 163(j) did not apply unless the corporation's debt to equity ratio exceeded 1.5 to 1.[6] Assuming a corporate taxpayer's debt-to-equity ratio exceeded 1.5:1 as of the end of such corporate taxpayer's taxable year, old Section 163(j) denied an interest deduction for amounts paid or accrued to a related tax-exempt (generally, foreign) person [7] to the extent that the corporation's net interest expense[8] exceeded 50% of its adjusted taxable income (i.e., taxable income computed without regard to deductions for net interest expense, net operating losses, net interest expense, domestic production activities under Section 199, depreciation, amortization and depletion).[9] Net interest expense in excess of 50% of the corporation's adjusted taxable income was defined as "excess interest expense."[10] Any interest deduction disallowed under Section 163(j) was treated as interest paid or accrued in the succeeding taxable year. [11]

Under old Section 163(j), all members of the same affiliated group (within the meaning of Section 1504(a)) were treated as a single taxpayer.[12] Pursuant to proposed regulations issued under old Section 163(j), all members of an affiliated group are treated as one taxpayer for Section 163(j) purposes without regard to whether the affiliated group files a consolidated return. [13]

Old Section 163(j) was applied at the partner level. A corporate partner's distributive share of interest income paid or accrued to the partnership was treated as interest income paid or accrued

[3] Prior to the Act, Section 163(j) applied to domestic "C" corporations and foreign corporations with income, gain or loss that was effectively connected to a U.S. trade or business, but did not apply to 'S' corporations. Proposed Regulation Section 1.163(j)-1(a)(1).

[4] For convenience, we sometimes refer to "**old Section 163(j)**" rather than Section 163(j) prior to the Act. Old Section 163(j) also applied to interest paid or accrued to an unrelated person if the debt was guaranteed by a related person and certain additional requirements were met. <u>See</u> old Section 163(j)(3)(B).

[5] Exempt related party interest referred to interest expense that was exempt in whole or in part from U.S. tax in the hands of the recipient, taking into account treaty benefits.

[6] Section 163(j)(2)(A)(ii) prior to the Act.

[7] Theoretically, old Section 163(j) could apply to interest paid by a taxable subsidiary to a tax-exempt parent corporation, although amendments to Section 512(b)(13) effectively limited the application of old Section 163(j) to interest paid or accrued to foreign persons.

[8] Net interest expense is the amount by which all interest paid or accrued during the taxable year exceeds the amount of interest includible by the taxpayer in gross income for taxable such year. Proposed Regulation Section 1.163(j)-2(d).

[9] Section 163(j)(1)(A), (2)(B)(i) prior to the Act.

[10] Section 163(j)(2)(B)(i) prior to the Act.

[11] Section 163(j)(1)(B) prior to the Act.

[12] Section 163(j)(6)(C) prior to the Act.

[13] Proposed Regulation Section 1.163(j)-5(a)(2). In addition, the proposed regulations would have expanded the definition of affiliated group beyond that provided in Section 1504(a).

to a corporate partner; a corporate partner's distributive share of interest paid or accrued by the partnership was treated as interest paid or accrued by a corporate partner; and a corporate partner's share of the partnership's liabilities was treated as liabilities of a corporate partner.[14]

### B. Section 163(j) as amended by the Act

#### 1. General

The Act amended Section 163(j) in several material ways. Section 163(j), as amended, applies to both corporate and noncorporate taxpayers. The debt-to-equity ratio test was removed, and Section 163(j) now applies at the partnership level rather than the partner level. Finally, new exceptions were added for electing real property businesses, electing farming businesses, utilities, certain small businesses and floor plan financing interest. The statutory provisions are described in greater detail below.

Section 163(j) provides, in pertinent part, that a taxpayer cannot deduct business interest expense for a taxable year to the extent that such interest exceeds the sum of (a) the business interest income of such taxpayer for such taxable year, and (b) 30 percent of the taxpayer's adjusted taxable income for such taxable year.[15] The statute defines "business interest expense," "business interest income," and "adjusted taxable income."

For Section 163(j) purposes, "business interest expense" means any interest paid or accrued on indebtedness properly allocable to a trade or business. It does not include investment interest (within the meaning of Section 163(d)).[16] (In this Report, we refer to business interest expense as "business interest expense," for ease of distinguishing it from "business interest income.")

The term "business interest income," for Section 163(j) purposes, means the amount of interest includible in the gross income of the taxpayer for the taxable year which is properly allocable to a trade or business. The term does not include investment income (within the meaning of Section 163(d)).[17]

Accordingly, the application of Section 163(j) turns on whether interest is properly allocable to a trade or business. The term "trade or business" is not defined affirmatively in Section 163(j) but the statute expressly excludes (i) the trade or business of performing services as an employee, (ii) any electing real property trade or business, (iii) any electing farming business, or (iv) the trade or business of the furnishing or sale of (a) electrical energy, water, or sewage disposal services, (b) gas or steam through a local distribution system, or (c) transportation of gas or steam by pipeline, if the rates for such furnishing or sale, as the case may be, have been established or

[14] Section 163(j)(8) prior to the Act.

[15] Section 163(j)(1). Although "floor plan financing interest" technically falls within the definition of business interest expense, such interest nevertheless is not subject to limitation under Section 163(j). Section 163(j)(1)(C).

[16] Section 163(j)(5). In very general terms, Section 163(d)(3) defines "investment interest" as interest paid or accrued on indebtedness properly allocable to property held for investment other than "qualified residence interest" under Section 163(h)(3) or interest which is taken into account under Section 469 in computing gain or loss from a passive activity of a taxpayer.

[17] Section 163(j)(6).

approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative.[18]

The term "adjusted taxable income" ("**ATI**") means the taxable income of the taxpayer computed without regard to (i) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business, (ii) any business interest expense or business interest income, (iii) the amount of any net operating loss deduction under Section 172, (iv) the amount of any deduction allowed under Section 199A, and (v) in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion.[19]

Any business interest expense not allowed as a deduction for any taxable year is treated as business interest expense paid or accrued in the succeeding taxable year.[20]

### 2. **Partnerships**

In the case of any partnership,[21] (a) Section 163(j) is applied at the partnership level and any deduction for business interest expense is be taken into account in determining the non-separately stated taxable income or loss of the partnership, and (b) the adjusted taxable income of each partner of such partnership, (i) is determined without regard to such partner's distributive share of any items of income, gain, deduction, or loss of such partnership, and (ii) is increased by such partner's distributive share of such partnership's excess taxable income.[22] For this purpose, a partner's distributive share of partnership excess taxable income shall be determined in the same manner as the partner's distributive share of non-separately stated taxable income or loss of the partnership.[23]

The amount of any business interest expense not allowed as a deduction to a partnership for any taxable year is not treated as business interest expense paid or accrued by the partnership in the succeeding taxable year, but, subject to the rules in the next paragraph, is treated as excess business interest expense which is allocated to each partner in the same manner as the non-separately stated taxable income or loss of the partnership.[24]

If a partner is allocated any excess business interest expense from a partnership for any taxable year (a) such excess business interest expense is treated as business interest expense paid or accrued by the partner in the next succeeding taxable year in which the partner is allocated excess taxable income (defined below) from such partnership, but only to the extent of such excess taxable income, and (b) any portion of such excess business interest expense remaining after

[18] Section 163(j)(7)(A).

[19] The Treasury is granted the authority to make other adjustments to ATI.

[20] Section 163(j)(2).

[21] Rules similar to the special Section 163(j) partnership rules also apply to any 'S' corporation and its shareholders. See Section 163(j)(4)(D).

[22] Section 163(j)(4)(A).

[23] Id.

[24] Section 163(j)(4)(B)(i).

applying the excess taxable income limitation, is treated as business interest expense paid or accrued in succeeding taxable years.[25] In addition, once all such excess business interest expense for all preceding taxable years has been treated as paid or accrued by a partner as a result of allocations of excess taxable income to the partner a partner by the partnership for any taxable year, any remaining excess taxable income that has been allocated to the partner will be taken into account when computing the partner's own Section 163(j) limitation with respect to any business interest expense the partner has incurred at the partner level.

The term “excess taxable income” ("**ETI**") means, with respect to any partnership, the amount which bears the same ratio to the partnership’s adjusted taxable income as the excess (if any) of (a) 30% of the adjusted taxable income of the partnership for the taxable year, over (b) the amount (if any) by which the business interest expense of the partnership exceeds the business interest income of the partnership, bears to 30% of the partnership’s adjusted taxable income for the taxable year.[26]

The adjusted basis of a partner in a partnership interest is reduced (but not below zero) by the amount of excess business interest expense allocated to the partner.[27] If a partner disposes of a partnership interest, the adjusted basis of the partner in the partnership interest is increased immediately before the disposition by the amount of the excess (if any) of the amount of such basis reduction over the portion of any excess business interest expense allocated to the partner which has previously been treated as business interest expense paid or accrued by the partner. This provision also applies to transfers of a partnership interest (including by reason of death) in a transaction in which gain is not recognized in whole or in part. No deduction is allowed to the transferor or transferee for any excess business interest expense resulting in a basis increase.[28]

### 3. **Exceptions to Section 163(j)**

Section 163(j) does not apply to certain activities and certain small businesses. Each of these exceptions will be described below.

#### a. **Electing Real Property Businesses**

Section 163(j) does not apply to an “electing real property trade or business” because that phrase is carved out of the Section 163(j) definition of trade or business. The term ‘electing real property trade or business’ means any trade or business which is described in Section 469(c)(7)(C) that elects to be excluded from Section 163(j). Section 469(c)(7)(C) defines “real property trade or business” as “any real property development redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.”

[25] Section 163(j)(4)(B)(ii).

[26] Section 163(j)(4)(C).

[27] Section 163(j)(4)(B)(iii)(I).

[28] Section 163(j)(4)(B)(iii)(II).

The statute grants authority to Treasury to determine the time and manner of the election. Once made, the election is irrevocable.[29]

b. **Electing Farming Businesses**

Similarly, Section 163(j) does not apply to an electing farm business because that term is excluded from the Section 163(j) definition of trade or business. The term "electing farming business" means a farming business (as defined in Section 263A(e)(4)) or any trade or business of a specified agricultural or horticultural cooperative (as defined in Section 199A(g)(2)) that elect to be excluded from Section 163(j).[30] The statute grants authority to the Treasury to determine the time and manner of the election. Once made, the election is irrevocable.[31]

c. **Small Business Exception**

There is an exemption for certain small businesses. In the case of any taxpayer[32] which meets the gross receipts test of Section 448(c) for any taxable year, Section 163(j) does not apply to such taxpayer for such taxable year. In general, a corporation or partnership meets the gross receipts test of Section 448(c) for any taxable year if the average annual gross receipts of such entity for the 3 taxable year period ending with the immediately prior taxable year does not exceed $25 million.[33] In the case of any taxpayer which is not a corporation or a partnership, the gross receipts test of Section 448(c) shall be applied in the same manner as if such taxpayer were a corporation or partnership.[34]

d. **Employees**

The trade or business of performing services as an employee is not treated as a trade or business for purposes of the Section 163(j) limitation.[35] As a result, the wages of an employee are not counted in the ATI of the taxpayer for purposes of determining the interest expense limitation.[36]

e. **Utilities Exception**

The trade or business of the furnishing or sale of (a) electrical energy, water, or sewage disposal services, (b) gas or steam through a local distribution system, or (c) transportation of gas or steam by pipeline, if the rates for such furnishing or sale, as the case may be, have been

[29] Section 163(j)(7)(B).

[30] Section 163(j)(7)(C).

[31] Section 163(j)(7)(C).

[32] Other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under Section 448(a)(3). Section 163(j)(3).

[33] All persons treated as a single employer under Section 52(a) or (b) or Section 414(m) or (o) are treated as one person for purposes of the $25 million gross receipts test. Section 448(c)(2).

[34] Section 163(j)(3).

[35] Section 163(j)(7)(A)(i).

[36] Section 163(j)(7)(A)(i).

established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative (a "**utilities business**") is not a trade or business for purposes of Section 163(j). [37]

#### f. Floor Plan Financing Interest

Interest paid or accrued on "floor plan financing indebtedness" is not subject to limitation under Section 163(j).[38] The term "floor plan financing interest" means indebtedness used to finance the acquisition of motor vehicles[39] held for sale or lease, and secured by the inventory so acquired.[40]

### 4. Effective Date

The amendments to Section 163(j) apply to taxable years beginning after December 31, 2017.

### 5. Conforming Amendments

The Act amended Section 381(c) to include the carryover of disallowed business interest expense to taxable years ending after the date of distribution and transfer. Section 382(d) was amended to include disallowed interest expense within the definition of "pre-change loss."[41]

# III. Discussion

## A. Interest

Section 163(j) contains no special rules defining interest. The Conference Report, however, states that "any amount treated as interest for purposes of the Code is treated as interest for purposes of Section 163(j)." The Conference Report appears to indicate a Congressional decision to apply Section 163(j) more narrowly than old Section 163(j). Old Section 163(j), for example, took a more expansive view of interest by including substitute payments made under a

[37] Section 163(j)(7)(A).

[38] Section 163(j)(1)(C) and (j)(9). Section 163(j)(1). The Conference report to the Act states "by including business interest income and floor plan financing interest in the limitation, the rule operates to allow floor plan financing interest to be fully deductible and to limit the deduction for net interest expense (less floor plan financing interest) to 30% of adjusted taxable income." H.R. Rep. 115-466, at 387.

In this Report, references to business interest expense are to interest that qualifies as such under Section 163(j)(5) and is not floor plan financing interest; and in all examples, the interest expense is not floor plan financing interest.

[39] The term "motor vehicle" means any (a) self-propelled vehicle designed for transporting persons or property on a public street, highway, or road, (b) a boat, or (c) farm machinery or equipment. Section 163(j)(a)(C).

[40] Section 163(j)(9)(B).

[41] Section 382(d)(3). Section 382(k)(1) was amended to include any corporation entitled to use a carry forward of disallowed interest.

securities loan that met the requirements of Section 1058(a) as interest for Section 163(j) purposes.[42]

We recommend that the Treasury and Service issue guidance confirming that Section 163(j) applies to all amounts treated as interest under the Code. Accordingly, under our recommendation for Section 163(j) purposes, interest would include:

- original issue discount, adjusted for any acquisition premium;
- acquisition discount;
- amounts treated as interest under Section 1286 (related to stripped bonds);
- gain treated as ordinary income on the disposition of a market discount bond;
- amounts treated as interest under Treas. Reg. Sec. 1.446-3T (related to notional principal contracts with nonperiodic payments);
- payments treated as interest under Section 483;
- amounts treated as interest under a Section 467 rental agreement;
- redeemable ground rent treated as interest under Section 163(c);
- amounts treated as interest under Section 988; and
- foregone interest treated as interest under Section 7872.

There is a reasonable policy argument that deductions for expenses that are the functional equivalent of interest ought to be limited in the same manner as interest deductions under Section 163(j). For example, if a taxpayer borrows a debt security in a Section 1058(a) transaction, substitute payments it makes on account of interest on that security logically should be subject to Section 163(j); otherwise the taxpayer could use that securities loan to generate cash which it uses to purchase a separate debt security, with interest income on the purchased debt security increasing the taxpayer's Section 163(j) limitation and substitute payments on the borrowed security not be subject to the limitation. As a similar example, if a taxpayer holds a fixed-rate debt instrument and a derivative swapping fixed for floating rate interest, then the taxpayer again may receive interest income that increases its Section 163(j) limitation and make interest-like payments under the swap that are not subject to the limitation. By comparison, if the taxpayer integrated the debt instrument with the hedge, all of the payments would be taken into account in applying Section 163(j). However, while the right answer in these examples may seem clear, we believe it becomes more difficult fairly quickly to determine where to draw the line, if a broader range of transactions

[42] The legislative history to old Section 163(j), by comparison, indicated that Congress contemplated Treasury could issue guidance, if it wished, regarding "expense items not denominated interest but appropriately characterized as equivalent to interest expense." H.R. Rep. 101-386 at 566-567 (1989).

(having some time-value element, but not solely or predominantly providing for payments that are determined by reference to the time value of money) is considered.

To the extent that certain deductible payments should be treated as interest expense for purposes of applying the statute, it would seem logical that receipt or accrual of the same types of payments should be treated as interest income for that purpose. There does not seem to be a principled justification for adopting an asymmetrical approach.

In view of the statutory language ("interest paid or accrued on indebtedness"), the legislative history, and the fact that Congress did not give any indication of following the long-established approach that was taken under old Section 163(j), it seems questionable whether there would be authority for guidance applying new Section 163(j) to interest equivalents, absent a statutory amendment. However, we note that to the extent guidance applies only to a limited set of specifically identified types of transactions, in all of which one party secures the use of funds for a period of time and makes payments that are determined solely or almost solely by reference to the time value of money (including making net payments determined taking into account a hedge of the cost of borrowing, as in the example above), such guidance would appear to be more easily defensible, as an antiabuse measure designed to protect the intended operation of the statute rather than to materially expand it. Similarly, guidance takes a symmetrical approach for purposes of identifying income and expenses equivalent to interest under Section 163(j) would seem more likely to be upheld, as applying in a relatively neutral way that is not intended to disadvantage taxpayers.

B. **Business Interest Expense; Business Interest Income**

Guidance should confirm that all interest expense of a corporation is business interest expense, and all interest expense of a non-corporate taxpayer, other than personal interest and Section 163(d) investment interest, is business interest expense. The goal of Section 163(j) is to limit a taxpayer's ability to use interest deductions to increase its after-tax rate of return from its activities, and thereby to curb the tax law's tendency to encourage excessive levels of debt in taxpayers' capital structures.[43] It is consistent with that goal for the concept of business interest expense to have a broad scope, with Section 163(j)(5)'s references to "trade or business" and "properly allocable" not being interpreted as imposing significant limitations. For example, a corporation should not be able to claim that, to the extent its interest expense is attributable to investment activities that do not rise to the level of a trade or business under general tax principles, or is not closely connected to a particular activity that constitutes a trade or business but instead has been incurred on debt borrowed for general corporate purposes, the interest is not subject to limitation Section 163(j). Similarly, a non-corporate taxpayer should not be able to successfully

[43] See H.R. Rep. 115-409, at 247-248 ("The Committee believes that the general deductibility of interest payments on debt may result in companies undertaking more leverage than they would in the absence of the tax system. The effective marginal tax rate on debt-financed investment is lower than that on equity-financed investment. Limiting the deductibility of interest along with reducing the corporate tax rate narrows the disparity in the effective marginal tax rates based on different sources of financing. This leads to a more efficient capital structure for firms.").

argue that it has interest expense that falls into an area uncovered by any of Sections 163(j), 163(d) or 163(h). The statute's legislative history provides direct support for such an approach.[44]

Logically, business interest income for purposes of Section 163(j) would be determined under a rule symmetrical to the one just described for business interest expense; that is, all interest income of a corporation, and all interest income of a non-corporate taxpayer other than investment income as defined in Section 163(d), would be business interest income. (In the case of a non-corporate taxpayer that is not a business entity, Treasury and the IRS could consider also excluding interest income on loans clearly made for personal reasons, such as interest income imputed under Section 7872 on a gift loan to a friend or relative of the taxpayer.) The legislative history just referenced supports such an approach.[45]

### C. **Adjusted Taxable Income**

In our view, it logically follows from our recommended approach to defining the business interest income and business interest expense of a corporation, that all of its other items of income and expense (exclusive of items attributable to a business exempt from Section 163(j)) should be included in the corporation's ATI. The legislative history discussed above suggests that for purposes of Section 163(j), all activities of a corporation constitute a trade or business, with the result that all its income and expense is "properly allocable" to a trade or business. In addition, assuming that (as recommended) all of the corporation's interest expense (not allocated to an exempt business) is treated as business interest expense, it seems fair to treat all of its non-interest income (other than from exempt businesses) as ATI; otherwise, there would be the potential for arbitrary mismatches, in which a taxpayer's interest expense is subject to the Section 163(j) limitation, while the taxpayer's income from an activity financed by the relevant borrowing is not taken into account as ATI to increase the amount of the limitation under Section 163(j)(1)(B). There is no apparent policy reason for applying the statute in a manner that creates such mismatches, and the text of the statute readily lends itself to a more symmetrical approach. Moreover, our recommended approach is relatively easily administrable, as compared to an

44 See H.R. Rep. 115-409, at page 248 note 444 ("Section 163(d) applies in the case of a taxpayer other than a corporation. Thus, a corporation has neither investment interest nor investment income within the meaning of section 163(d). Thus, interest income and interest expense of a corporation is properly allocable to a trade or business, unless such trade or business is otherwise explicitly excluded from the application of the provision."); H.R. Rep. 115-466, at 386 n. 688 ("a corporation has neither investment interest nor investment income within Section 163(d). Thus, interest income and interest expense of a corporation's properly allocable to a trade or business, unless such trade or business is otherwise explicitly excluded from the application of [Section 163(j)].").

In Part III of this report, except where specifically stated, all references to a "corporation" are to a C corporation (as defined in Section 1361(a)(2)) that is not a real estate investment trust, a regulated investment company.

45 As noted in the legislative history, if a taxpayer conducts a business that is explicitly exempted from Section 163(j), then interest income and interest expense allocable to that business is excluded from the definitions of business interest income and business interest expense, pursuant to Section 163(j)(7). We discuss further in Part III.D below recommendations for the method to be used to allocate interest expense, and other items of income and expense, to an exempt business conducted by a taxpayer.

approach that requires a fact-intensive inquiry into the connection between items of income and a trade or business of the corporation.

Similar logic should apply to a non-corporate taxpayer. As proposed above, all of a non-corporate taxpayer's interest income and interest expense, other than investment income and investment interest under Section 163(d), interest income and expense from exempt businesses, and personal interest under Section 163(h) (and, possibly, interest income on loans clearly made for personal reasons, such as interest imputed under Section 7872 on gift loans), would be treated as business interest income and business interest expense under Section 163(j). It is thus seems reasonable to treat all of a non-corporate taxpayer's non-interest income as being included in the taxpayer's ATI, other than items that are investment income under Section 163(d), or that are attributable to exempt businesses or (in the case of a taxpayer that is not a business entity) are specifically enumerated items of income that are personal in nature, such as gain on the sale of the taxpayer's home. In addition, all of the taxpayer's non-interest deductible expenses, other than investment expenses under Section 163(d), expenses attributable to exempt businesses, and (in the case of a taxpayer that is not a business entity) specifically enumerated non-business deductions including for charitable contributions, state or local property taxes not related to a business, and medical or dental expenses, should be taken into account in ATI.

### D. Allocation of Interest Expense Among a Taxpayer's Activities

Application of Section 163(j) requires that interest expense be allocated among different activities of a taxpayer. Under Section 163(j)(5) and 163(j)(7)(A), interest expense allocable to a trade or business of acting as an employee, an electing real property trade or business, an electing farming business, or a utilities business is exempted from the Section 163(j) limitation. Other provisions of the Code adopt a range of different approaches to allocating interest expense to different assets or activities: tracing based on the taxpayer's use of the borrowed funds;[46] tracing based on the purpose for the borrowing;[47] and allocation rules based on the relative amounts of assets used in different activities of the taxpayer.[48]

On balance, we recommend that guidance be issued under Section 163(j) allocating interest expense of a corporation based on the relative amounts of assets used in the corporation's exempt and non-exempt businesses, or based on the relative amounts of income the businesses generate, rather than an approach based on tracing or the purpose of a borrowing. We believe that an asset- or income-based approach to allocating interest expense would be more difficult for corporate taxpayers to manipulate, and would lead to significantly less litigation based on factual disputes, than a system based on tracing or the taxpayer's purpose would. However, we recognize that the

[46] See Treasury Regulation Section 1.163-8T; see also Treasury Regulation Section 1.108(i)-2(d)(1) (adopting certain safe harbors based on the use of borrowed funds, for purposes of determining whether debt was issued by a partnership or S corporation "in connection with the conduct of a trade or business").

[47] See Section 265(a)(2) (denying a deduction for interest on debt incurred or continued to purchase or carry tax-exempt securities; was issued by a partnership or S corporation "in connection with the conduct of a trade or business"); Treasury Regulation Section 1.265-1(c); Rev. Proc. 72-18 (describing standards, including based on objective factors, for determining whether debt in incurred for the purpose of purchasing or carrying tax-exempt securities).

[48] See Treasury Regulation Sections 1.861-9 – 1.861-12T, 1.882-5, 1.884-4.

considerations for corporate and non-corporate taxpayers are somewhat different relating to the choice of a Section 163(j) allocation method, and we acknowledge that, as a practical matter, it may be necessary to adopt a method for non-corporate taxpayers that is based largely or entirely on tracing principles.

Although we outline below multiple possible approaches to allocation for the government's consideration, we believe that guidance should provide mandatory rules, rather than taxpayer elections between allocation methods, in order to maximize the likelihood of consistent outcomes that do not unduly disadvantage the government.

1. **Corporations**

**a. Asset-Based Allocation Method**

Corporate taxpayers in many cases may find an asset-based approach familiar, from their calculations under Section 861 for foreign tax credit purposes. The basic principles of the Section 861 rules are well-understood and have been fairly stable over a long period of time, and it would appear those principles could be applied under Section 163(j) without undue difficulty in the case of a corporation with exempt and non-exempt businesses. A system based on tracing the use of funds or based on the purpose of a borrowing, by comparison, would be a relatively new exercise for many corporate taxpayers, and could be a complex one for large corporate groups.

Either fair market value or tax basis could be used to measure a taxpayer's assets. Fair market value could be seen as a less arbitrary metric for measuring the assets used in different businesses, than tax basis would be (for example, valuable self-developed intangibles may have a low or no tax basis); and the Code and regulations provide several other examples of determinations made based on the relative fair market values of different groups of assets.[49] However, fair market values often can be difficult to determine, thus increasing opportunities for disagreements between taxpayers and the IRS. Possibly for that reason, the Act adopted Section 864(e)(2), which eliminated taxpayers' right under prior law to allocate interest expense between domestic and foreign assets for sourcing purposes based on fair market value, and instead mandated the use of tax basis.[50]

If tax basis is used to measure a corporation's assets, there would be a natural tendency for exempt businesses to attract a relatively large share of interest expense, because those businesses tend to be capital-intensive and to involve assets with longer depreciation schedules (or non-depreciable assets). However, as a practical matter, it often would be relatively easy for taxpayers to use basis, as it would be computed for other purposes; and it would generally be difficult to manipulate basis for purposes of skewing the apportionment.[51] In addition, a number of businesses of the types that are exempted from Section 163(j) may be relatively heavily levered, for reasons

[49] See, e.g., Section 856(c)(4) (asset tests for REIT status); Section 897(c)(2) and Treasury Regulation Section 1.897-2 (determination of a corporation's status as a U.S. real property holding corporation).

[50] See Treasury Regulation Section 1.861-9T(g) (which historically permitted taxpayers to choose to use fair market value).

[51] Congress has used basis as a way of measuring capital investment in assets in multiple other places in the Act (see new Sections 199A, 951A, and 250).

unrelated to tax; indeed, that might have been one of the reasons Congress had for exempting them from Section 163(j).

Regardless of whether basis or fair market value is used, Treasury and the IRS should consider adopting special rules that allow interest expense on a particular debt obligation to be allocated to a business, in specific cases where there is a relatively clear economic link between the business and that debt. For example, in the case of a utilities business, the regulatory authority that approves the rates the business is entitled to charge customers may have taken into account particular debt incurred by the business in the ratemaking process, permitting the business to charge rates that cover the expected debt service. This would be an objective measure of the debt attributable to the utilities business. Similarly, if a non-exempt business is subject to regulatory oversight that involves a review of particular debt owed by the taxpayer, then interest expense on that debt could be treated as allocable entirely to the non-exempt business. In addition, a taxpayer often may incur nonrecourse debt to finance the construction, improvement or purchase of real property. In a case where the lenders are looking exclusively to the property built or purchased with the borrowed funds and the cashflows generated by that property for repayment, there would seem to be reasonable grounds for allocating the interest expense on the debt to the business in which the property is used. This traditional type of financing arrangement has been taken into account in other contexts when allocating interest expense.[52] Such a rule could also apply to a future refinancing of a construction or acquisition loan; in such a case, we would propose that the rule apply only to the extent the amount of the new debt does not exceed the amount of debt being refinanced.

**b. Income-Based Allocation Method**

In our view, it is worth considering an income-based approach to allocation of interest expense as an alternative to an asset-based approach. We are not aware of an existing statutory or regulatory regime that provides for taxpayers to allocate interest expense on the basis of income (or cash flow) from different activities.[53] The Act has amended Section 864(e)(2), in a manner that prohibits such an allocation methodology. Nevertheless, we believe such an approach may have merit under Section 163(j). Debt capacity often is determined by lenders using income-based metrics, rather than asset values. In addition, and more importantly, an income-based approach can be seen as fitting well with the basic design of Section 163(j). As noted above, the legislative history indicates that the goal of the statute is to prevent a taxpayer from making excessive use of interest deductions to increase its after-tax rate of return from its activities.[54] The statute accomplishes this goal by limiting the extent to which each dollar of net interest expense can shield the ATI of a non-exempt business from tax. Allocating a taxpayer's interest expense between exempt and non-exempt businesses based on those businesses' relative contributions to the

[52] See Treasury Regulations Sections 1.861-10(e), 1.861-10T(b), 1.882-5(a)(2).

[53] Prior to the Act, it was permissible to compute a controlled foreign corporation's Subpart F income, by allocating its interest expense among different activities based on the relative amounts of gross income generated by each activity. See Treasury Regulation Section 1.861-9T(j).

[54] See H.R. Rep. 115-409, at 247-248.

taxpayer's overall net income[55] fits well with the basic proposition that a dollar of interest expense is meant to shield from tax at most $0.30 of the ATI generated by a non-exempt business.[56]

### 2. Non-Corporate Taxpayers

For non-corporate taxpayers, the considerations relating to the choice of a Section 163(j) allocation method are somewhat different than described above. In particular, individuals have long characterized their interest expense as personal interest under Section 163(h), investment interest under Section 163(d), an expense of passive activities under Section 469, or an expense of non-passive businesses in which they materially participate, using the tracing rules of Treasury Regulation Section 1.163-8T. The most straightforward way to apply new Section 163(j) to individuals, which would require the least administrative guidance in the near term, would be for individuals simply to continue to trace interest expense under Treasury Regulation Section 1.163-8T to each of their business and non-business activities; and interest that is traced to an exempt business under these principles would not be subject to Section 163(j), while interest traced to a non-exempt business would be subject to limitation.

Treasury and the IRS might consider applying a set of rules to individuals that is based only in part on tracing. For example, as a first step, tracing could be used to divide an individual's interest expense between personal interest and other interest.[57] Then, asset-based or income-based rules like the ones described above for corporations could be applied, to allocate the other interest expense between the individual's investments and businesses, and between exempt and non-exempt businesses. This would reduce, at least to some extent, the potential for an individual to manipulate the allocation of business interest expense between exempt and non-exempt businesses, for purposes of applying Section 163(j). However, it is questionable whether such an approach would be fair, if it applied to allocate interest expense on existing indebtedness among an individual's business and investment activities for purposes other than just applying Section 163(j) – for example, for purposes of determining how much interest is allocable to a particular activity of an individual for purposes of applying Section 469. Treasury Regulation Section 1.163-8T has long been a part of the framework of rules that individuals have taken into account when planning business transactions; and many of those transactions may extend well into future periods. It appears that such an approach also would apply to a relatively limited population of individual taxpayers, in view of the exception in Section 163(j)(2) for taxpayers that have average annual gross receipts under $25 million. As a result, at least in the near term, it is questionable whether individuals should be subject to rules that depart from a tracing approach.

[55] For this purpose, the taxpayer's overall net income would be computed taking into account income and expenses from its exempt businesses, in the same manner as ATI is computed under the statute for non-exempt businesses.

[56] By comparison, if a taxpayer's interest expense is allocated based on the relative amounts of assets used in different businesses, then the result could be that each dollar of the taxpayer's interest expense ends up sheltering more than $0.30 of income from a non-exempt business. For instance, that would be the case if a taxpayer's debt, and interest expense, was allocated largely to an asset-intensive exempt business carried on by the corporation that generated little net income, resulting in a net loss attributable to that business. That loss could be used to shelter ATI generated by the taxpayer's non-exempt businesses without the 30% limitation applying.

[57] It appears it would be difficult to use an approach other than tracing, to identify an individual's personal interest.

By comparison, in the case of a partnership, an approach not based purely on tracing principles may make more sense. In particular, if a partnership used rules based purely on tracing, then opportunities could arise for a corporation to avoid the rules described in Part III.D.1 above providing for asset-based or income-based allocation of business interest expense, simply by investing in those businesses through a partnership rather than directly. We discuss issues relating to the application of Section 163(j) to a partnership and its partners in detail in Part III.H below.

### 3. Additional Issues Related to the Choice of Allocation Method

#### a. Allocation of Income and Expenses (Other than Interest Expense) to Exempt Businesses

In order to apply Section 163(j) to a taxpayer that conducts both exempt and non-exempt businesses, it will be necessary to determine not only the amount of the taxpayer's interest expense, but also the amounts of its other items of income and expense, that are attributable to the taxpayer's exempt businesses (and thus excluded from ATI). We believe that, in general, it should be more straightforward to allocate these items than to allocate interest expense, and that such determinations are generally best made based on a practical review of the facts that link an item to an exempt business. In cases where the appropriate allocation of an item of income is not entirely clear, principles that are similar to those in Section 864(c) could be applied.[58] A reasonable rule could be developed to identify investment assets held for the reasonable present and anticipated future needs of an exempt business, income from which would be part of that business's income.[59] In addition, principles can be used to allocate a taxpayer's expenses (other than interest) to an exempt business that are similar to those used in Treasury Regulation Section 1.861-8 and Treasury Regulation Section 1.954-1(c).

#### b. Grouping of Taxpayers for Purposes of Allocating Interest Expense to Exempt and Non-Exempt Businesses

An additional point related to the choice of allocation method, is whether guidance will provide for grouping of different taxpayers or entities. As discussed further below, we believe grouping is appropriate for members of a consolidated group. On the whole, however, the basic approach taken by Congress in drafting Section 163(j) suggests it did not contemplate broad grouping or aggregation rules. For example, if a partner owns interests in two partnerships, one of which conducts an exempt electric power business and the other of which conducts a non-exempt trade or business, it does not appear that the assets and interest expense of those two partnerships ought to be aggregated, for purposes of determining how much of the interest expense should be viewed as allocable to the exempt electric power business; as discussed in more detail

[58] This would be consistent with the approach taken in Section 199A, a provision that could be expected to be applied in tandem with Section 163(j). <u>See</u> Section 199A(c)(3)(A)(i). The Tax Section intends to submit separately recommendations for guidance under Section 199A.

[59] <u>See</u> Treasury Regulation Section 1.897-1(f) (amount of cash and investment assets considered to be business assets for purposes of applying Section 897(c)); Treasury Regulation Section 1.537-1 (principles for determining whether a corporation has accumulated earnings and profits that exceed the reasonable needs of its business).

later in this Report, Section 163(j)(4) contemplates fairly clearly that the statutory limitation (or lack thereof) will be computed separately, partnership by partnership.

## E. Coordination of Section 163(j) With Other Limits in the Code on Interest Deductions and Non-Interest Deductions

### 1. Coordination with Other Limits on Interest Deductions

A straightforward reading of Section 163(j) indicates that it places a cap on the amount of interest for which a deduction otherwise would be allowed to a taxpayer in a given year, after having taken into account all the other statutory and regulatory rules that would disallow or defer such deductions. ("The amount allowed as a deduction under this chapter for business interest expense shall not exceed…").[60] This application of the statute is justified as a policy matter: as noted above, the statute is intended to prevent taxpayers from relying excessively on interest deductions to increase their after-tax returns;[61] and that purpose is achieved in a simple, effective manner by applying the formula for the annual Section 163(j) limit to interest expense that would otherwise be currently deductible. Consistent with that logic, the Congressional reports state that: "It is generally intended that, similar to present law, section 163(j) apply after the application of provisions that subject interest to deferral, capitalization, or other limitation. Thus, section 163(j) applies to interest deductions that are deferred, for example under section 163(e) or section 267(a)(3)(B) in the taxable year to which such deductions are deferred. Section 163(j) applies after section 263A is applied to capitalize interest and after, for example, section 265 or section 279 is applied to disallow interest." [62]

New Section 59A contains a special ordering rule, for application of the "Base Erosion and Anti-Abuse Tax" ("**BEAT**"). Section 59A generally requires that a U.S. corporation that (together with affiliates) has average annual gross receipts of at least $500 million to pay a minimum tax, equal to 10% of its "modified taxable income"; and modified taxable income, in turn, is generally defined as taxable income computed without regard to any deductible payment to a foreign related party (including interest) (a "base erosion payment"). Section 59A(c)(3) provides that for purposes of computing a taxpayer's modified taxable income, "in the case of a taxpayer to which section 163(j) applies for the taxable year, the reduction in the amount of interest for which a deduction is allowed by reason of such subsection shall be treated as allocable first to interest paid or accrued to persons who are not related parties with respect to the taxpayer and then to such related parties." Thus, in effect, Section 163(j) is applied before BEAT, so that there is the maximum possible disallowance of interest under the former, and the imposition of the greatest possible amount of tax under the latter. Although the BEAT statute is not drafted as a limitation on the deductibility of base erosion payments, it does function in a somewhat similar manner, in effect limiting the maximum reduction in a U.S. corporation's tax liability that can be achieved through such payments; and it can be asked whether Section 59A(c)(3) should be seen as suggesting a broader approach to how Section 163(j) should be coordinated with other limits on deductibility of interest

[60] Section 163(j)(1).

[61] See H.R. Rep. 115-409, at 247-248.

[62] H.R. Rep. 115-409, at 249; H.R. Rep. 115-466, at 228-229 (repeating this statement, in describing the House bill, and then going on to describe changes to the House bill made by the Senate and in the Conference Committee that do not impact this point).

payments (i.e., in a manner that maximizes the effect of each limit). In our view, the fact that Congress added a specific rule in the Code to achieve this result, and did so in the BEAT statute instead of in Section 163(j), indicates that Congress viewed BEAT as a special case that required a unique, and relatively harsh, rule, rather than an indication more broadly of how Section 163(j) is meant to interact with other limits in the Code. [63] Except in the case of BEAT, the approach described in the preceding paragraph – applying other limits before applying Section 163(j), and thus applying its formula only to interest otherwise allowable as a current deduction – appears preferable.

We recommend that guidance be issued confirming these conclusions.

In the case of Sections 465 and 469, if Section 163(j) is applied to a taxpayer's interest expense after those provisions, the effect may be that the taxpayer's income from a passive or limited-risk activity is not sheltered to the full extent permitted by those provisions even though the taxpayer has substantial non-interest expenses from the activity. It would seem in keeping with the purposes of Section 465 and 469 to remove the possibility for such results, by having the taxpayer re-apply the limits these provisions impose, after taking into account the Section 163(j) limitation on interest expense from the relevant activity. In addition, such an approach would not undercut the goals of Section 163(j). In this connection, we note that proposed regulations under old Section 163(j) took a contrary approach, and Congress opted to overrule those proposed regulations. [64]

The Tax Section plans to submit comments on whether Treasury Regulation Section 1.385-3 should be withdrawn or modified as a result of various changes made pursuant to Act, including the enactment of Section 163(j).

#### 2. **Carryforwards of Disallowed Interest Under Old Section 163(j)**

Interest expense that was disallowed by reason of Section 163(j) as in effect prior to the Act should be treated as interest paid or accrued by the taxpayer in the first year new Section 163(j) is effective. Old Section 163(j)(1)(B) expressly provided for the carryforward of such interest to that year: such interest would be treated as "paid or accrued within" that year for purposes of Section 163(a), as well as for purposes of the annual limitation on the Section 163(a) interest deduction set forth in Section 163(j).

The new statute and its legislative history do not expressly state whether this carryforward will be recognized in the period following the statute's enactment. However, the Act did not amend Section 163(a); and there would seem to be no reason why Treasury and the IRS cannot simply continue to interpret the reference in Section 163(a) to "interest paid or accrued within" 2018, as including disallowed interest carried forward from 2017. Doing so would be fully consistent with the policy of the new provision, as the carried forward interest would simply become subject to

[63] We note that the BEAT, unlike Section 163(j), also applies to a corporation's gross, rather than net, interest expense.

[64] See Section 163(j)(7).

the same formulaic limitation as interest paid or accrued after the effective date of the amendments to Section 163(j).

Old Section 163(j) also provided that if a corporation's Section 163(j) limit for a taxable year exceeded its interest expense, the corporation was entitled to carry forward that excess to increase its Section 163(j) limit in the next three taxable years.[65] We recommend that guidance confirm that a corporation with such a carryforward from the last year old Section 163(j) was in effect, will simply lose the benefit of that carryforward under the new provision. The new provision includes no concept of carrying forward an unused limitation to future years. In addition, the old Section 163(j) limit was considerably different than the new one, reaching only interest paid to a related party not subject to U.S. tax on that amount, and only to the extent interest expense exceeded 50% of EBITDA; it would seem to give taxpayers a significant advantage to be able to use a carryforward designed to provide leniency under the relatively narrowly targeted former provision, in order to lessen the impact of the new, broader restriction.

### 3. Interaction Between Section 163(j), and Sections 246(b) and 250(a)

Under our recommendation in Part III.C above, a corporation's ATI would include dividends received by it, Subpart F income, global intangible low-taxed income ("**GILTI**") as defined in Section 951A and "foreign-derived intangible income" ("**FDII**") as defined in Section 250. The corporation's ATI also would take into account the dividends-received deductions provided by Sections 243, 245 and 245A, as well as the deductions in respect of GILTI and FDII provided in Section 250(a)(1).

Section 246(b) provides that, in general, the total of a corporation's dividends-received deductions under Sections 243(a)(1) and 245 and its deduction under Section 250 cannot exceed 50% of the corporation's taxable income, determined without regard to any Section 172 deduction for a net operating loss carryover and with certain other adjustments. It is not entirely clear how this limitation interacts with the one in Section 163(j)(1)(B), generally restricting interest deductions to 30% of ATI. If one of these limits is applied before the other (i.e., by simply disregarding the other), then a taxpayer may end up with a result that is not in literal compliance with the latter Code provision. In similar circumstances, the IRS and the courts have approved of the use of simultaneous linear equations.[66] We recommend that guidance confirm whether such an approach also applies when applying the two limits in the present case.[67]

[65] Old Section 163(j)(2)(B)(ii).

[66] See Rev. Rul. 79-347, 1979-2 C.B. 122 (corporation had (i) a Section 243(a)(1) dividends received deduction, subject to the limitation in Section 246(b), and (ii) depletion deductions under Section 613A, subject to the limitation in Section 613A(d)(1) based on 65% of the corporation's taxable income; the IRS approved the use of simultaneous equations to apply these two limits); Shell Oil Co. v. Comm'r, 89 T.C. 371, 419-421 (1987) (describing situations under the Code in which use of simultaneous equations has been necessary), rev'd. in part and remanded in part, 952 F.2d 885 (5th Cir. 1992).

[67] Under Section 246A, if a corporation owns "debt-financed portfolio stock," then the corporation's dividends received deduction with respect to a dividend paid on that stock generally is limited to (a) the portion of the dividend that is attributable to the part of the stock that has not been financed with debt plus (b) the excess (if any) of the portion of the dividend that is attributable to the debt-financed part of the stock over the interest

The interaction between Sections 163(j) and 250(a)(2) raises similar ordering questions. In general, Section 250(a)(1) provides that a U.S. corporation is entitled to a deduction equal to the sum of (a) 37.5% of its FDII for the taxable year and (b) 50% of (i) the GILTI amount included in its gross income under Section 951A for the taxable year. However, Section 250(a)(2) adds the limitation that, if the sum of the corporation's FDII and GILTI amounts exceeds its taxable income (computed without regard to the deduction provided in Section 250), then the corporation's deduction under Section 250(a)(1) must be reduced under a formula. Again, Treasury and the IRS should confirm whether simultaneous equations need to be used in order to apply Sections 163(j) and 250(a)(2) in tandem.

The FDII rules also require the resolution of one additional ordering question related to Section 163(j). In general, FDII is defined as a portion of the excess of a U.S. corporation's "deduction eligible income" over a deemed return on its investment in tangible assets – specifically, the portion of such excess income that is attributable to selling property or services to foreign persons.[68] "Deduction eligible income" is defined as the excess of the corporation's gross income (computed without regard to specified items) over "the deductions (including taxes) properly allocable to such gross income."[69] Guidance should be provided regarding whether, for this purpose, "the deduction" for interest takes into account the limitation on deductibility imposed by Section 163(j).

### F. Impact on Earnings and Profits

We recommend that Treasury and the IRS confirm that disallowance of a corporation's interest expense under Section 163(j) should not have an effect on the year in which the expense reduces the corporation's earnings and profits ("**E&P**"). Caselaw and rulings have established a principle that, generally, E&P should be determined in a manner that is consistent with the economic reality of a corporation's ability to make distributions in excess of a return of capital.[70] Consistent with that principle, Treasury and the IRS have concluded that when a corporation has an economic outlay in a particular year and the tax deduction or loss associated with that outlay is disallowed for the year and carried forward, the corporation reduces its E&P in the year the outlay

deduction allocable to the dividend. Generally, debt financed portfolio stock is a minority stockholding in a corporation, to the extent there is debt that is "directly attributable" to the corporation's investment in that stock. Section 246A does not present the same kind of issue that Section 246(b) does, regarding the order of applying Section 163(j)(1)(B) and a separate deduction limitation in the Code that uses a formula based on taxable income. However, depending on what method is used to allocate a corporation's interest expense between exempt and non-exempt businesses for purposes of Section 163(j), it is possible that a different allocation method will need to be used under Section 246A to determine whether any portion of the corporation's investment in stock is considered to be debt-financed portfolio stock under Section 246A (Section 246A generally requires that debt be incurred for the purpose of investing in the portfolio stock or is otherwise directly traceable to the purchase of the stock). In addition, the portion of the interest on such debt that is deductible under Section 163(j) will need to be determined.

68 See Section 250(b).

69 See Section 250(b)(3)(A)(ii).

70 See Beck v. Comm'r, 52 T.C. 1 (1969) (E&P is "an economic concept which the tax law has utilized 'to approximate a corporation's power to make distributions which are more than just a return of investment.'), aff'd, 433 F.2d 309 (5th Cir. 1970); Bittker & Eustice, Federal Income Taxation of Corporations & Shareholders ¶8.04.

is made notwithstanding the disallowance.[71] Treasury and the IRS adopted that approach in proposed regulations under old Section 163(j);[72] and we believe it would be appropriate to do the same under new Section 163(j).

G. **Consolidated Groups**

1. **Single Taxpayer Approach**

The statute applies Section 163(j) to a "taxpayer." It appears appropriate to view a consolidated group as a single "taxpayer" for this purpose, in keeping with the consolidated group regulations' basic approach of computing a single consolidated taxable income for a group's members, which is reduced by the aggregate amount of interest expense incurred by the group's members.[73] Such an approach would make sense as a policy matter, and is consistent with Section 163(j)'s legislative history. The House report states: "In the case of a group of affiliated corporations that file a consolidated return, the limitation applies at the consolidated tax return filing level."[74] In addition, a similar statement appears in the Joint Committee's description of the Senate's version of the legislation; and the Conference Committee report notes this would have been the approach under the House's proposal, and then goes on to describe changes to the House's proposal made by the Senate and Conference Committee, none of which impact this point.[75]

Under a "single taxpayer" approach, a consolidated group's ATI, business interest income, and business interest expense all would be computed at the group level, by reference to items included each year in consolidated taxable income.[76] One refinement to this basic approach, is that interest on intercompany loans could be disregarded for purposes of determining the amount

[71] See Treasury Regulation Section 1.312-7(b)(1) (corporation's capital loss reduces E&P in the year recognized, even if disallowed under Section 1211, not the year to which carried forward under Section 1212); Rev. Rul. 75-515, 1975-2 C.B. 117 ("In general, the computation of earnings and profits of a corporation for dividend purposes is based upon reasonable accounting concepts that take into account the economic realities of corporate transactions as well as those resulting from the application of tax law. Thus, losses and expenses that are disallowed as a deduction for Federal income tax purposes, charitable contributions in excess of the limitations provided therefore, and other items that have actually depleted the assets of the corporation, even though not reflected in the income computation, are allowed as deductions in computing earnings and profits."); see also Field Service Advice 1993-540 (noting that a corporation's E&P is reduced by a net operating loss in the year the loss is incurred, rather than the year to which it is carried forward under Section 172).

[72] See Proposed Regulation Section 1.163(j)-1(e), 1.163(j)-8(g).

[73] See Treasury Regulation Section 1.1502-11.

[74] H.R. Rep. 115-409 at 248.

[75] See JCT Description of Senate Finance Committee Chairman's Mark of the Tax Cuts and Jobs Act, at 71 (same statement); H. Rep. 115-466, at 228.

[76] Compare Treasury Regulation Section 1.1502-24 (computing Section 170(b)(2) limit on charitable contribution deduction at the consolidated group level); Treasury Regulation Section 1.1502-26 (same for Section 246 limit on dividends received deduction); Treasury Regulation Section 1.1502-44 (same for Section 613A(d) limit on percentage depletion deductions); proposed Treasury Regulation Section 1.163(j)-5(b) (same for old Section 163(j) limit).

of the consolidated Section 163(j) limitation. This would be consistent with the basic principle here that a group is a single economic unit for purposes of Section 163(j).[77]

> **Example 1**. Parent, S1 and S2 are the members of a consolidated group. In 2018, Parent has no income or deductions; S1 has 100 of business interest expense on loans from non-group members and 10 of ATI; and S2 has 20 of business interest expense on loans from non-group members and 290 of ATI.

In Example 1, the consolidated group's ATI is 300 (= 290 + 10), and its Section 163(j) limit should be 90 (90 = 30% x 300). Thus, the group should be entitled to deduct 90 of its 120 of business interest expense for 2018, with the remaining 30 being a carryforward.[78]

For years prior to 2022, ATI is computed without reference to the taxpayer's depreciation and amortization deductions. However, gain from a sale of a depreciable or amortizable asset is included in ATI. In a case where one consolidated group member sells a depreciable or amortizable asset to another in an intercompany transaction, it is not entirely clear how these rules should apply. It would appear that, since the selling member's gain is generally taken into account under the "matching rule" in a manner designed to produce the same effect as a transaction between divisions (i.e., the character and timing of the selling member's gain will match the purchasing member's deductions), and since the purchasing member's deductions are disregarded in computing ATI, the gain also logically should be disregarded.[79] This result would be consistent with the basic principle recommended, to treat the consolidated group as a single taxpayer for purposes of Section 163(j).

More broadly, we note that in general, items from intercompany transactions either could be disregarded when computing a consolidated group's ATI, or included in the calculation. Because intercompany transactions normally should result in items of offsetting amount and the same character in a particular year under the matching rule, it appears such items normally would not result in a net change in the amount of the group's consolidated ATI, whether such items are disregarded when computing consolidated ATI or not.[80]

### 2. Exempt Businesses of a Consolidated Group

A logical corollary of the single taxpayer approach, and of the allocation principles recommended above, is that a consolidated group would allocate its interest expense between a trade or business that is exempt from Section 163(j), and another one that is not, based on the relative assets or income of each business – regardless of the location of each business, or of the interest expense, within the consolidated group.

[77] Compare Treasury Regulation Section 1.385-4T (taking a similar approach for purposes of applying the debt recharacterization rules in Treasury Regulation Section 1.385-3 to consolidated groups).

[78] In Part III.G.4 below, we consider the appropriate treatment of intragroup loans when applying Section 163(j) to a consolidated group.

[79] See Treasury Regulation Section 1.1502-13(c).

[80] We discuss in the next section, however, a case where Section 163(j) might be applied differently to a consolidated group, depending on whether items from intercompany transactions are taken into account.

**<u>Example 2</u>.** Parent, S1 and S2, are the members of a consolidated group. Parent has incurred no debt, and owns no assets other than the shares of S1 and S2. S1 owns 1,000 of assets, which it uses in a non-exempt trade or business, and has 200 of ATI and 50 of interest expense on loans from non-group members in 2018. S2 owns 500 of assets, which it uses in a real property trade or business for which S2 has made an election under Section 163(j)(6)(B), and has 50 of income from that trade or business and 100 of third-party interest expense on loans from non-group members in 2018.

In Example 2, assuming that an asset-based approach is used to allocate interest expense to the consolidated group's exempt and non-exempt businesses, it appears that the consolidated group should disregard members' stock when making that allocation.[81] The group should compute a consolidated ratio of assets used in an exempt business (500) to total assets (1,500), and thus should treat 1/3 of the group's 150 of total interest expense as being allocated to S2's real property trade or business and not being subject to Section 163(j), notwithstanding that S2 has actually incurred 100 of interest expense. All of the group's remaining 100 of interest expense should be treated as being allocated to S1's trade or business and being subject to Section 163(j). For purposes of computing the group's limitation, only S1's 200 of ATI from its non-exempt business should be taken into account. Thus, the consolidated group should be limited to a deduction of 60 under Section 163(j) with respect to the group's 100 of non-exempt business interest expense, resulting in a disallowance of 40.

Alternatively, if an income-based method is used to allocate interest expense in Example 2, then the group's ratio of exempt income (50) to total group income (250) is computed, with the result that 20% of the group's 150 of interest expense (30) should be treated as not subject to Section 163(j). The Section 163(j) limitation would apply to the remaining 120 of interest expense, resulting in a disallowance of 60.

We note that, consistent with the basic approach described in Part III.G.1 above, the income that is taken into account for purposes of making an income-based allocation of interest expense between exempt and non-exempt businesses conducted by a consolidated group should take into account all items that are included in consolidated taxable income. Generally speaking, it appears that it should not make a difference whether items from intercompany transactions are taken into account. However, this may not always be the case, as when a subsidiary that conducts an exempt business has intercompany items from transactions with a subsidiary that conducts a non-exempt business. In such a case, it seems that either taking into account those intercompany items (or else, possibly, seeking to allocate income and non-interest expenses from transactions with non-group members in some fashion between the exempt and non-exempt businesses) may be appropriate.

In Example 2, if S2's business consists solely or predominantly of leasing real property to (or conducting other activities described in Section 469(c)(7)(C) for) other members of the consolidated group, it can be asked whether it is consistent with a single taxpayer approach to view S2 as conducting a real property trade or business for which a Section 163(j)(6)(B) election can be made. In other contexts, the separate existence of a trade or business that principally serves

[81] <u>Compare</u> Treasury Regulation Section 1.1502-91(g)(1) and 1.1502-93(b)(1) (member stock and intercompany debt is disregarded for purposes of certain consolidated group Section 382 computations).

affiliates is respected.[82] However, the basic consolidated return principle of treating members as divisions of a single corporation, and the application of that principle in the Section 163(j) context to treat a group as a single "taxpayer," suggest that S2's activities should be viewed as an indivisible part of the group's overall (non-exempt) business activity.[83] (This view has particular force, if it is the case that items from intercompany transactions are not taken into account in allocating interest expense among the group's businesses.)

### 3. **Corporations Joining a Consolidated Group**

When a corporation joins a consolidated group, in a transaction that results in a Section 382 ownership change for the corporation, the corporation's carryforward of disallowed business interest expense from a separate return year would be subject to the resulting Section 382 limitation. It would appear consistent with the treatment of other Section 382-limited attributes to allow the consolidated group to take into account the portion of the corporation's business interest expense carryforward permitted under Section 382 to be treated as incurred in a consolidated return year, and to subject that amount of interest of such corporation to the consolidated Section 163(j) limitation for the consolidated return year in the same manner as any other interest expense incurred by a group member in that year – without any special treatment or limitation as a result of the fact the interest has been carried forward from a separate return year.[84]

### 4. **Corporations Leaving a Consolidated Group; Apportionment of Consolidated Group's Carryforwards**

Although Section 163(j) generally should be applied to a consolidated group as if it were a single taxpayer, in the manner described above, it nevertheless may be appropriate to apportion among the members the effects of any disallowance and carryforward of the group's business interest expense. In particular, such apportionment may be appropriate in order to determine how

[82] Cf. Proposed Regulation Section 1.355-3(d)(2), Example 16 (manufacturing corporation has an R&D department that develops new products for the corporation to manufacture; R&D department's activity can be transferred to a separate corporation and used to satisfy the Section 355(b) active trade or business requirement), Example 17 (corporation that sells meat products carries on activity of processing meat, which it sells to customers; meat processing activity can be held in a separate corporation from the sales function and used to satisfy the active trade or business requirement).

In addition, as noted above in the text, our basic recommended methodology recognizes intercompany transactions and takes into account items from those transactions for purposes of applying Section 163(j), rather than simply disregarding such items.

[83] Support for this approach can be found in Treasury Regulation Section 1.1502-13(c)(7)(ii), Example 2. S, a member of a group that holds land for investment, sells the land to B, a member of the group that develops the land as residential real estate and sells the developed lots to customers. In the example, the character of S's gain from its sale of land must be determined by treating S and B as a single corporation and assessing whether, based on their combined activities, the land is described in Section 1221(a)(1). By analogy, in the case described in the text above, the character of S2's rental income and activities giving rise to that income, would be determined by treating S2 and the subsidiaries to which it leases property as a single corporation.

[84] We do not analyze in this Report the proper result in a case where a corporation joins a consolidated group in a transaction not resulting in an ownership change under Section 382.

much of the group's business interest expense carryforward a member should take with it, if it leaves the group. We consider several different potential apportionment methods below.[85]

#### a. Method One: Apportionment Based on Each Member's Business Interest Expense on Debt Owed to Non-Group Members

One relatively simple method would be to treat each member that has business interest expense on debt owed to non-group members in the year a carryforward is generated, as having a portion of that business interest expense disallowed and carried forward, corresponding to the portion of the group's total business interest expense owed to non-group members that is disallowed and carried forward.

Under this method, if the group has any business interest expense on intercompany debt for the year in which the carryforward is generated, none of that interest expense would be considered to have been disallowed and carried forward; rather, only business interest expense on debt owed to lenders outside the group would be so treated. The rationale is that each dollar of intercompany business interest expense is matched by a dollar of intercompany business interest income and, thus, should not be viewed as causing or contributing to any disallowance and carryforward of business interest expense by the group under Section 163(j).

> **Example 3**. Parent, S1 and S2 are members of a consolidated group. Parent is a holding company that has borrowed from third parties and lent to S1 and S2, which are both operating subsidiaries. In 2018, Parent's only items of income and expense are 150 of business interest expense on a loan from an unrelated lender, 100 of business interest income from S1 and 50 of business interest income from S2. S1 has 100 of business interest expense and 200 of ATI. S2 has 50 of business interest expense and 100 of ATI. At the end of the year, Parent sells S1 to an unrelated buyer.

In this example, the consolidated group's Section 163(j) limit for 2018 would be 90 (90 = 30% x 300). Under Method One, S1's 100 of business interest expense, S2's 50 of business interest expense, and Parent's 150 of business interest income, would be disregarded for purposes of applying Section 163(j) to the group. Parent's 150 of business interest expense owed to the unrelated lender would be limited, with 60 of that interest expense being disallowed and carried forward. When Parent sells S1, none of that carryforward would go with S1; rather, the entire carryforward would remain with Parent.

Method One would be generally similar to the principles for apportionment of other group attributes to a departing member.[86]

[85] As discussed below, each of the apportionment methods that we have considered may lead to what can be seen as distortions in some cases, and involve potential complexity. A possible alternative that could be considered, is for none of a group's business interest expense carryforwards to be apportioned to a member that leaves the consolidated group. Instead, the entire disallowed business interest expense carryforward would simply remain with the group. Cf. Treasury Regulation Section 1.1502-36(d).

[86] See Treas. Regulation Sections. 1.1502-21(b) (apportioning a consolidated net operating loss carryover based on the approach that the consolidated loss consists of a ratable portion of each loss-making member's separate

**b. Method Two: Apportionment Based on Each Member's Net Business Interest Expense (Determined Taking into Account Interest on Intragroup Debt)**

A second possible method would be to apportion the disallowance and carryforward of business interest expense based on each member's net business interest expense (i.e., the excess, if any, for each member of its business interest expense over its business interest income) for the year in which the Section 163(j) carryforward is generated. Under this method, a member's net business interest expense would be determined by taking into account not only interest on debt that the member has borrowed from or loaned to non-members, but also interest on intragroup debt.

Under Method Two, the consolidated group would be treated as a single taxpayer, and loans between members would be disregarded, when computing the amount of the group's consolidated Section 163(j) limit, and the total amount of business interest expense to be disallowed. However, unlike Method One, that disallowed interest would not all be apportioned to the members with external business interest expense, but instead would be spread among the members in a manner that takes into account intercompany debt.

The rationale for this approach is that often, external borrowing may be done by only one or a few holding companies in the consolidated group, which members then on-lend the funds to other group members that are operating companies (as in Example 3). If one of these operating subsidiaries ultimately leaves the consolidated group, it is that subsidiary which could generate ATI that would provide capacity to use carryforwards of disallowed business interest expense; thus, it would seem logical to choose an apportionment methodology that is relatively likely to apportion carryforwards to the operating subsidiary.

For instance, in Example 3, the consolidated group's Section 163(j) limit continues to be 90, and the total amount of interest disallowed continues to be 60, as was the case under Method One. However, the manner in which the disallowed interest expense is apportioned to the various group members would be different. In 2018 Parent's net business interest expense is 0; S1's is 100; and S2's is 50. As a result, of the 60 of business interest expense disallowed in 2018, 40 would be apportioned to S1 (40 = 60 x 100/150). When Parent sells S1, S1 would take 40 of the carryforward with it; and the remaining 20 would stay with the consolidated group.

Under Method Two, S1 would be entitled to deduct only 60 of its 100 of business interest expense on its loan from Parent in 2018. Parent, however, would have 100 of business interest income and 100 of currently deductible business interest expense. This result represents an (arguably anomalous) departure from the matching principles that would normally apply to Parent's and S1's interest income and expense on their intercompany loan.[87] However, an advantage of this method is that when S1, which (at least in 2018) possesses most of the group's

net operating loss for the year), 1.1502-79 (applying a similar approach to apportion a consolidated group's investment tax credit carryforwards, foreign tax credit carryforwards, and excess charitable contribution carryforwards to a departing group member).

87 See Treasury Regulation Section 1.1502-13(c).

capacity to generate ATI, leaves the group, S1 will take most of the business interest expense carryforward.[88]

An additional advantage of Method Two, is that it appears to lead to more appropriate results than Method One in cases where the group conducts both businesses that are exempt from Section 163(j), and non-exempt businesses.

> **<u>Example 4</u>**. Parent, S1 and S2 are members of a consolidated group. In 2018, Parent, a holding company, borrows from third parties and on-lends the funds to S1, which conducts a non-exempt business, and S2, which conducts an exempt business. Parent's interest income on these loans matches its interest expense on its third-party debt. At the end of the year, P sells S1 to a third party.

In Example 4, any carryforward of disallowed business interest expense that the consolidated group generates in 2018 logically should be attributed to S1. However, under Method One, when Parent sells S1, the entire carryforward would remain with the consolidated group – which at that point will own only an exempt business. Presumably, in 2019, the consolidated group would be entitled under Section 163(j) to deduct the full amount of the carried-forward interest assuming sufficient pre-deduction taxable income.

By comparison, under Method Two, S2 could logically be treated as not having any business interest expense in 2018, since its sole activity is an exempt business. Under that approach, none of the carryforward would be apportioned to it. In addition, Parent would have no net business interest expense. Thus, the entire amount of disallowed interest, and carryforward, would be apportioned to S1.

#### c. Method Three: Apportionment Based on Members' Relative Assets or Income

A third possibility would be to apportion a group's disallowed interest expense among its members using one of the asset-based or income-based methodologies described above in Part III.D. Similar to Method Two, this approach is intended to achieve suitable results in cases where the group members that have business operations (and thus have capacity to use the carryforward) are different than the ones borrowing from third parties; it also is intended to address cases where a group conducts both exempt and non-exempt businesses. This approach is also designed to eliminate a potential weakness of Method Two – that outcomes can differ depending on whether a particular group member has net business interest expense, or not.

> **<u>Example 5</u>**. The facts are the same as in Example 4, except that Parent does not on-lend any funds to S1 and S2. Instead, Parent makes capital contributions to S1 and S2.

88 Such an approach can be seen as consistent, at a practical level, with the rules for apportioning a group's NOLs to a departing member. The rules governing that issue generally have the effect of apportioning the NOLs to a group member that carries on revenue-generating activities, which activities might in the future become profitable and utilize the NOLs.

Under both Method One and Method Two, none of the group's disallowed interest expense would be apportioned to S1 when it is sold by Parent. By comparison, in Method Three, rules would be established to apportion the disallowed interest expense to the members of the group that conduct non-exempt businesses, based on the relative assets they use, or income they generate, in those businesses. Thus, in the example, the carryforward of disallowed interest expense is apportioned to S1.

As Example 5 indicates, Method Three often would impute interest expense to group members that in form have no debt. Thus, while this method achieves results that can be seen as more economically accurate, and less susceptible to manipulation, than either of the other methods, this method also would represent a substantial departure from traditional tax principles. On the other hand, this departure might be seen as appropriate given its matching of the methodology employed to determine disallowed interest during the time that S1 and S2 were members of the group.[89]

### 5. Captive Partnerships

It can be asked whether the single taxpayer approach discussed above should be extended to a case where a partnership that is wholly owned by members of a consolidated group incurs business interest expense. A rational argument could be made that such a partnership is part of a single economic unit to the same extent as any of the partnership's partners are, and that to refrain from subjecting the partnership's business interest expense to the consolidated group's Section 163(j) limit is at odds with economic reality. It also could be asserted that treating group members as a single taxpayer for purposes of Section 163(j) is conceptually consistent with treating a partnership wholly owned by the group as (for purposes of Section 163(j)) a disregarded entity with a single owner, rather than as a partnership with separate existence. A minority of us would propose to take this position.

However, while there may be reasonable policy arguments for such a position, it nevertheless appears it would be difficult to reconcile any guidance applying the group's Section 163(j) limit to the partnership's interest expense, with the terms of the statute. As discussed in Part III.H below, Congress clearly intended that Section 163(j) would apply at the partnership level, and that a partnership's business interest expense for which it is allowed a deduction would not then be subject to a further Section 163(j) limitation in a partner's hands.[90] See Section

[89] If Method Three were adopted, then additional rules addressing adjustments to basis of member stock and other attributes might be required in order to explain the migration of interest expense to a non-borrower member.

In a related point, it also would be appropriate to consider whether, in a case where a departing member's business tends to be relatively heavily leveraged for non-tax reasons (e.g., a financial institution), it would be reasonable for carryforwards of interest expense attributable to debt incurred by that member to be apportioned only to that member, rather than being apportioned at least in part to non-borrower members remaining in the group. Method Three appears potentially to raise this question to a greater extent than either Method One or Method Two above.

[90] Section 163(j)(4)(A)(i) and (j)(7)(A). When it decided to apply Section 163(j) at the partnership level, it appears Congress may have been motivated, at least in part, by a belief that a business organized in the form of a partnership is as likely to try to generate large interest deductions to shelter its profits, as is a business organized in the form of a corporation. See H.R. Rep. 115-409 at 247 ("The Committee believes that it is necessary to apply the limitation on the deductibility of interest to businesses regardless of the form in which such businesses

163(j)(4)(A)(i). If a partnership had one partner that was a member of a consolidated group, and another that was not, it would seem highly difficult as a technical matter to take a bifurcated approach, computing ATI, business interest income and business interest expense at the partnership level for the non-member partner, as mandated by the statutory text, and computing these items under an aggregate approach for the partner that was a member of the consolidated group. In view of this, it appears questionable whether a special aggregate approach should be adopted for a partnership all of whose partners, in a given period, are members of a consolidated group. Such a partnership is treated as a separate entity for purposes of other provisions of the tax law; and Section 163(j)(4) gives no indication that, notwithstanding those other provisions, the Section 163(j) limit is not meant to be applied at the partnership level when the partners are all members of a group, or otherwise closely related.

While Treasury and the IRS might have authority for such an approach under Section 1502, it would appear to create significant potential for complexity, and also would entail a novel decision to disregard a partnership (at least for a limited purpose) merely because its owners are group members.[91] An approach more consistent with precedent would be to conclude that, if the partnership passes muster under economic substance, business purpose, and similar doctrines, its existence as a partnership should be respected and the normal rules applicable to partnerships should govern.[92]

### 6. **Application to Affiliated (Rather than Consolidated) Group**

Old Section 163(j)(6)(C) provided that the members of an affiliated group, as defined in Section 1504(a), would be treated as a single taxpayer for purposes of the interest limitation formula. The regulations that were proposed in 1991 under old Section 163(j) would have determined whether the ownership requirements of Section 1504(a) were met based not only on actual ownership, but also on constructive ownership under Section 318. Thus, for example, two

are organized so as not to create distortions in the choice of entity."). That rationale would seem to be as relevant in a case where a partnership's owners are members of a consolidated group, as in a case where they are not.

91 In the proposed version of the anti-avoidance rule relating to intercompany transactions, Treasury and the IRS included an example in which a bona fide partnership is owned solely by members of a consolidated group, and one of those members obtains a tax advantage by selling an asset to the partnership. (In the example, there was no subsequent transfer by the partnership, or another person, to a group member.) It was concluded in the example that the sale could be disregarded as a sale to a non-member and, instead, treated as an intercompany transaction. Proposed Regulation Section 1.1502-13(h)(2), Example 2, in 59 Fed. Reg. 18,011, 18,043 (Apr. 15, 1994). After receiving substantial criticism of this example from stakeholders, Treasury and the IRS did not include it in the final version of the regulations. Instead, they indicated in the preamble that such a transaction in an appropriate case could be attacked under other anti-avoidance rules and authorities not specifically tied to the consolidated return context. T.D. 8597, 60 Fed. Reg. 36,677 (July 12, 1995).

92 See PLR 200252070 (partnership wholly owned by members of consolidated group, treated as preventing consolidation with subsidiaries owned by the partnership until it liquidated); PLR 9645015 (sale by a consolidated group member to an entirely captive partnership was not an intercompany transaction or subject to the intercompany transaction anti-avoidance rule); TAM 9644003 (deferred intercompany gain with respect to stock of a consolidated group member triggered when the member merged into a partnership wholly owned by two other members of the consolidated group); cf. Rev. Rul. 83-156 (respecting a partnership between parent and wholly owned subsidiary in a corporate group).

separate consolidated groups, owned by the same foreign parent corporation, would be considered a single group for purposes of applying old Section 163(j).[93]

We do not recommend that a similar approach be taken under new Section 163(j). In 2017, Congress acted with old Section 163(j) as a long-established, well-understood precedent – and did not adopt any rule similar to old Section 163(j)(6)(C) or the proposed regulations. It is difficult in such circumstances to find statutory support for application of the new interest limitation at the level of an affiliated group. Indeed, the statute provides detailed rules under which Section 163(j) must be applied separately at the partnership level, and not at the partner level using aggregate principles. That conceptual approach seems antithetical to any rule requiring aggregation of separate corporations. Even under old Section 163(j), where there was an express prompt in the statute, the affiliated group rules were viewed as highly complex; it is not warranted to attempt to duplicate those rules here.[94]

We note that one consequence of not treating an affiliated group as a single taxpayer under new Section 163(j), is that if such an affiliated group has a carryforward of disallowed interest under the old statute, it will need to allocate that disallowed interest expense among the consolidated groups, and/or separate U.S. corporations, that were components of that affiliated group. For simplicity, we recommend that such allocation be done using the existing rules in Proposed Regulation Section 1.163(j)-5(c)(2)(iii) for allocations to a member leaving an affiliated group. These rules generally allocate the impact of disallowance of a portion of the affiliated group's interest expense in a particular year among the members of the group, based on their relative amounts of interest paid or accrued to non-taxable related parties. We recognize that other approaches are possible (including allocation based on the relative amount of business assets of each group member), but do not believe it is necessary to create a new rule for this limited purpose.

## H. **Partnership Issues**

### 1. **Applying the Statute at the Partnership Level**

The starting point for applying Section 163(j) to a partnership and its partners, is to classify that partnership's interest income, interest expense, and other income and expense at the partnership level: "In the case of any partnership (i) this subsection shall be applied at the partnership level and any deduction for business interest expense shall be taken into account in determining the non-separately stated taxable income or loss of the partnership."[95]

Generally speaking, a partnership should be treated in the same manner as other non-corporate taxpayers for purposes of identifying its business interest income, its business interest

93 Legislative history to old Section 163(j) contemplated that, at least in some cases, the affiliated group definition might be broadened, where non-member entities had been inserted in a structure that had the effect of breaking apart what otherwise would be a single affiliated group. It was viewed as questionable, however, whether the general statutory grant of authority in Section 163(j)(7) to issue regulations under old Section 163(j) contemplated an approach as broad as that taken in the proposed regulations. See NYSBA Tax Section Report No. 701, Report on Proposed Regulations under Section 163(j), at 20 - 22 (Oct. 23, 1991).

94 See id.

95 Section 163(j)(4)(A)(i).

expense, and its ATI.[96] Thus, a partnership's interest income should not be treated as business interest income to the extent such interest income is treated as "investment income" under Section 163(d) (e.g., interest income from passive investment in debt securities). In addition, as discussed further below, a partnership can have interest expense that is not treated as business interest expense because such interest expense qualifies as "investment interest" under Section 163(d).

Once a partnership has computed its business interest income, business interest expense, and ATI, the partnership should first apply its business interest expense against its business interest income under Section 163(j)(1)(A).[97] The partnership will be entitled to a deduction for business interest expense to the extent such business interest expense does not exceed the partnership's business interest income. Next, any remaining business interest expense should be deducted to the extent such remaining business interest expense does not exceed 30% of the partnership's ATI.[98] Finally, to the extent the partnership has any business interest expense remaining after the deductions just described, the partnership will not be allowed a deduction for that excess interest; instead, the carryforward rules of Section 163(j)(4)(B) (discussed below) will apply to such excess. While the statute does not expressly mandate that a partnership's business interest expense will be applied in the manner described in the three preceding sentences, this is the result – for example, the provisions in Section 163(j)(4)(ii)(II) and Section 163(j)(4)(C) concerning "excess taxable income" make this clear.

### 2. Classification of a Partnership's Interest Expense As Business Interest or Investment Interest

In the case of a partnership whose partners are solely or mainly individuals, it would seem reasonable to allocate its interest expense between business interest expense and investment interest using the tracing principles of Treasury Regulation Section 1.163-8T, consistent with the approach recommended in Part III.D.2 above for interest expense incurred directly by individuals. In addition, tracing could be used to allocate interest expense to such a partnership's businesses that are exempt from Section 163(j), and those that are not.

This approach has significant practical advantages. Under both Section 163(d) and Section 469, current law provides that a determination is made at the partnership level whether interest expense of a partnership is attributable to a particular activity pursuant to Treasury Regulation Section 1.163-8T; and then each partner makes a determination, at the partner level, whether their distributive share of the interest expense attributable to that activity is investment interest or is an expense of a passive activity of the partner. If tracing principles are also used to determine whether interest expense of a partnership should be treated as business interest expense under Section 163(j), then the framework just described can be left unchanged. By comparison, if a partnership owned largely or entirely by individuals was required to use an asset-based or income-based allocation method to determine what portion of its interest expense was business interest expense, it would seem the partnership would need to apply consistent principles to allocate interest expense

[96] See Section 703(a), providing that a partnership generally computes its taxable income in the same manner as an individual.

[97] If the partnership has any floor plan financing interest, this interest should be separated out from the rest of its business interest expense, and deducted in full by the partnership under Section 163(b)(1)(C).

[98] Section 163(j)(1)(B).

to all its activities (including investment activities and passive activities). This in turn would have an impact on how all the partners applied Sections 163(d) and 469 to their shares of interest expense; they would use different rules than would apply for interest expense attributable to activities that a partner conducted directly.[99] In addition, when an individual made a contribution to, or received a distribution from, a partnership, rules would need to be developed in order to coordinate between the special allocation methodology that would apply at the partnership level and the traditional tracing principles applying to individual partners. Moreover, in interest of fairness, grandfathering rules would likely need to be provided in order to exclude pre-existing partnership debt, which had already been traced to a partnership activity under Treasury Regulation Section 1.163-8T prior to the Act, from the new allocation methodology. The complexity involved in implementing such an approach, would seem to outweigh any benefits it might provide.

However, as noted in Part III.D.2, it is questionable whether the same conclusion applies, where a partnership is owned solely or mainly by corporations. In such a case, it would seem preferable for the partnership to apply an asset-based or income-based approach to allocate its interest expense between investment interest and business interest expense, and between exempt and non-exempt businesses. Such an approach would limit opportunities for a corporation to use a partnership to manipulate how much interest expense could be allocated to exempt businesses.

Whatever method is generally used by a partnership to allocate its interest expense, we believe that at least one limited departure from traditional tracing principles is appropriate. If a partnership distributes borrowed funds, we believe that for purposes of applying Section 163(j) at the partnership level (and only for that purpose), the partnership's interest expense should be allocated among the partnership's exempt and non-exempt businesses, and its investments, based on the relative assets or income attributable to each business and its investment portfolio. None of the interest should be allocated based on the distributee partners' use of funds.

By comparison, Notice 89-35 applied the principles of Treasury Regulation Section 1.163-8T to a partnership borrowing that funded a distribution, to determine how to characterize the partnership’s interest expense under Section 163. In the case of the partner that received the distribution, the character of that partner’s interest expense generally depended on how the partner used the borrowed funds. If a partner was allocated interest expense on a share of the debt exceeding the amount (if any) of the borrowing proceeds distributed to him, then the partner was free to allocate the interest expense on that excess debt using any reasonable method, including by reference to the nature of the partnership’s expenses during the year.[100] It appears that a rule that is based on how a partner uses the proceeds of a debt-financed partnership distribution, does not

[99] As discussed in Part III.H.7 below, the exception in Section 163(j)(3) for small taxpayers (those with average annual gross receipts of not more than $25 million) appears to apply at the partnership level rather than the partner level. Thus, if a partnership had gross receipts of at least $25 million, its methodology for allocating interest expense among its activities would impact all of its partners, large and small.

[100] In addition to the general rules described in the text, Notice 89-35 provides an optional alternative. Under that alternative, a partnership can choose to determine the character of its interest expense on debt used to fund a distribution by allocating the debt to any one or more expenditures made by the partnership during the year of the distribution. However, the portion of the debt allocated in this manner cannot exceed the amount of the selected expenditures. Any excess portion of such debt, and the related interest expense, must be allocated under the general rules described in the text.

fit well with the statutory mandate in Section 163(j)(4) that Section 163(j) should be applied separately at the partnership level. A rule that allocates the interest expense on the debt based on the assets and activities of the partnership would more fully comport with this statutory requirement.[101]

### 3. Treatment of a Partnership's Business Interest Expense That Is Allowed as a Deduction

Section 163(j)(4)(A)(i) states that all business interest expense of a partnership for which a deduction is allowed under Section 163(j), is taken into account in the partnership's "non-separately stated income." Although "non-separately stated income" is not defined in Section 163(j), we understand it to mean the partnership's "taxable income or loss, exclusive of items requiring separate computation under other paragraphs of [Section 702(a)]."[102]

In general, an item of income or deduction that is included in the non-separately stated income of a partnership, as determined under Section 702(a)(8), loses its tax character in the hands of the partner to whom the item is allocated.[103] In the case of a partnership's deduction for business interest expense, it is clear such deduction loses its character as interest, when applying Section 163(j) at the partner level. As a result, such deduction is not subject to any additional Section 163(j) limit at the partner level – only the limit, if any, imposed at the partnership level applies.

However, while not entirely clear, it seems very unlikely that such interest loses its character for purposes of applying other provisions of the Code. The legislative history and structure of the statute suggest that the purpose of the rule is to help coordinate the Section 163(j) limit imposed at the partner and partnership levels; there is no suggestion the rule is intended to apply more broadly. Thus, for example, the source of a partner's share of the partnership's business interest expense deduction presumably is determined under Section 861 under the normal rules that apply to interest expense.

We recommend that Treasury and the IRS issue guidance confirming that partnership business interest expense that is deductible for Section 163(j) purposes and taken into account in determining the partnership's "non-separately stated income" nevertheless retains its character for all other Code purposes.

[101] For avoidance of doubt, this Report is not suggesting that Treasury undertake a broader re-examination of the guidance provided in Notice 89-35, for any purpose other than the application of Section 163(j) at the partnership level.

[102] Section 702(a)(8). See also Section 6225(a)(2)(A), referring to "non-separately stated income or….non-separately stated loss (whichever is appropriate) under section 702(a)(8).").

[103] See Rev. Rul. 71-278 (partnership is subject to Indiana gross receipts tax; partnership is entitled to a deduction for this tax under Section 164 when computing its taxable income and its partners' distributive shares of such taxable income; partnership's partners do not get a separate Section 164 deduction, and they are not precluded from choosing the standard deduction instead of itemized deductions); McKee, Nelson & Whitmire, Federal Taxation of Partnerships & Partners, ¶ 9.01[3][a] ("Partnership items that are not separately stated are lumped together in an undifferentiated residual hotchpot that constitutes partnership Section 702(a)(8) "bottom-line" taxable income or loss.").

Because, under our recommendation, partnership business interest expense would retain its character as interest at the partner level other than for purposes of applying Section 163(j), it could be asked whether a non-corporate partner's share of such interest expense could be subject to limitation under Section 163(d). We believe this result is not intended; rather, it would seem that under Section 702 principles a partner's share of interest expense allocable to a business of the partnership should retain that character in the partner's hands.[104]

### 4. Rules Relating to a Partnership's Business Interest Income

Section 163(j) does not provide that a partnership's business interest income is treated as part of its non-separately stated income. The statute does not contain any express rule regarding how the partnership's business interest income should be treated in the hands of its partners.

> **Example 6**. A owns 10% of partnership (PS) and B owns the remaining 90%. In 2018, PS has $1,000 of business interest income, $990 of business interest expense, and no other items of income or deduction. In the same year, A has 100 of business interest expense on debt that A has incurred outside PS, and $0 of ATI from sources other than PS.

The statute does not provide guidance about how A should be treated in Example 6 – in particular, whether A is allowed under Section 163(j) to claim a deduction for A's 100 of business interest expense on partner-level debt, as a result of the allocation of 100 of PS's business interest income to A.

In general, if a partnership has business interest income, it appears that under Section 702, a partner's distributive share of that income would retain its character as such; and, as a result, the partner would be able to increase the partner's Section 163(j) limitation by its share of that interest income, pursuant to Section 163(j)(1)(A).

However, in a case like Example 6, it seems logical, and consistent with the statutory scheme, to provide in administrative guidance that to the extent PS's business interest income has been taken into account in determining the amount of PS's business interest expense deduction allowed under Section 163(j)(1)(A), such business interest income cannot then be taken into account a second time, in computing the limit under Section 163(j) on A's deduction for business interest expense incurred by A on partner-level debt. Such a rule would be a reasonable interpretation of the statutory requirement that Section 163(j) must be applied "at the partnership level" (i.e., 990 of PS's business interest income should be taken into account at the PS level only, in computing PS's interest deduction limit under Section 163(j)(1)(A) – and not at the partner level). This result would also would be conceptually similar to the statute's express rules to ensure that, once a dollar of a partnership's ATI is used to support a deduction of the partnership's business interest expense under Section 163(j)(1)(B), that same dollar of ATI cannot then be used a second time, to support a deduction of a partner's business interest expense on partner-level debt.

[104] This result also comports with legislative history that suggests the same dollar of interest expense is not meant to be subject to limitation under both Section 163(j) and Section 163(d). See H.R. Rep. 115-409, at page 248 note 444; H.R. Rep. 115-466, at 386 n. 688.

Under the guidance proposed above, A would not be entitled to use the whole $100 of business interest income allocated to A, to support a deduction under Section 163(j)(1)(A) of A's partner-level business interest expense. Instead, A would be entitled to use only $1 out of the $100 of PS's business interest income allocated to A, to deduct A's partner-level interest expense in 2018.

As a mechanical matter, a relatively straightforward way to achieve the desired results would be to require that a partnership's business interest income must be included in the partnership's non-separately stated income, to the extent such business interest income does not exceed the partnership's business interest expense for the year.

By comparison, in the absence of the proposed guidance, A would appear to have a compelling argument that the business interest income allocated to A supports a deduction of the full $100 of A's business interest expense under Section 163(j)(1)(A). In that case, the result would be that PS's $100 of business interest income allocated to A would have supported $200 of deductions of business interest expense – a $100 deduction at the PS level, allocated to A; plus a second $100 deduction at the partner level for A. It would be difficult to justify such a result as a policy matter.

### 5. Business Interest Expense Disallowed at the Partnership Level: Carryforward Rules

#### a. In General

A partnership's business interest expense for which a deduction is not allowed at the partnership level under Section 163(j) is allocated to the partners per Section 163(j)(4)(B) as "excess business interest." Any excess business interest of a partner may not be deducted until the partner is allocated "excess taxable income" ("**ETI**") from the partnership in futures years. When a partner is allocated ETI, it treats an equivalent amount of excess business interest as business interest expense paid or accrued by the partner in the year of the ETI allocation.

It seems clear that ETI is intended to be defined as that portion of a partnership's ATI for a given year that is not needed to support the partnership's deduction under Section 163(j)(1)(B) for business interest expense in that year.

> **Example 7**. C owns 10% of PS. In Year 1, PS incurs $1,000 of business interest expense that it is not able to deduct by reason of the partnership-level limitation under Section 163(j). PS allocates 10 percent, or $100, of that amount to C as excess business interest expense under Section 163(j)(4)(B)(ii).
>
> In Year 2, PS has 1,500 of ATI and 150 of business interest expense. PS allocates 150 of ATI and 15 of business interest expense to C in Year 2.

Under Section 163(j)(1)(B) and (j)(4)(i), PS uses 500 of its ATI to support PS's deduction of 150 of business interest expense for Year 2. This leaves PS with 1,000 of ETI. Because PS allocates 10% (or 150) of its ATI to C, this means 10% (or 100) of PS's ETI is allocated to C. Logically, it is appropriate for C to be able to use the 100 of ETI to deduct only 30 of its carryforward of interest expense from Year 1. That result would put C in the same position as it would have been in had the 100 of business interest expense in Year 1 been incurred by PS and allocated to C in Year 2 – rather than being carried forward by C from Year 1.

However, Section 163(j)(4)(B)(ii) indicates that C is entitled to deduct (at least to the extent it has excess available ATI) its carried-forward 100 of interest expense "to the extent of such excess taxable income," i.e., to the extent of the ETI that PS allocates to C in Year 2. The relevant provision reads, in full:

> If a partner is allocated any excess business interest expense from a partnership under clause (i) [requiring the allocation among partners of business interest expense for which a deduction is not allowed for a taxable year] for any taxable year—
>
> (I) such excess business interest expense shall be treated as business interest expense paid or accrued by the partner in the next succeeding taxable year in which the partner is allocated excess taxable income from such partnership, but only to the extent of such excess taxable income, and
>
> (II) any portion of such excess business interest expense remaining after the application of subclause (I) shall, subject to the limitations of subclause (I), be treated as business interest expense paid or accrued in succeeding taxable years.

Under this provision, because C recognizes 100 of ETI in Year 2, all 100 of its carryforward is treated as business interest expense "paid or accrued by" C in Year 2.

We believe that the reference to "paid or accrued" should not be interpreted as providing that C is automatically entitled to a deduction under Section 163(a) for 100 of interest paid or accrued in Year 2, without any limitation under Section 163(j) applying. Instead, this provision should be interpreted to treat such business interest expense in a manner similar to any other business interest expense paid or accrued by C in Year 2. That is, because that business interest expense is treated as having been "paid or accrued by C" in Year 2, it should be subject to the same limitations under Section 163(j)(1) as other business interest expense incurred by C.

Under this approach, pursuant to Section 163(j)(4)(A)(ii)(II), C's 100 of ETI is added to C's ATI, thus supporting a deduction of 30 of the business interest expense C is deemed to have accrued in Year 2. The remaining 70 of business interest expense is treated like any other business interest expense incurred by C in Year 2; that is, C is entitled to deduct it to the extent C has sufficient ATI and/or business interest income, and C is required to carry forward to future years any portion of that business interest expense that it cannot deduct. Thus, because that business interest expense is treated as having been "paid or accrued by C" in Year 2, it ceases to be a carryforward of excess business interest that can be used only against C's share of PS's ETI pursuant to Section 163(j)(4)(B)(ii).

We recommend that guidance make clear that any excess business interest expense of a partner "freed up" as a result of an allocation of ETI must be treated like any other business interest expense of the partner paid or accrued in the same year (and thus potentially subject to limitation at the partner level). In the absence of such guidance, we believe taxpayers might argue that the statutory language entitles a partner to an immediate deduction for the full amount of business interest expense that has been "freed up" and is treated as paid or accrued as a result of an allocation of ETI.

Even if such guidance is provided, however, Section 163(j)(4)(B)(ii) will lead to the apparently inappropriate result of each dollar of ETI allowing one dollar of excess business expense to be deducted by a partner (subject to such partner having sufficient excess ATI from other sources), even though one dollar of ATI recognized by a partnership only permits the deductibility of thirty cents of business interest expense. While we recommend that this issue be addressed, it is unclear that regulatory authority exists for preventing this result, in which case a technical correction would be appropriate.

In addition, guidance should provide a clear ordering rule under which a partner's share of ETI, to the extent such share exceeds the amount the partner needs in order to be entitled to deduct carryforwards of disallowed business interest expense, is added to the partner's ATI. Section 163(j)(4)(A)(ii)(II) indicates fairly clearly this result is intended. However, the last sentence of Section 163(j)(4)(B)(ii) may cause some confusion: the sentence states that “For purposes of applying this paragraph [i.e., Section 163(j)(4), which applies Section 163 in the partnership context], excess taxable income allocated to a partner from a partnership for any taxable year shall not be taken into account under paragraph ***(1)(A)*** with respect to any business interest expense other than excess business interest expense from the partnership until all such excess business interest expense for such taxable year and all preceding taxable years has been treated as paid or accrued” (emphasis added). Treasury and the IRS should clarify that such ETI in fact will be taken into account by the partner under Section 163(j)(1)(B).

### b. Use of a Partner's Share of the Partnership's Business Interest Income to Absorb a Carryforward

We recommend providing guidance under which, if a partnership has business interest income in a particular year that exceeds the partnership’s business interest expense for the year, then a partner will be permitted to use its share of that excess business interest income to absorb the partner's carryforwards of excess business interest from prior years.

> **Example 8**. D owns 10% of PS. In Year 1, PS has $1,000 of ATI and $1,000 of business interest expense, and 10% of this ATI and business interest expense is allocated to D. In Year 2, PS has $1,000 of business interest income and $300 of business interest expense, and again 10% of these items are allocated to D.

In Example 8, under Section 163(j)(4)(i)(A), PS is entitled to deduct $300 of its $1,000 of business interest expense in Year 1. Under Section 163(j)(4)(ii)(B), $70 out of the remaining $700 of interest is allocated to D and treated as excess business interest expense, which is carried forward to Year 2. Section 163(j)(4)(B)(ii) allows D to apply the $70 against D's share of any ETI that PS recognizes in future years. In Example 8, PS has no ETI in Year 2; but, it would seem logical, and justified as a policy matter, to allow D to apply the $70 of excess business interest expense against D's share of PS’s business interest income for Year 2, as reduced by PS's business interest expense for Year 2. Under this approach, PS’s business interest income of $1,000 for Year 2, net of PS’s $300 of business interest expense for the year, leaves $700 of excess business interest income, of which $70 is allocable to D; D thus would be entitled to deduct the entire $70 of disallowed interest in Year 2.

While the statute sets forth a detailed formula for the computation of a partnership's ETI, and specific rules prescribing how a partner is allowed to use its distributive share of ETI to absorb carryforwards of excess business interest expense, it does not incorporate "excess" business interest income into the formula for ETI. The statute also does not, however, expressly prohibit guidance permitting the use of excess business interest income to absorb carryforwards; and such guidance seems consistent with legislative intent. Section 163(j)'s legislative history indicates that the carryforward rules in Section 163(j) are intended to deal with the fact that, due to due to business cycles or other factors, a business might sometimes incur an amount of interest expense that is large, relative to the business' income.[105] In the partnership context, Congress dealt with the most obvious manifestation of this issue when it adopted rules allowing a partner to use the partner's share of ETI to claim deductions for excess business interest expense. Congress did not adopt specific rules for a partnership whose principal income from its trade or business in fact happens to be interest, as with a lending business, rather than (say) income from the sale of inventory or provision of personal services. Indeed, there may not be a large number of partnerships that fit this description, relative to the total number of partnerships in the United States.[106] However, the fact that Congress focused on providing relief for the most common cases that warranted it, logically should not be interpreted as precluding Treasury and the IRS from extending the principles of the statute to equally appropriate, if less mainstream, cases involving a partnership that has excess business income that happens to be interest, rather than ATI.

#### 6. Cases Where a Partnership Has Interest Income/Expense that is Not Treated as Business Interest Income/Expense at the Partnership Level, Or Has Other Items That Are Treated as Investment Income at the Partnership Level

A partnership can have interest income and expense that is not treated as business interest income or business interest expense at the partnership level.

> **Example 9**. E, a U.S. corporation, and F, an individual, each own 50% of PS. PS has passive investments in securities, which it finances partially by incurring debt. In 2018, PS incurs 100 of interest expense on the debt, which it allocates pro rata to E and F.

PS’s 100 of interest expense would qualify in Example 9 as investment interest under Section 163(d), if PS were an individual. Thus, such interest is not business interest expense, in PS’s hands.

105 See H.R. Rep. 115-409, at 248 (Nov. 9, 2017).

106 IRS data indicates that in 2011 through 2014, partnerships in the finance and insurance sector represented about 9% of all partnerships filing returns. IRS data also indicates that in 2011 through 2013, S corporations in that sector represented about 4% of S corporations filing returns. See IRS, Total Assets, Trade or Business Income and Deductions, Portfolio Income, Rental Income and Total Net Income; IRS, Returns of Active Corporations, Form 1120S - Table 7).

In E's hands, however, that interest should be treated as business interest expense.[107] Section 163(j)(4) does not require that such interest be included in PS's non-separately stated income. Instead, under Section 702(a)(7) and Section 702(b), the interest expense ought to be treated in E's hands in the same manner as interest on debt incurred directly by E to finance direct investments in securities by E. Such interest expense of E would be business interest expense that is subject to limitation under Section 163(j).

By comparison, if Section 163(j) did not apply to the interest expense allocated to E, that would create an opportunity for E to avoid Section 163(j) by borrowing through a partnership, rather than borrowing directly. That result appears to be contrary to the intent of the statute: the statute's drafters clearly placed emphasis on preventing the use of partnerships to avoid the Section 163(j) limit.

An approach similar to the one just described should be taken in the case of F. Thus, similar to the analysis in E's case, the 50 of interest expense allocated to F should be treated as incurred by F to finance an investment in securities. Under Section 163(d), that interest should be treated as investment interest.

In Example 9, if PS earns interest income on its securities then it seems that the same approach as described above for interest expense, should apply to that income. Thus, E's share of PS's interest income should be treated as business interest income, in E's hands. F's share of such interest should be treated as investment income as defined in Section 163(d), in F's hands.

In addition, a partnership may have items other than interest income which are treated, at the partnership level, as investment income that is not part of the partnership's ATI. For example, it would appear that dividends, Subpart F income and qualified electing fund inclusions that are included in income by a partnership should be treated as investment income at the partnership level that does not enter into its ATI.[108] Similarly, the partnership's ATI should not include any dividends received deduction claimed by a corporate partner, as such items are not partnership-level deductions but, instead, are tied to the corporate status of the partner.[109]

[107] See H.R. Rep. 115-409, at 248 note 444 (Nov. 9, 2017) ("Section 163(d) applies in the case of a taxpayer other than a corporation. Thus, a corporation has neither investment interest nor investment income within the meaning of section 163(d). Thus, interest income and interest expense of a corporation is properly allocable to a trade or business, unless such trade or business is otherwise explicitly excluded from the application of the provision.").

[108] See Section 163(d)(5)(A)(i), 469(e)(1)(A)(i)(I); cf. Treasury Regulation Section 1.1411-10(c)(5), (g) (for purposes of calculating net investment income, a taxpayer can elect whether to compute his Section 163(d) investment interest limitation based on different timing for inclusion of Subpart F income and QEF amounts, than applies for regular income tax purposes).

The Tax Section plans to make a separate submission on the GILTI rules that will address, among other issues, the application of Sections 250 and 951A to partners and partnerships.

[109] If a corporate partner borrows at the partner level to finance an investment in a partnership that owns stock, the result under Section 163(j) will be different (generally less favorable) than if the borrowing had been at the partnership level. The corporate partner's ATI will take into account both its share of the dividend income and the dividends received deduction, whereas the partnership's ATI would not take into account the dividends received deduction. It could be asked whether that difference is justifiable as a policy matter. On balance, we believe it is. The difference in treatment is a direct consequence of Congress' decision in Section 163(j)(4) that

Guidance confirming the above results would be useful.

### 7. Application of Exemptions/Exclusions from Section 163(j)

#### a. Election for a Real Property Trade or Business/Electing Farming Business (Section 163(j)(7)(B) & (C))

Guidance should provide that, where a partnership conducts a real estate business of a type that qualifies for the election under Section 163(j)(7)(B), or a farming business that qualifies for the election under Section 163(j)(7)(C), the election should be made at the partnership level, rather than at the partner level.

In general, most elections affecting the treatment of partnership items are required to be made by the partnership.[110] In addition, Section 163(j)(4) specifically provides that Section 163(j) must be applied at the partnership level. It would be consistent with Section 163(j)(4), and simple as a mechanical matter, to have a partnership make the elections under Sections 163(j)(7)(B) and (C) with respect to a business it conducts. By comparison, if it is desired to give each partner the option to elect out, with respect to that partner's distributive share of income and interest expense from a partnership's real estate or farming business, the necessary mechanics for the election would be significantly more complicated. Among other things, a partner that elected out would need to take into account that partner's distributive share of depreciation deductions using a slower depreciation schedule, than a partner who did not elect out would use. In addition, it would seem hard to reconcile a partner-by-partner approach with the basic principle of applying Section 163(j) at the partnership level.

#### b. Impact on the Partners Where a Partnership Conducts an Exempt Business

If a partnership conducts an electing real property or farming trade or business, or a utilities business, then the partnership's interest expense allocable to that business, as well as all the other items of income and deduction that are allocable to such business, should retain their character in the hands of the partners to whom such items are allocated. In other words, under Section 702(a), such items should be treated as received/incurred by a partner in the conduct of a business that is excluded from Section 163(j), and so should not enter into the partner's ATI, business interest income or business interest expense.

> **Example 10**. PS conducts a business of renting real estate to third parties, for which PS makes an election under Section 163(j)(7)(B), as well as a non-exempt business. In 2018, G, a partner in PS, is allocated 3 of income from PS's real estate business and 7 of ETI from the non-exempt business. G has business interest expense allocable (under the allocation principles described in Part III.D above) to non-exempt activities unrelated to its investment in PS.

it is appropriate to apply the Section 163(j) limit at the partnership level, rather than adopting an aggregate approach to partnerships.

110 See Section 703(b).

On these facts, G should add its 7 of ETI to its ATI, thus increasing its Section 163(j)(1)(B) limit for purposes of deducting its business interest expense unrelated to PS. G's 3 of income from PS's real estate business, however, should not be included in G's ATI or increase G's Section 163(j) limitation.

In a case where a partner incurs debt which is allocable to its interest in a partnership that conducts an exempt business, guidance should provide that interest on the partner-level debt is exempt from Section 163(j).

> **Example 11**. PS conducts a business of renting real estate to third parties as PS's sole activity and makes an election under Section 163(j)(7)(B). H, a partner in PS, borrows and its interest expense is allocable (under the allocation principles described in Part III.D above) to H's interest in PS.

In Example 11, it is appropriate for H's interest expense to be exempted from Section 163(j), because the interest is allocable entirely to an asset (H’s interest in PS) that generates income from an electing real property trade or business. Such an approach is conceptually similar to the approach taken in the statute to PS’s ETI, which a partner can use to support a deduction of partner-level interest expense.

If PS in Example 11 conducts both a real estate business, and a trade or business that is not excluded from the scope of Section 163(j) (similar to Example 10), then the treatment described above would apply only for the portion of H’s partner-level interest expense that is properly allocable to the real estate rental business.

#### c. Small Businesses (Section 163(j)(3))

> **Example 12**. PS conducts a business and has business interest expense. However, PS has average annual gross receipts of less than $25 million, as determined for purposes of Section 448(c). One or more of PS’s partners has average annual gross receipts of over $25 million.

In Example 12, it seems clear that, at the partnership level, Section 163(j) does not apply to limit PS’s interest deductions, because PS qualifies for the small business exception in Section 163(j)(3). However, a question remains as to whether, at the partner level, each partner should separately determine whether that partner is below the $25 million threshold in Section 163(j)(3).

The general principle that Section 163(j) will be applied at the partnership level indicates that, if PS is exempt by reason of the small business exception in Section 163(j)(3), then the interest expense of PS allocated to its partners should remain exempt from Section 163(j) in their hands – rather than being re-tested at the partner level. In addition, Section 163(j)(3) incorporates the $25 million threshold from Section 448(c), which by its terms clearly applies that threshold at the partnership level to allow the partnership to use the cash method of accounting, notwithstanding that the partnership may have large, accrual-method partners.

Such a result is permitted under Section 448(c) because it contains aggregation rules, pursuant to which the $25 million threshold is applied taking into account the gross receipts of all entities related under Sections 52(a) or (b) or 414(m) or (o) (broadly, all entities in a group connected to one another through greater than 50% ownership, as well as entities that are functionally connected by conducting integrated activities). The effect of these rules is to limit opportunities for gamesmanship, by forcing a partner that has a significant relationship to a partnership to add the partner's (and its affiliates') gross receipts to those of the partnership. These aggregation rules are incorporated by reference in Section 163(j)(3), with a similar effect.

Arguably, there is not a compelling reason for a partner with a large amount of gross receipts to be able to claim deductions for its share of business interest expense incurred by small partnerships with which the partner is not closely related, without any Section 163(j) limitation on those deductions. However, on balance, that result seems to provide little opportunity for abuse, and it appears consistent with the statutory scheme. We recommend that Treasury and the IRS confirm that result is correct.

#### 8. **Special Allocations**

Guidance should expressly confirm that special allocations by a partnership of items of ATI, ETI, business interest income and/or business interest expense do not affect the determination of the Section 163(j) limitation at the partnership level.

> **<u>Example 13</u>**. I and J own all of the interests of PS. In 2018, PS has no business interest income, 300 of ATI, and 60 of business interest expense. PS allocates all items comprising its ATI solely to I and its business interest expense solely to J. Assume these allocations are respected under Section 704(b).

In Example 13, the Section 163(j) limitation is applied at the partnership level, and PS's limitation is 60 with the result that PS's business interest expense should not be subject to limitation. We note that because PS's business interest expense (but not its ATI) is allocated to J, applying the limitation at the partnership level can result in a better outcome for J (i.e., full deductibility of the business interest expense allocated from PS) than had the limitation been applied at the partner level. Nevertheless, we believe that it is consistent with the plain language of the statute to apply the limitation at the partnership level only (and not again at the partner level where special allocations have effect).

Once the limitation has been applied at the partnership level, however, it is important that regulations, consistent with the statutory provision, make clear that, in then applying Section 163(j) at the partner level, the partners should take into account neither (i) their shares of the partnership's business interest expense that is deductible after application of the limitation at the partnership level, nor (ii) their share of the partnership's ATI that was used to allow its business interest expense to be deductible (and thus not included in ETI) (collectively, "**Post-Calculation Items**"). Thus, in Example 13, 200 of the 300 of ATI allocated to I and all 60 of business interest expense allocated to J would be considered Post-Calculation Items. As a result, I would be unable to use 200 of the ATI it is specially allocated to calculate its own Section 163(j) limitation. Correspondingly, the 60 of business interest expense allocated to J would be subject to no further limitation regardless of the amount of ATI and business interest income otherwise recognized by J. The remaining 100 of ATI allocated to I for 2018 would constitute ETI (and not a Post-Calculation Item), and thus would be potentially usable by I in determining its own Section 163(j) limitation.

A more challenging fact pattern would be present where a partnership specially allocates deductions that are included in its ATI in a manner that differs from how it allocates items of income that are included in its ATI.

> **<u>Example 14</u>**. I, J and K own all of the interests of PS. In 2018, PS has no business interest income, 300 of ATI, and 60 of business interest expense. PS's ATI consists of 500 of gross income and 200 of gross deductions. PS allocates that gross income solely to I, those gross deductions solely to J, and its business interest expense solely to K. Assume these allocations are respected under Section 704(b).

In Example 14, like in Example 13, because the Section 163(j) limitation is applied at the partnership level, PS's business interest expense should be fully deductible. Thus, the 60 of business interest expense allocated to K should be considered a Post-Calculation Item and, thus, not subject to further limitation on K's return.

In Example 14, PS will also have 100 of ETI. Because, however, PS's items of income and deduction comprising its ATI will be allocated to different partners, it is not clear how the gross items of income and deduction allocated to I and J, respectively, should be treated. We believe the simplest approach would be to (i) treat gross income included in ATI ("**ATI Income**") allocated to a partner as ETI on a proportionate basis based on the proportion of the partnership's ATI Income allocated to each partner (with any remaining ATI Income allocated to the partner treated as a Post-Calculation Item) and (ii) treat all deductions included in ATI ("**ATI Deductions**") allocated to a partner as Post-Calculation Items. Under this approach, because PS has 100 of ETI, and all 500 of PS's ATI Income was allocated to I, 100 of the 500 of ATI Income allocated to I will be ETI, with the remaining 400 of ATI income allocated to I, and all 200 of ATI Deductions allocated to J, being treated as Post-Calculation Items.

Our recommended approach to cases like Examples 13 and 14 comports with the final sentence of Section 163(j)(4)(A), which provides that a partner's distributive share of ETI must be determined in the same manner as the partner's share of the partnership's non-separately stated income or loss. Under our approach, a proportionate part of the ATI Income allocated to each partner (whether as part of an allocation of net ATI, as in Example 13, or through an allocation of gross income items, as in Example 14) is treated as ETI. The remaining proportionate part of the ATI Income allocated to each partner (i.e., the part that is a Post-Calculation Item) loses its character in the partner's hands as ATI, and so cannot be used by the partner to support deductions of partner-level business interest expense. This proportionate allocation is, in our view, contemplated by the statute.

It would be appropriate to apply a similar approach to allocations of a partnership's excess business interest.

> **<u>Example 15</u>**. Same facts as Example 14, except that in 2018, PS has 100 of business interest expense.

In Example 15, PS's Section 163(j) limitation is 90 (90 = 0 business interest income + {30% x 300 of ATI}). Thus, PS can deduct only 90 of its 100 of business interest expense, and has 10 of excess business interest. Under our approach, each dollar of business interest expense that is allocated to a partner, must consist of a proportionate part of (i) business interest expense for which the partnership was allowed a deduction under Section 163(j) (a Post-Calculation Item), and (ii) excess business interest. Thus, since PS allocated all of its business interest expense to K in Example 15, the entire 10 of excess business interest must be allocated to K.

In this connection, we note that Section 163(j)(4)(B)(ii)(II) provides that excess business interest must be allocated to each partner in the same manner as the non-separately stated taxable income or loss of the partnership. We believe our approach, in which excess business interest is allocated among the partners in the same proportions as business interest expense for which the partnership is allowed a deduction, meets this requirement.

### 9. **Section 704(c) Allocations**

Where a partnership owns Section 704(c) property, it is required to allocate items with respect to that property so as to take into account any variation between the property's adjusted tax basis and its fair market value at the time of contribution (or revaluation) using a reasonable method that is consistent with the purposes of Section 704(c). The three methods that are deemed to be generally reasonable for purposes of making those allocations (the traditional method, the traditional method with curative allocations, and the remedial method) affect how partnership items are allocated among its partners and, in the case of the remedial method, may cause offsetting items of income and loss to be created and allocated among the partners.

None of the Section 704(c) methods affects the net amount of income or loss recognized by a partnership. As a result, and consistent with our discussion of special allocations above, we believe that the Section 163(j) limitation should be applied at the partnership level without regard to the manner in which partnership items are allocated among its partners under Section 704(c). While disregarding the allocation of items under Section 704(c) can result in a different amount of interest disallowance under Section 163(j) than had the limitation been applied at the partner level, we believe that it is consistent with the plain language of the statute to apply the limitation at the partnership level only by ignoring the effect of Section 704(c) on the partnership's allocations.

### 10. **Section 743 Allocations**

A partner's items of depreciation or amortization (or adjustment to gain or loss on sale of an asset) that results from a Section 743(b) basis adjustment appears similar, in some ways, to a special allocation. As a technical matter, basis adjustments under Section 743(b) increase or decrease the basis of partnership property. Such adjustments, however, do not enter into the partnership's taxable income or loss as computed under Section 703; instead, such adjustments affect only the adjusted partner (and have no effect on the partnership's other partners).[111] In other words, notwithstanding the fact that the basis adjustment occurs at the partnership level, the existing regulatory framework makes clear that such basis has no effect on the calculation of the partnership's taxable income. Accordingly, we recommend that regulations clarify that (i) Section 743(b) adjustments of a partnership's partners are not taken into account in applying the Section 163(j) limitation to the business interest expense of the partnership and (ii) each partner's Section 743(b) adjustments are taken into account as items derived directly by the partner in determining

[111] See Treasury Regulation Section 1.743-1(j).

its own Section 163(j) limitation. If a rule was adopted requiring that a partner's Section 743(b) adjustment be included in the computation of a partnership's ATI for purposes of applying Section 163(j) at the partnership level, then a particular partner's Section 743(b) items could impact the deductibility of partnership interest by other partners. Such a result seems inconsistent with the basic approach taken in the Section 743(b) regulations. Instead, a Section 743(b) adjustment is appropriately taken into account at the partner (rather than partnership level) in determining ATI.

Our recommended approach creates potentially significant differences between a transaction in which a partnership purchases assets (where depreciation and amortization deductions generated by the stepped-up basis of those assets will, until the end of 2021, enter into the partnership's ATI), and a transaction structured as a purchase of partnership interests (where depreciation and amortization deductions generated by the Section 743 basis adjustment will not enter into the partnership's ATI). However, we believe these differences are unavoidable consequences of the decision to exclude a partner's Section 743(b) items from the partnership's taxable income.

### I. International Issues

#### 1. Outbound Investment

We recommend that guidance be issued discussing how (if at all) Section 163(j) applies to business interest expense of a controlled foreign corporation ("**CFC**") or passive foreign investment company ("**PFIC**").

We believe the analysis for a U.S. investor in a PFIC (specifically, a PFIC for which the investor elects qualified electing fund status) is relatively straightforward. Under Section 1293(a), such an investor's annual income inclusion is limited to the investor's pro rata share of the PFIC's E&P for the year. Thus, the key point for a U.S. investor is the impact on the calculation of the PFIC's E&P of a disallowance of business interest expense under Section 163(j). As explained in Part III.F above, such a disallowance should not cause a delay in time the interest expense is taken into account in computing E&P.[112]

The picture for a U.S. shareholder of a CFC is more complicated. It appears that the U.S. shareholder's computation of its Subpart F income will be impacted by application of Section 163(j) to the CFC's interest expense, unless guidance provides relief from that result. However, it is not entirely clear that it makes sense for Section 163(j) to apply to a CFC's interest expense, for purposes of computing Subpart F income. In addition, assuming Section 163(j) should have an impact on the computation of Subpart F income, guidance could be developed in order to clarify exactly how big that impact will be.

As an initial question, it can be asked whether, as a policy matter, Section 163(j) should apply at all to interest expense of a CFC. On one hand, if Section 163(j) did not apply to CFCs, then it would be possible for U.S. taxpayers to conduct leveraged activities through a CFC and get

[112] We note that Congress has on occasion specifically instructed that departures from the normal E&P rules be made, when computing a PFIC's E&P. See Section 1293(e)(3). It has not done so in the case of new Section 163(j).

the effect of a full interest deduction. However, the strength of this concern appears to be diluted, in cases where a CFC earns not only Subpart F income, but also material amounts of income that is not subject to Subpart F. This will particularly be the case if it is difficult to predict of the mix of Subpart F and non-Subpart F income from year to year. In addition, to the extent that a CFC's business interest expense is disallowed and then, in future years, a U.S. shareholder's percentage ownership goes below 10%, or the CFC does not have Subpart F income, the U.S. shareholder may have a limited, or no, ability to benefit from a carryforward of the interest by the CFC under Section 163(j)(2).

In the proposed regulations under old Section 163(j), Treasury and the IRS decided not to apply the statutory limitation to the interest expense of any foreign corporation (including a CFC) that did not conduct a U.S. trade or business. The Preamble stated that "The disallowance rules do not apply if the payor corporation is either an S corporation or a foreign corporation (except as provided under 1.163(j)-8, related to foreign corporations with effectively connected income)."[113] Consistent with that statement, the proposed rules for a foreign corporation with a U.S. trade or business applied only with respect to the corporation's income and expense attributable to that trade or business; and the proposed affiliated group rule referenced above applied only to U.S. corporations that were in an affiliated relationship (foreign corporations were not treated as members of the affiliated group).[114]

However, in the absence of similar guidance under new Section 163(j), it appears the provision would apply to CFCs. Pursuant to Section 954(b)(5), when a CFC has foreign base company income ("**FBCI**"), that income is reduced by "deductions…properly allocable to such income" (including interest expense) for purposes of computing the amount of a U.S. shareholder's income inclusion under Section 951.[115] For this purpose, a CFC computes the amounts of its items of income and deduction under largely the same U.S. federal income tax principles as apply to determine the taxable income of a U.S. corporation, including any applicable limits under the Code on the deductibility of particular expenses.[116] Thus, a CFC would compute its interest deduction for purposes of Section 954(b)(5) taking into account the Section 163(j) limit.

Under a straightforward reading of the rules, that limit would be computed by reference to a CFC's ATI from all its activities, other than exempt businesses, and all of its interest expense. Part of that deduction then would be apportioned to the CFC's FBCI, apparently by reference to the tax basis of the assets used to generate that income as compared to the assets of its business.[117]

113 See Fed. Reg. Vol. 56, No. 117, p. 27907, at 27908 (June 18, 1991).

114 Proposed Regulation Section 1.163(j)-5(a)(3).

115 A CFC's interest expense is allocated to foreign base company income and other income using an asset-based allocation method. See Treasury Regulation Sections 1.861-9T(f)(3), 1.954-1(c)(1)(i). Historically, allocation on the basis of gross income was permitted as an alternative to allocation based on assets. Treasury Regulation Section 1.861-9T(j).

116 See Treasury Regulation Sections 1.952-2(b), (c).

117 Section 864(e)(2) (as amended by the Act) requires interest expense to be allocated using the tax basis of a taxpayer's assets, for purposes of the sourcing rules (and, presumably, rules that incorporate the sourcing rules by reference, such as the Section 954(b)(5) regulations).

It would appear reasonable for guidance to reverse the order of operations here, for purposes of computing a CFC's FBCI (and other Subpart F income): that is, a CFC's interest expense first would be allocated between its FBCI and other Subpart F income on one hand, and its non-Subpart F income on the other; and the CFC then would apply Section 163(j) to its FBCI or other Subpart F income and the interest expense allocated to such income. Such an approach would avoid seemingly distortive results, in which the amount of a CFC's non-Subpart F income or loss impacts its ATI and, thus, the amount of its Section 163(j) limitation. (We have recommended a conceptually similar approach in Part III.I.2 below regarding application of Section 163(j) to a foreign corporation with a U.S. branch.)

In a related point, if business interest expense allocated to a CFC's Subpart F income is disallowed under Section 163(j), then that interest expense should automatically be carried forward and allocated against Subpart F income in future years (rather than first being allocated in those years between Subpart F income, and other income included in ATI).

The Tax Section intends to submit separate comments on the provisions of the Act that deal with GILTI. This Report thus does not address questions about how Section 163(j) should be applied to a CFC for purposes of applying the GILTI rules.

### 2. **Inbound Investment**

We recommend that Treasury and the IRS issue guidance confirming that new Section 163(j) applies to a foreign corporation with a U.S. trade or business in a manner similar to the methodology adopted in the proposed regulations under old Section 163(j). That is, when applying Section 163(j) in order to determine the corporation's liability for corporate income and branch profits taxes, only business interest income and ATI that are included in the corporation's effectively connected taxable income and business interest expense that is allocated to effectively connected income pursuant to the regulations under Sections 882 and 884 would be taken into account. [118] This approach properly focuses on the economic activity a foreign corporation has in the United States, for purposes of computing the applicable Section 163(j) limitation.[119]

If a foreign corporation's interest expense allocable to its effectively connected income is disallowed under Section 163(j) and carried forward to a future year, it seems to us that the carryforward should automatically be treated in such future year as interest expense properly allocable to the corporation's effectively connected income for such year. That is, the corporation

We note that it sometimes may be difficult for a U.S. shareholder that owns a non-controlling stake in a CFC to obtain the detailed information about tax basis that will be needed in order to make an allocation of the CFC's interest expense in accordance with new Section 864(e)(2).

118 See Proposed Regulation Section 1.163(j)-8(c); Treasury Regulation Section 1.882-5(a)(5).

119 An approach could be imagined under which the limitation is computed by reference to the foreign corporation's worldwide ATI, business interest income and business interest expense; the resulting limitation is then applied to the corporation's worldwide interest expense; and the post-limitation interest expense is then allocated between the corporation's effectively connected income, and its other income. However, such an approach would appear to have the potential to lead to more arbitrary results than the one recommended.

should not be required, in the year to which the interest expense is carried forward, to allocate that interest expense between the corporation's effectively connected income and its other income.

## IV. Additional Issues Under Section 163(j)

The issues addressed above do not represent all the significant issues raised by Section 163(j). A non-exclusive list of additional issues that Treasury and the IRS should consider addressing in subsequent guidance includes:

- Confirmation of whether a corporation that undergoes an ownership change under Section 382 is treated as using its carryforwards of disallowed business interest expense before it uses other tax attributes limited by Sections 382 and 383.

- An explanation of how a corporation that inherits carryforwards of disallowed business interest expense pursuant to new Section 381(c)(20) should treat those carryforwards following a Section 381(a) transaction, including confirmation whether rules analogous to those in Treasury Regulation Section 1.381(c)(1)-1 apply.

- Treatment of disallowed business interest carryforwards upon a taxable liquidation of a corporation under Section 331.

- Treatment of a non-corporate taxpayer's disallowed business interest carryforwards, upon death or other final disposition or termination of all trade or business activities.

- Application of Section 163(j) to S corporations, including (i) the treatment of shareholder carryforwards of an S corporation's disallowed business interest expense, in the event the S corporation subsequently converts to a C corporation, and (ii) the treatment of corporate carryforwards of disallowed business interest expense, in the event a C corporation converts to an S corporation.

- Application of Section 163(j) to trusts, estates and their beneficiaries.

- Whether Section 163(j) should apply, or not, to real estate investment trusts, regulated investment companies, and real estate mortgage investment conduits.

- The scope of activities that may be treated as an electing real property trade or business, including whether making mortgage loans constitutes such a trade or business.

- The time and manner for making an election for an electing real property trade or business or an electing farming business.

- Application of Section 163(j) to tiered partnership structures.

- Whether a taxpayer that cancels a debt with accrued, unpaid interest that has been disallowed under Section 163(j) should have a reduction in its cancellation of debt income, by the amount of such disallowed interest.

- Whether, in cases where a taxpayer excludes COD income under Section 108(a), the taxpayer's carryforwards of disallowed business expense should be reduced and, if so, the appropriate ordering for reduction of those carryforwards relative to the other attributes listed in Section 108(b).

- Whether the issuer of a contingent payment debt instrument should be entitled to offset disallowed business interest expense that has accrued under Treasury Regulation Section 1.1275-4, against the income inclusion that otherwise would be required under Treasury Regulation Section 1.1275-4(b)(6)(iii)(B) when there is a negative adjustment to the projected amount of a contingent payment.

The Tax Section would be happy to submit an additional report addressing some or all of the issues listed above or any other issues on which the government would like our input.

**NEW YORK STATE BAR ASSOCIATION TAX SECTION**

**REPORT ON THE GILTI PROVISIONS OF THE CODE**

**May 4, 2018**

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## I. Introduction

This Report[1] discusses the so-called "GILTI" provisions of the Code added by the legislation informally known as the Tax Cuts and Jobs Act (the "**Act**").[2] The GILTI provisions are primarily in new Code Section 951A (income inclusion) and Section 250 (deduction), although the Act made conforming changes to other Code provisions.[3] In general, the GILTI provisions require a U.S. shareholder (a "**U.S. shareholder**")[4] of a controlled foreign corporation ("**CFC**")[5] to pay, on a current basis, a minimum aggregate U.S. and foreign tax on its share of the earnings of the CFC. The GILTI rules, along with other changes to the international tax rules made by the Act, are the most far-reaching changes made to these rules in many decades.

Part II of this Report is a summary of our recommendations. Part III is a summary of the GILTI rules. Part IV is a more detailed analysis of certain of the GILTI provisions and discussion of our recommendations. Appendix 1 contains diagrams and more detailed calculations concerning some of the Examples in the Report.

The Report discusses the issues under the GILTI rules that we have identified so far and that we consider most significant. As a consequence, there are many issues that are beyond the scope of the Report. In most cases we comment on the statute as written without proposing far-reaching revisions to it, although we make some specific suggestions for statutory changes to make the GILTI regime work better.

[1] The principal authors of this report are Kara Mungovan and Michael Schler. Helpful comments were received from Neil Barr, Kimberly Blanchard, Nathan Boidman, Andy Braiterman, Peter Connors, Charles W. Cope, Michael Farber, Kevin Glenn, Peter Glicklich, David Hardy, David P. Hariton, Monte Jackel, Shane Kiggen, John Lutz, Jeffrey Maddrey, Alexey Manasuev, Teddy McGehee, David Miller, Michael Mollerus, Jose E. Murillo, John Narducci, Richard M. Nugent, Amanda H. Nussbaum, Cory John O'Neill, Paul Oosterhuis, Alexander Pettingell, Vasujith Hegde Rajaram, Yaron Z. Reich, Richard L. Reinhold, Robert Scarborough, Stephen Shay, David R Sicular, Eric B. Sloan, Andrew P. Solomon, Karen G Sowell, David Stauber, Chaim Stern, Ted Stotzer, Joe Sullivan, Jonathan Talansky, Marc D. Teitelbaum, Shun Tosaka, Richard R. Upton, Philip Wagman, Andrew Walker, Gordon E. Warnke and Robert H. Wilkerson. This report reflects solely the views of the Tax Section of the New York State Bar Association (***"NYSBA"***) and not those of the NYSBA Executive Committee or the House of Delegates.

[2] The Act is formally known as "*An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018*", P.L. 115-97.

[3] Unless otherwise stated, all "Code" and "Section" references are to the Internal Revenue Code of 1986, as amended.

[4] A U.S. shareholder is defined in Section 951(b) as a U.S. person that actually or constructively owns 10% or more of the vote or value of the stock in a foreign corporation. Prior to the Act, the test was based solely on voting power.

[5] A CFC is defined in Section 957(a) as a foreign corporation if stock with more than 50% of the total vote or value of its shares is actually or constructively owned by U.S. shareholders on any day during its taxable year.

## II. Summary of Principal Recommendations

### A. Purpose of the GILTI Regime

1. The GILTI regime contains elements of both a flat rate of tax on foreign income and the treatment of GILTI as an imperfect add-on to the existing rules for foreign source income. We believe that to the extent consistent with the statutory language, regulations should give significant weight to the theory that Congress intended to adopt the former approach. *See* Part IV.A.

### B. Aggregation of Members of a Consolidated Group

2. Members of a group filing a consolidated U.S. Federal income tax return (a "**consolidated group**") should be treated as a single corporation for purposes of (a) the taxable income limitation under Section 250(a)(2), *see* Part IV.B.2, (b) the Section 904 foreign tax credit ("**FTC**") limit on the GILTI basket, *see* Part IV.B.3, and (c) the amount of the GILTI inclusion and the "inclusion percentage" (defined below), *see* Part IV.B.4.

3. We do not recommend applying aggregation principles to CFCs held by U.S. members of a controlled group that do not file a consolidated return, except perhaps as an anti-abuse rule if a principal purpose of having multiple owners of multiple CFCs is to avoid the purposes of the GILTI rules. *See* Part IV.B.4(b).

4. If this approach for the GILTI inclusion is adopted, Treasury and the Internal Revenue Service ("**IRS**") (Treasury and IRS referred to collectively as "**Treasury**") should consider whether the same rule should apply to CFCs held by a partnership where a specified percentage of the partnership is owned by group members. *See* Part IV.B.4(b).

### C. Deductions Allowed in Calculating Tested Income

5. Regulations should clarify the method for calculating the tested income of a CFC. In general, we do not see a policy justification for deductions not allowed to a U.S. corporation to be allowed to a CFC in calculating tested income. We recommend that regulations adopt as a starting point either U.S. taxable income or the existing rules for Subpart F (which are largely based on GAAP income). In either case, Treasury should have the ability to make adjustments to bring the result closer to the other, and in the latter case the existing rule under Subpart F that the result should not be materially different than U.S. taxable income should be retained. *See* Part IV.C.2.

6. To the extent a U.S. corporation would be entitled to carry over a loss or deduction to a future year, we believe the same should be true of a GILTI loss. Therefore, if a CFC has a tested loss that is not utilized currently by its U.S. shareholders, regulations or a statutory amendment should permit the loss to be reattributed to the shareholders and carry over at the shareholder level to offset future GILTI inclusions, under rules similar to rules for domestic net operating losses ("**NOLs**"). Permitting carryovers of tested losses at the CFC level presents many complex issues and is likely not feasible. *See* Part IV.C.3(a).

7. If regulations apply Section 163(j) to CFCs, a CFC should be permitted to carry forward interest deductions disallowed under Section 163(j) in the same manner as a domestic corporation. *See* Part IV.C.3(b).

## D. Other Computational Issues for GILTI Inclusions

8. Regulations should confirm that tested income of a CFC is determined before Section 956 inclusions. *See* Part IV.D.1.

9. When stock of a first tier or second tier CFC is sold, amendments made by the Act in some cases will cause the portion of the Subpart F income and Section 951A inclusions of the CFC for the taxable year of sale and attributable to the selling shareholder to permanently avoid inclusion in the U.S. tax base. We take no position on whether these results should be changed by legislation or regulations. However, we point out some possible approaches if a change is desired. *See* Part IV.D.2.

10. Regulations should clarify that under Section 951A(e)(3), while there is no minimum period of time that a CFC needs to qualify as a CFC in order for it to be a CFC during its qualification period, it is only a CFC during its qualification period rather than for the entire taxable year in which it is qualified for any period of time. *See* Part IV.D.2.

11. Regulations should address the order in which Section 163(j) and Section 250 are to be applied. The deduction in Section 250(a)(1) could come first, then the limits under Section 163(j) could apply, and then the taxable income limit for the Section 250 deduction under Section 250(a)(2) could apply. *See* Part IV.D.3.

12. Regulations should clarify that for purposes of the taxable income limit in Section 250(a)(2), taxable income includes all Section 951A, Subpart F, Section 78, and FDII inclusions, without regard to the Section 250(a)(1) deduction. In addition, regulations should clarify whether the Section 250(a)(2) carve-back applies to a Section 78 gross-up amount for a Section 951A inclusion. *See* Part IV.D.4.

13. Regulations should provide that typical nonconvertible preferred stock in a CFC is not allocated any tested income of the CFC in excess of accrued and unpaid dividends, and should clarify whether any allocation in excess of such dividends is made to convertible preferred stock. *See* Part IV.D.5.

14. Regulations should clarify whether the gross interest expense of a CFC with a tested loss reduces the NDTIR (defined below) of the U.S. shareholder without any adjustment for any notional QBAI return (defined below) of the CFC in question. *See* Part IV.D.6.

15. Regulations should address a number of issues involving tax basis and earnings and profits ("**e&p**") that arise from GILTI inclusions. *See* Part IV.D.7. The Tax Section will be submitting a separate Report discussing these issues in more depth.

## E. Foreign Tax Credit Issues

16. Principles from Treas. Reg. § 1.904-6 should be applied to determine whether foreign taxes paid by a CFC are "properly attributable" to tested income of the CFC. Once such a connection is made, the foreign taxes should not need to be traced to particular dollars of tested income in order to be considered properly attributable to tested income. *See* Part IV.E.1(a).

17. When income accrues in a different year for U.S. and foreign tax purposes, foreign taxes on that income should still be treated as tested foreign income taxes eligible for FTCs. In addition, regulations should confirm that Section 905(c)(2)(B) applies to audit adjustments relating to tested income, and clarify the application of that provision. Finally, the principles of Section 905(c)(2)(B) should be extended so that, in as many situations as possible, the foreign tax will be deemed to arise in the same year as the U.S. inclusion rather than in the taxable year in which the tax is paid or accrued. *See* Part IV.E.1(b).

18. Regulations should confirm that withholding tax on a distribution of tested income that is previously taxed income ("**PTI**") is not subject to the 20% cutback on GILTI FTCs or to cutback by the inclusion percentage (defined below). *See* Part IV.E.1(c).

19. If Treasury determines that no expenses of the U.S. shareholder are "properly allocable" to income in the GILTI basket, Treasury could issue regulations that no allocation of expenses to that basket should be made. However, arguments can be made that such an interpretation would be inconsistent with the structure and purpose of the statute.

In any event, as a policy matter, we do not believe that no shareholder expenses should be allocated to the GILTI basket. Rather, we believe the existing regulatory framework for allocating expenses should not be applied wholesale to GILTI, and consideration should be given to modifying certain of the existing allocation rules to minimize allocations to GILTI inclusions that are not economically justified.

In particular, certain aspects of the allocation rules for research and development expenses should be reconsidered, and regulations should clarify that Section 864(e)(3) does not apply to stock giving rise to dividends eligible for the Section 245A deduction. In addition, regulations should determine whether expenses should be allocated to a CFC based on the exempt CFC return of the CFC for the year or based on the Section 245A dividends actually paid by the CFC during the year. Moreover, when allocations of expenses are now based on gross income rather than assets, possibly these allocations should be based on net GILTI rather than gross GILTI. *See* Part IV.E.2(a).

20. Regulations should clarify the application of new Section 904(b)(4), and in particular whether it results in the calculation of FTC baskets by disregarding all exempt income from a CFC and shareholder expenses related to such exempt income, without any reallocation of such expense to other income or assets. *See* Part IV.E.2(b).

21. Regulations should confirm that the portion of the Section 250 deduction that is allocable to the GILTI inclusion is allocated to the GILTI basket. *See* Part IV.E.2(c).

22. Regulations should specify that the Section 78 gross-up for foreign taxes deemed paid under Section 960(d) is in the GILTI basket. If this position is rejected, so the gross-up is in the general basket, regulations should provide that the portion of the foreign tax allocable to the gross-up is also in the general basket. *See* Part IV.E.2(d).

23. Regulations should confirm that interest, rent and royalties received by a U.S. shareholder of a CFC from the CFC should be treated as non-GILTI inclusions for Section 904(d) purposes. *See* Part IV.E.2(e).

24. Legislation should be adopted to treat foreign taxes on items that are not in the U.S. tax base as being in a basket determined on the basis of the facts and circumstances, rather than always being in the general basket as in the past. If this recommendation is rejected, a statutory amendment should be adopted to correct a drafting error that now puts these residual taxes in the branch basket. *See* Part IV.E.2(f).

25. Regulations should provide that withholding tax on distributions of tested income that is previously taxed income is in the GILTI basket. In addition, regulations or legislation should extend the principles of Section 960(c)(1)(A) to such withholding tax, so that excess limitation in the year of the inclusion of the underlying tested income would be available to allow FTCs for such withholding tax in the year the tax is imposed. *See* Part IV.E.2(g).

26. Regulations should clarify issues that arise in 2018 and later years from an overall foreign loss or overall domestic loss under Sections 904(f) and (g) in 2017, in light of the fact that the Section 904(d) baskets have changed in 2018. *See* Part IV.E.2(h).

27. Regulations should clarify issues involving FTCs that arise because the concept of tested income did not exist before 2018. Part IV.E.2(i).

**F. U.S. Partnership as a U.S. Shareholder in a CFC**

28. If a CFC is held through a U.S. partnership, the GILTI inclusion and the Section 250 deduction should be determined at the partner level. However, Section 163(j) should not apply at the partnership level in a manner that allows a greater interest deduction than if Section 250 and Section 163(j) applied at the same level. We propose two methods to achieve the latter result. *See* Parts IV.F.1 through IV.F.3.

29. If regulations determine instead that the GILTI inclusion and deduction should be made at the partnership level, they should clarify how the rule applies to certain ownership situations, whether the Section 250(a)(2) limit is determined at the partner or partnership level, and how the Section 250 deduction is to be modified at the partnership level to reflect partners (such as individuals) that are not eligible for such deduction, in order to calculate the Section 163(j) limit at the partnership level. *See* Part IV.F.4.

## G. Other Issues

30. Regulations or legislation should allow a Section 250 deduction based on the deemed GILTI inclusion under Section 962, and should clarify whether a dividend from the CFC is to be treated as qualified dividend income **("QDI")**. We also support the positions on Section 962 taken in Notice 2018-26.[6] *See* Part IV.G.1.

31. We take no position on whether Treasury should adopt anti-abuse rules to deal with fiscal year 2017-2018 transition issues under GILTI. If Treasury determines to do so, we suggest various standards it might consider. If it believes anti-abuse rules are necessary but that the statutory grant of authority is too limited, it should request legislation to conform the statute to the scope of anti-abuse authority referred to in the Conference Report. *See* Part IV.G.2.

32. The consequences of the repeal of Section 958(b)(4) should be limited, by regulations or a statutory amendment, to the intended scope of repeal as reflected in a colloquy on the floor of the Senate. However, any such regulations or amendment should only be adopted after taking into account its effect on other Code provisions. *See* Part IV.G.3.

33. Regulations should address the overlap between Section 250(a)(2) (limiting the Section 250 deduction to a percentage of taxable income) and Section 172(d)(9) (stating that the deduction cannot be used to create an NOL). *See* Part IV.G.4.

34. Regulations should clarify whether GILTI inclusions are investment income under Section 1411 (*see* Part IV.G.5), clarify the extent to which GILTI inclusions are qualified income for REIT purposes (*see* Part IV.G.6), clarify the rules for a RIC having a GILTI inclusion (Part IV.G.7), and confirm that GILTI inclusions are not UBTI to a tax-exempt U.S. shareholder (*see* Part IV.G.8).

35. Legislation should be enacted to treat all CFCs related to a particular U.S. shareholder as a single corporation for purposes of the GILTI calculations for that shareholder. The existing rules that treat each CFC separately are unjustified as a policy matter, are very unfair to taxpayers, and invite restructurings solely for tax purposes. *See* Part IV.H.

# III. Summary of GILTI Rules

## A. Income Inclusion

Section 951A requires each U.S. shareholder of a CFC to include in its gross income each year its share of "global intangible low-taxed income" or "**GILTI**" for the year.[7]

[6] 2018-16 IRB (April 2, 2018).

[7] Section 951A(a).

GILTI is calculated on a U.S. shareholder-by-U.S. shareholder basis. It is the excess, if any, of the U.S. shareholder's "net CFC tested income" for the year over its "net deemed tangible income return" ("**NDTIR**") for the year.[8] GILTI cannot be negative.

In addition, if the U.S. shareholder is a domestic corporation that elects to receive the benefit of FTCs for a taxable year, 100% of the foreign taxes attributable to the Section 951A inclusion are included in gross income under Section 78.

References herein to the "**GILTI inclusion**" mean the inclusion under Section 951A and, where applicable when a CFC pays foreign taxes, the Section 78 gross-up of such inclusion for such foreign taxes.

1. Net CFC Tested Income

A U.S. shareholder's "net CFC tested income" for a taxable year is based on the "tested income" or "tested loss" for the year of each CFC of which it is a U.S. shareholder. (With respect to any U.S. shareholder, each such CFC is referred to herein as a "**Related CFC**"). The U.S. shareholder's net CFC tested income is the excess (if any) of the aggregate of the U.S. shareholder's *pro rata* share of the tested income of each Related CFC with positive tested income, over the U.S. shareholder's *pro rata* share of the tested loss of each Related CFC with a tested loss.[9] Net CFC tested income cannot be negative.

"Tested income" of a CFC for a taxable year is the excess (if any) of the CFC's gross income, with certain specified exceptions, over the "deductions (including tax) properly allocable to such gross income under rules similar to the rules of section 954(b)(5) (or to which such deductions would be allocable if there were such gross income)".[10] The specified exceptions are:

(1) effectively connected income described in Section 952(b),

(2) gross income taken into account in determining the Subpart F income of the CFC,

(3) gross income excluded from foreign base company or insurance company Subpart F income by reason of the high-tax exception in Section 954(b)(4),[11]

[8] Section 951A(b)(1).

[9] Section 951A(c)(1).

[10] Section 951(c)(2)(A).

[11] This exclusion means that high-taxed Subpart F income is excluded from GILTI, but other high-taxed operating income is included. It can be helpful to taxpayers to allow the averaging of high- and low-taxed tested income for FTC purposes, but it can also be harmful because it can "waste" high GILTI FTCs

(4) dividends received from a related person (as defined in Section 954(d)(3)), and

(5) foreign oil and gas extraction income (as defined in Section 907(c)(1)).[12]

Tested loss is the excess (if any) of the deductions described above over the income, calculated as described above.[13] Accordingly, a CFC can have tested income or tested loss, but not both. A CFC that breaks even has neither tested income nor tested loss.

2. NDTIR

A U.S. shareholder's NDTIR for a year is determined by a multi-step process. First, for each Related CFC with positive tested income for the year, its "specified tangible property" is its tangible property used in the production of tested income,[14] and its "qualified business asset investment" ("**QBAI**") is the aggregate adjusted tax basis of its specified tangible property that is used in a trade or business and subject to an allowance for depreciation.[15] If a CFC does not have positive tested income for a year, none of its tangible property for the year is taken into account and it has no QBAI.

Second, the U.S. shareholder aggregates its *pro rata* share of the QBAI for all of the Related CFCs. Third, this aggregate QBAI amount is multiplied by ten percent, which is considered a deemed return on the tangible assets that should not be subject to U.S. tax.[16] Fourth, this deemed return is reduced by any interest expense taken into account in calculating the shareholder's net CFC tested income for the year, except to the extent interest income attributable to that interest expense was also taken into account in determining the shareholder's net CFC tested income.[17] The reduction applies even if the

that cannot be carried over as GILTI credits (*see* the discussion in Part III.D) but might be usable currently or as future carryovers in the general basket or passive basket. Note that Treas. Reg. § 1.954-1(d)(1) allows the high-tax exception from Subpart F income to be elected on a CFC by CFC basis, but the exclusion from GILTI will apply to a CFC whether or not such an election is made (under the Subpart F exclusion if no election is made or under the exclusion for high-taxed Subpart F income for which the election is made).

[12] Section 951A(c)(2)(A).

[13] Section 951A(c)(2)(B)(i).

[14] Section 951A(d)(2)(A). If property is used in the production of tested income and other income, then it is treated as specified tangible property in the same proportion as the tested income bears to the total income. Section 951A(d)(2)(B).

[15] Section 951A(d)(1). The adjusted tax basis is determined at the end of each quarter of the taxable year and then averaged.

[16] Section 951A(b)(2)(A).

[17] Section 951A(b)(2)(B).

interest expense is not in the same Related CFC as is the QBAI. The result is the U.S. shareholder's NDTIR.[18] Note that gross interest expense of a CFC (unless paid to a Related CFC of the same U.S. shareholder) reduces the U.S. shareholder's NDTIR to the extent thereof, even if the CFC has offsetting interest income from an unrelated party.

It is important to distinguish calculations that are done at the CFC level and calculations that are done at the U.S. shareholder level. Tested income is purely a CFC level concept, and NDTIR is purely a shareholder level concept. Each CFC with positive tested income has its own QBAI, but the calculation of the exempt return on QBAI is done at the shareholder level by aggregating QBAI of all Related CFCs and multiplying the total by 10%. Likewise, each CFC has its own interest expense allocable to its own tested income, but the total of such interest expenses of all Related CFCs of a U.S. shareholder (except if paid to another Related CFC of the same U.S. shareholder) is aggregated at the shareholder level in calculating the reduction to NDTIR.

Stated simply, the GILTI gross income inclusion is essentially the U.S. shareholder's share of (1) the aggregate net tested income, if positive, of all Related CFCs, with limited exceptions such as Subpart F income, minus (2) 10% of the tax basis of the tangible depreciable assets of those Related CFCs with positive tested income. However, any gross interest expense (not paid to a Related CFC of the same U.S. shareholder) will reduce the size of item (1) and automatically also reduce the size of (2), so such interest expense does not reduce the GILTI gross income inclusion except to the extent it exceeds the size of item (2).

For convenience, we use the term "**QBAI return**" of a particular CFC with tested income to refer to 10% of the QBAI of the CFC, without reduction for any interest expense. In practice, this is the amount of exempt income generated by the CFC for the U.S. shareholder, before reduction for interest expense. If a particular CFC does not have positive tested income, we use the term "**notional QBAI return**" to refer to the QBAI return the CFC would have if it had positive tested income. Unless indicated otherwise, we assume throughout that there is no interest expense that reduces QBAI return.

## B. Section 250 Deduction

### 1. Initial Calculation

A domestic corporation is entitled to a deduction equal to the sum of (A) 37.5% of its "foreign-derived intangible income", or "**FDII**", (B) 50% of the Section 951A inclusion and (C) 50% of the Section 78 amount included in its income and attributable to GILTI (together, the "**Section 250 deduction**").[19]

[18] Section 951A(b)(2).

[19] Section 250(a)(1). The percentages are lowered from 37.5% and 50% to 21.875% and 37.5%, respectively, for taxable years beginning after December 31, 2025. A discussion of the Section 78 amount is included below. FDII is calculated pursuant to Section 250(b), but a detailed discussion of FDII is beyond the scope of this report.

> Example 1. U.S. shareholder with no FDII has $100 of Section 951A inclusion solely from a CFC with no foreign taxes. The Section 250 deduction is $50, resulting in $50 of taxable income. The income is taxed at 21% to a corporate U.S. shareholder, for an effective tax rate of 10.5% on GILTI.

2. Carve-Back to Deduction

Under Section 250(a)(2), if the sum of the U.S. shareholder's FDII and Section 951A (and possibly Section 78) inclusions exceeds its taxable income (not taking into account the Section 250 deduction), then, solely for purposes of calculating the Section 250 deduction, those inclusions are reduced *pro rata* by the excess (the "**carve-back**").[20] In addition, the Section 250 deduction is disallowed in calculating a net operating loss.[21]

The carve-back comes into effect if the U.S. shareholder has current losses or loss carryovers to the year in question, and those losses exceed the non-GILTI, non-FDII income of the corporation. In that case, the carve-back requires that these losses be used to offset FDII and GILTI eligible for the Section 250 deduction, and the deduction is calculated by reference to the FDII and GILTI that remain (if any) after the losses have been used. As a result, the excess losses might be absorbed in the year but provide the U.S. shareholder with a tax benefit of only a fraction of the usual tax benefit of a loss.

> Example 2(a). U.S. shareholder has $100 of operating income and $100 of Section 951A inclusion. If the shareholder has no other income or loss, the Section 250 deduction is $50, taxable income is $150, and the tax is $31.50. If the shareholder instead has a $100 NOL carryforward to the year, the pre-Section 250 taxable income and Section 951A inclusion for the year are both $100, so there is no carve-back. The Section 250(a)(1) deduction is $50, the taxable income is $50, and the tax is $10.50. The tax savings from the NOL is $21, as would be expected.

> Example 2(b). Same facts as Example 2(a), except the NOL is $150. Now, the taxable income

[20] Section 250(a)(2). It is not clear if the carve-back applies to Section 78 inclusions. *See* the discussion in Part IV.D.4. The reductions in GILTI and FDII are not completely symmetrical, because expenses of the U.S. shareholder allocable to its FDII income reduce its FDII, while expenses of the U.S. shareholder allocable to its Section 951A inclusion do not reduce that inclusion.

[21] Section 172(d)(9).

> before Section 250 is $50, and the carve-back limits the Section 250 deduction to 50% of that, or $25. Taxable income is $25, and tax liability is $5.25. The tax savings from the extra $50 of NOL is $10.50 minus $5.25, or $5.25, a rate of savings of 10.5% rather than 21%.

In fact, every $100 of NOL that exceeds non-GILTI, non-FDII income reduces the GILTI and FDII inclusion in taxable income by $100, and therefore reduces the Section 250 deduction by $50. This results in a net decrease in taxable income of $50, for a net tax saving of $10.50, half the usual benefit from an NOL.[22]

## C. Foreign Tax Credits

### 1. Calculation of the FTC

If a domestic corporation includes GILTI in income, and elects to credit foreign taxes, it is treated as having a "deemed paid" FTC equal to the product of (1) 80% of the aggregate "tested foreign income taxes" paid or accrued by the Related CFCs, and (2) the domestic corporation's "inclusion percentage".[23]

"Tested foreign income taxes" are foreign income taxes paid or accrued by a Related CFC that are "properly attributable" to the tested income of the CFC taken into account by the U.S. shareholder in calculating GILTI.[24] Accordingly, foreign taxes include taxes attributable to QBAI return, since tested income is not reduced by QBAI return. However, if a particular CFC does not have positive tested income for a year, foreign taxes paid by that CFC for that year do not give rise to tested foreign income taxes for the year.[25]

A domestic corporation's "inclusion percentage" is a fraction, the numerator of which is its Section 951A inclusion and the denominator of which is the aggregate of its share of the tested incomes of all Related CFCs with positive tested income.[26]

[22] Under the rules for FTCs discussed below, the tax saving from the NOL is further reduced if the Section 951A inclusion carried with it a foreign tax credit, since in that case the U.S. residual tax rate on the inclusion is less than 10.5%. As a general matter, subject to various complications discussed herein, the higher the foreign tax rate (up to a point), the lower the U.S. residual tax and the smaller the benefit from the carryforward.

[23] Section 960(d)(1).

[24] Section 960(d)(3).

[25] Section 960(d)(3); Conference Report, at 643 n. 1538, describing the Senate Bill ("Tested foreign income taxes do not include any foreign income tax paid or accrued by a CFC that is properly attributable to the CFC's tested loss (if any).)"

[26] Section 960(d)(2).

Note that the corporation's Section 951A inclusion is the tested income of Related CFCs with positive tested income, reduced by (1) tested loss of Related CFCs with tested loss, and (2) NDTIR based on QBAI of Related CFCs with positive tested income. As a result, these two items reduce the numerator but not the denominator of the inclusion percentage, and so they reduce the percentage.

> Example 3. U.S. shareholder owns (1) CFC1 with tested income of $100 after foreign taxes, foreign taxes of $15, and QBAI return of $20, and (2) CFC2 with tested loss of $30 after foreign taxes and foreign taxes of $10. The Section 951A inclusion is $100 (tested income of CFC1)) minus $20 (NDTIR) minus $30 (tested loss of CFC2), or $50, and the tested foreign income taxes are $15. The inclusion percentage is $50 (the Section 951A inclusion) divided by $100 (the positive tested income of CFC1), or 50%. The allowed FTC is therefore 80% times 50% times $15, or $6.

2. GILTI Basket

For FTC purposes, GILTI is a separate basket, with no carrybacks or carryforwards.[27] Any income that is GILTI is not general category income.[28]

3. Section 78 Amount

As noted above, if a domestic corporation elects to receive the benefit of FTCs for a taxable year, 100% of the foreign taxes deemed paid by the domestic corporation are counted in the deemed dividend, or "Section 78 amount".[29] The Section 250 deduction is allowed against the full grossed-up amount.[30]

> Example 4(a). In Example 3, the U.S. shareholder would have a Section 78 amount of $7.50, for total GILTI inclusion of $50 plus $7.50, or $57.50.[31]

[27] Section 904(c) and (d)(1)(A).

[28] Section 904(d)(1)(A) and (2)(A)(ii).

[29] Section 78.

[30] Section 250(a)(1)(B)(ii).

[31] The U.S. shareholder's allowed FTC was 80% times 50% times $15, or $6. Its inclusion under Section 78 is the same as the allowed FTC, but without the 20% cutback, so it is 50% times $15, or $7.50.

> We assume hereafter that the gross-up goes in the GILTI FTC basket.[32]
>
> Example 4(b). Consider the simple case where the U.S. shareholder owns a single CFC with $100 of pre-tax tested income, no QBAI return, and $13.125 of foreign taxes. The tested income and Section 951A inclusion are $86.875. The inclusion percentage is 100% (86.875/86.875), so it does not reduce the foreign tax credit of $13.125. The credit results in a Section 78 inclusion of $13.125. The GILTI inclusion is $100 and the allowed foreign tax credit is 80% of $13.125, or $10.50. If the full Section 250 deduction of $50 is allowed, taxable income will be $50 and the tentative U.S. tax liability is $10.50. If no expenses are allocated to GILTI income (*see* Part III.D) the FTC will exactly offset the U.S. tax.

**D. Limitations on Use of FTCs**

In general, a taxpayer's FTC for a year is limited to (1) the taxpayer's foreign source taxable income for the year, multiplied by (2) the effective U.S. tax rate on the taxpayer's worldwide taxable income for the year.[33] This determination is made separately for each FTC basket, including the GILTI basket.[34] The U.S. shareholder must therefore determine which items of gross income belong in the GILTI basket, and then allocate and apportion its deductions to determine net income in the GILTI basket.[35]

Under preexisting law, deductions that are "definitely related" to gross income are generally allocated and apportioned to that gross income, and other deductions are generally ratably allocated and apportioned.[36] Following the Act, interest deductions are

[32] *See* Part IV.E.2(d).

[33] Section 904(a). The formula in the text assumes no U.S. source losses. The statutory formula is that the allowed FTC cannot exceed the same proportion of total U.S. tax liability (before FTCs) that foreign source taxable income bears to worldwide taxable income. Mathematically, this is equivalent to the rule that the allowed FTC cannot exceed (1) total U.S. tax liability, multiplied by (2) foreign source taxable income, with the product divided by (3) worldwide taxable income. Since (1) divided by (3) is the effective U.S. tax rate on worldwide taxable income, the formula is equivalent to that in the text. New Section 904(b)(4), discussed below, modifies this formula in certain cases.

[34] Section 904(d).

[35] Various re-sourcing rules under Section 904 must be taken into account but are beyond the scope of this discussion.

[36] *See generally*, Sections 861(b), 862(b), 863(a) and Treasury Regulations thereunder.

generally allocated and apportioned on the basis of the tax basis of assets, rather than the value of assets or income.[37]

> Example 5(a). Same facts as Example 4(b). U.S. source income is $0, foreign source income (after Section 250 deduction) is $50, U.S. tax before FTC is $10.50, and effective U.S. tax rate is 21% ($10.50/$50). The Section 904 limit is $50 (foreign source income) multiplied by 21% (effective U.S. tax rate), or $10.50, so the full credit is allowable.
>
> Example 5(b). Same facts as Examples 4(b) and 5(a), except that U.S. shareholder also has U.S. source business income of $10 (before interest deductions) and $10 of interest deductions. Assume the interest deductions are all treated as U.S. source deductions. The result is the same as in Example 5(a).
>
> Example 5(c). Same facts as Example 5(b), except $5 of the interest deductions are allocable to the foreign source GILTI inclusion. Then, nothing changes except the FTC limit under Section 904(a). That limit is now $45 (foreign source GILTI inclusion of $50 minus interest expense of $5) times the effective U.S. tax rate of 21%, or $9.45. Thus, only $9.45 of FTC is allowed, and there is U.S. tax of $10.50 minus $9.45, or $1.05. Note that this loss of credits has the same tax cost ($1.05) as would the allowance of the full FTC and the disallowance of the $5 of foreign source interest deductions. The same result would arise for any other deductions allocable to the GILTI inclusion.

Members of an affiliated group, whether or not they file a consolidated return, must allocate and apportion interest expense of each member as if all members of the

[37] Section 864(e)(2), Temp. Treas. Reg. § 1.861-9T(a). Prior to the Act, Section 864(e)(2) allowed an allocation based on the basis or value of assets, but now basis is required. There are exceptions to this general rule, including that (i) interest expense is directly allocated to income generated by certain property acquired, constructed or improved with proceeds of qualified nonrecourse indebtedness, (ii) interest expense is directly allocated to certain investments funded with amounts borrowed in connection with certain integrated financial transactions and (iii) third party interest expense must be directly allocated to certain separate foreign tax credit limit categories in certain circumstances where the U.S. shareholder's debt is much greater than its CFCs' debt. Temp. Treas. Reg. § 1.861-10T(a), (b), (c), Treas. Reg. § 1.861-10(e).

group were a single corporation.[38] A similar rule applies for purposes of allocating and apportioning certain other expenses that are not directly allocable or apportioned to any specific income producing activity.[39] For affiliated groups filing a consolidated return, all foreign taxes paid by group members are aggregated, and a single Section 904 limit is calculated for the group.[40]

## IV. Discussion and Recommendations

### A. Purpose of the GILTI Regime

As can be seen from the description above, the GILTI regime creates a tax system for the United States that is a hybrid between a territorial system and a world-wide system. Like a world-wide system, a significant amount of income of a U.S. shareholder that is earned through CFCs is subject to immediate U.S. tax if the foreign tax rate is insufficient. Moreover, gains on a sale of CFC stock are taxable if they exceed previously taxed income in the CFC. While the territorial system in most countries does not tax foreign operating income at all, the GILTI regime taxes GILTI income at a significantly lower rate than domestic income. Moreover, NDTIR is permanently exempt from U.S. tax, and dividends from foreign subsidiaries are exempt from U.S. tax.[41]

In addition, to the extent that GILTI is a world-wide tax system, it results in yet another hybrid between (1) a flat minimum domestic and foreign tax rate on a U.S. shareholder's non-NDTIR GILTI inclusions earned through CFCs[42] (the "**flat-rate theory**"), and (2) the imperfect adding of the GILTI regime onto the existing tax regime for foreign source income, particularly Subpart F income (the "**add-on theory**").

The strongest evidence that Congress intended the flat-rate theory is that the Conference Report arguably contemplates no GILTI tax if the foreign tax rate is at least 13.125%,[43] although this may have merely been intended as an illustrative rate.[44] Other

[38] Section 864(e)(1), Temp. Treas. Reg. § 1.861-11T. Foreign corporations are excluded from an affiliated group for this purpose. Treas. Reg. § 1.861-11(d)(1).

[39] Section 864(e)(6), Temp. Treas. Reg. § 1.861-14T.

[40] Treas. Reg. § 1.1502-4(d).

[41] In the case of a U.S. shareholder that is not a domestic corporation (and assuming no Section 962 election), the GILTI regime creates a system that is even closer to a worldwide tax system. GILTI inclusions are subject to tax at the same rate as other ordinary income because neither the Section 250 deduction nor foreign tax credits are available. The discussion in this Part IV.A assumes the applicable U.S. shareholder is a domestic corporation.

[42] This approach is similar to the approach taken for pass-through income in Section 199A, where a deduction of a fixed percentage of specified categories of pass-through income results in a reduced tax rate on that type of income.

[43] Conference Report at 626-7 ("Since only a portion (80 percent) of foreign tax credits are allowed to offset U.S. tax on GILTI, the minimum foreign tax rate, with respect to GILTI, at which no U.S. residual tax is owed by a domestic corporation is 13.125 percent....Therefore, as foreign tax rates on GILTI range

factors that are consistent with this theory (although with the add-on theory also) are the ability to offset tested income of some CFCs with tested losses of other CFCs, and the fact that the GILTI FTC limitation is determined on a world-wide basis rather than a country-by-country basis.

Moreover, the flat rate theory is arguably more consistent with the tax rate on FDII. Aside from the deemed return on QBAI, which is fully taxable under FDII and exempt under GILTI, the FDII rules are designed to lower the U.S. tax rate on FDII export income to a rate that is approximately the rate the taxpayer could achieve by engaging in activities through a CFC. FDII income would not normally generate significant foreign tax credits except for withholding taxes on royalties from non-treaty jurisdictions. As a result, Congress could have considered the statutory FDII rate to be close to the final worldwide rate.

Thus, if Congress had not believed it was adopting the flat-rate theory, it arguably should have realized that the effective world-wide tax rate on GILTI will often be much higher than the rate on FDII, and it would not have been necessary to lower the rate on FDII as much. The fact that Congress did reduce the rate on FDII as much as it did arguably indicates that it believed the rate on GILTI inclusions would usually be 13.125% or not much higher. On the other hand, FDII is also reduced by allocable deductions such as interest and research and development,[45] so arguably Congress intended both the FDII rate and the GILTI rate to be higher than 13.125%.

Other elements of the GILTI regime support the add-on theory because they can cause a much higher tax rate on the net world-wide income of the CFCs owned by a U.S. shareholder. Under this view, the add-on theory is in effect a "minimum tax theory", namely that Congress intended the world-wide effective tax rate on GILTI to be no less than 10.5%, but U.S. tax could apply even if the foreign rate is more than 13.125%. For example, a tested loss in a CFC can cause a loss of FTCs and NDTIR exclusion, and neither unused tested losses nor unused FTCs can be carried over.[46] All interest expense of a shareholder's CFCs not reflected in tested income of a Related CFC is in substance first allocated to tax-exempt NDTIR, rather than being allocated between taxable income and exempt NDTIR. The Section 250 deduction of the U.S. shareholder is limited to its taxable income. All of these restrictions would have to be reconsidered as a legislative matter if the flat-rate theory was to be implemented.

As to the placement of GILTI FTCs in a separate FTC basket, on its face this is a neutral factor, since even a system for taxing GILTI at a fixed tax rate might prohibit

between zero percent and 13.125 percent, the total combined foreign and U.S. tax rate on GILTI ranges between 10.5 percent and 13.125 percent.").

[44] The quoted language is under the heading "Illustration of effective tax rates on FDII and GILTI". *Id.* at 626.

[45] Section 250(b)(3)(A)(ii).

[46] We propose in Part IV.C.3(a) that unused tested losses should be allowed to carry over.

cross-crediting of FTCs arising on non-GILTI income. On the other hand, by placing the FTC limitation in Section 904, Congress intentionally or unintentionally adopted the add-on theory, because it thereby incorporated numerous limitations on GILTI FTCs that can give rise to a combined U.S. and foreign tax rate on CFC income that is well in excess of 13.125%.

In many cases the statute is clear and Treasury would not have discretion to change a specific rule even if it wished to. However, regulations will be needed to resolve many ambiguities and unanswered questions under the statute. The resolution of many issues depends upon whether one believes that the intent of Congress was, as much as possible, to create a uniform maximum tax rate of 13.125% on foreign income, or, alternatively, to (imperfectly) lay the GILTI rules on top of the existing rules for foreign income.

There is no definitive way to resolve this dual nature of the GILTI regime. To the extent the statute provides flexibility for interpretation, we believe that regulations should give significant weight to the theory that Congress intended to create a flat tax at a 13.125% rate, even if the statute itself does so imperfectly. Many of our suggestions for regulations in this Report, such as allowing carryovers of CFC losses and modifying the existing rules for allocating expenses to FTCs, reflect this view. We also suggest some legislative changes to further achieve this result.

## B. Aggregation of Members of a Consolidated Group

This section discusses the extent to which members of a consolidated group should be treated as a single corporation for purposes of the various GILTI calculations.

1. In General

Under Sections 951A and 78, each U.S. corporation must calculate its own GILTI inclusion based on its own Related CFCs. However, a consolidated group is treated as a single entity for many purposes of the Code, and in a typical group there will be more than one, and perhaps many, members that are U.S. shareholders of CFCs. It is important for guidance to state the extent to which a consolidated group is to be treated as a single corporation for purposes of the various GILTI calculations.

The statute itself provides no specific guidance. The statute[47] and the legislative history suggest similarity between Subpart F income and GILTI,[48] and consolidation principles do not apply to calculating Subpart F inclusions. However, the GILTI rules are

[47] Section 951A(f)(1)(A) lists the Code sections for which GILTI is to be treated in the same manner as Subpart F income.

[48] For example, in describing the Senate Amendment, the Conference Report at 641 says: “a U.S. shareholder of any CFC must include in gross income for a taxable year its global intangible low-taxed income (“GILTI”) in a manner generally similar to inclusions of subpart F income”.

different from Subpart F in many critical respects, and we discuss below the extent to which we believe that consolidation principles should apply to GILTI.

2. The Section 250(a) Deduction

Consider a consolidated group where a single member (M1) has a single Related CFC with tested income. Because consolidation principles do not change the location of items of income and deduction, the GILTI inclusion would be income of M1, and the Section 250 deduction would be a deduction of M1. However, Section 250(a)(2) limits the deduction to the taxable income "of the domestic corporation". The question is whether this refers to M1's separate taxable income or to the taxable income of the group as a whole. If more than one member of the group had a Related CFC, the issue would be whether to count the entire taxable income of the group and the entire Section 250(a)(1) deduction of the group. There is no relevant analogy to Subpart F, since income inclusions under Subpart F do not depend in any way on taxable income of the U.S. shareholder.

We believe that regulations should provide that the Section 250(a)(2) limitation is determined on the basis of the taxable income of the group as a whole. We have several reasons for this conclusion.

First, placing such importance on a particular member's taxable income would require the IRS to police the allocation of income among group members, such as intercompany pricing for transactions between group members. Separately determined taxable income of a member is rarely relevant from a nontax point of view, and so taxpayers would be incentivized to take aggressive positions with few (if any) nontax economic consequences. These issues rarely arise today.

Second, looking at the single member's taxable income would be a trap for unwary taxpayers, who would not expect this result. Well-advised taxpayers could easily avoid it, as discussed below.

Third, if the separate taxable income of the member-shareholder is the relevant test, it will be trivial for taxpayers to avoid ever having the carve-back apply. No matter how big the overall loss of the consolidated group, the CFC could be held by a member with no other items of income or deduction. In that case, the GILTI inclusion would by itself create sufficient taxable income to support the full Section 250(a)(1) deduction without the carve-back. Even in the unusual case where this was not practicable, it would not generally be difficult to locate a CFC in a corporation that was not expected to have a taxable loss without regard to the GILTI inclusion.

Fourth, in a consolidated group, losses of one member can freely be used against income of another member, and (as long as the members remain in the group), the location of losses is generally irrelevant. Consistent with this policy, it is difficult to see why the carve-back should apply if the group as a whole has positive taxable income, solely because the member that is the U.S. shareholder has a tax loss on a stand-alone basis. Likewise, if the group as a whole has a tax loss, it is difficult to see why the carve-back should *not* apply merely because the particular member that is the U.S. shareholder has positive taxable income.

Note that if the member has a loss but the group as a whole has positive taxable income, even if a Section 250 deduction is allowed, the carve-back would prevent the deduction from creating a loss in the member that could not be used by the group on a current basis. Therefore, even aside from Section 172(d)(9), the loss created by the deduction could not be carried forward outside the group even if the stock of the member was sold.

Finally, consolidated groups determine their income on a group-wide basis, and it is rarely relevant to determine taxable income on a member-by-member annual basis. It could be a considerable administrative burden for a group to have to separately calculate the taxable income of every member that had a Related CFC solely for purposes of GILTI and FDII.

We believe that Treasury has regulatory authority under Section 1502 to reach the result we propose. That section specifically authorizes consolidated return regulations "that are different from the provisions of chapter 1 that would apply if such corporations filed separate returns." This provision was adopted in 2004, and the legislative history makes clear that it authorizes regulations to treat members of a group as a single taxpayer or as separate taxpayers, or a combination of the two approaches.[49]

We note that Section 5 of Notice 2018-28[50] applies the interest deduction limits of Section 163(j) on a consolidated basis. Those limits are based on the adjusted taxable income of the taxpayer and are analogous to the limits on the deduction under Section 250(a)(2). To be sure, the Notice relies in part on the legislative history of Section 163(j) that specifically supports the conclusion of the Notice. While there is no similar legislative history concerning Section 250, we believe the implicit logic of the Section 163(j) legislative history applies equally to Section 250.

3. Section 904 Limit on the Deemed Paid Foreign Tax Credit

Under the existing consolidated return regulations,[51] the Section 904(a) limit on foreign tax credits is determined on a consolidated basis. This is consistent with the calculation of taxable income on a consolidated basis, as discussed above. We believe that regulations should confirm that this principle continues to apply to the calculation of the limitation on the GILTI basket under Sections 904(a) and (d).

[49] *See* Staff of the Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress*, JCS-5-05 (2005) at 415.

[50] 2018-16 IRB (April 2, 2018).

[51] Treas. Reg. § 1.1502-4(d).

The foregoing discussion applies equally here. A separate company limitation for the GILTI basket would necessarily require a company-by-company calculation of notional taxable income and U.S. tax liability, neither of which is relevant today. In fact, for purposes of allocating research expenses, as well as most other expenses (other than interest) that are not directly allocated or apportioned to any specific income producing activity, an affiliated group is treated as a single corporation,[52] and a member-by-member allocation would be necessary solely for purposes of GILTI.

These special rules for GILTI calculations would result in enormous administrative complexity, a trap for the unwary taxpayer, and a very large tax planning opportunity for taxpayers. In fact, no matter how large the overall group losses or how many deductions the group had that might be allocated to GILTI inclusions, a group could avoid a Section 904 limitation by having a CFC be held by a member with no losses and with no expenses that might be allocated to foreign source income.

4. The Amount of the GILTI Inclusion

A more complex question is whether all members of a consolidated group should be considered a single U.S. shareholder for purposes of calculating a single GILTI inclusion for the group. If the answer is yes, then, since each Section 951A inclusion creates its own FTC inclusion percentage, the group would also have a single inclusion percentage. The result would generally be the same as if all the Related CFCs of all members of the group were owned by a single group member.

For the reasons stated below, we believe that regulations should adopt this approach. As discussed above, we believe that Section 1502 provides clear authority for such regulations. Treating all group members as a single member is referred to below as the "**aggregation approach**", while treating each member as having its own separately computed GILTI is referred to as the "**nonaggregation approach**".

(a) Why it matters

The aggregation approach can be either beneficial or harmful to taxpayers, depending on the situation. The reason is that aggregating or not aggregating particular CFCs with other CFCs in calculating GILTI can have a significant effect in determining the benefits that the group will receive from tested losses, QBAI return, and FTCs.

There are at least six distinct ways in which aggregation can be better or worse for taxpayers. The examples that follow illustrate these situations. In the examples, CFC1 is owned by group member M1, and CFC2 is owned by group member M2. If aggregation applies, M1 and M2 are together referred to as M. Unless otherwise indicated, there is no FTC or QBAI return. Charts and more detailed calculations for certain of these Examples are provided in Appendix 1.

[52] Section 864(e)(6); Treas. Reg. §§ 1.861-14T and 1.861-17(a)(3)(i).

(i) *Tested income can be offset by tested loss of another CFC*

Absent FTCs or QBAI return, aggregation is generally better for taxpayers when CFC1 has tested income and CFC2 has a tested loss. This is because tested income and tested loss can offset each other when they are included in a single GILTI calculation.

> Example 6(a) (tested income and tested loss; aggregation is taxpayer-favorable). Assume CFC1 has $100 of tested income, and CFC2 has $100 of tested loss. Under aggregation, M has a $0 Section 951A inclusion. Under nonaggregation, M1 has $100 of tested income and Section 951A inclusion, and M2 obtains no benefit from the tested loss of CFC2. The group is better off under aggregation.

However, if there is interest expense in a CFC with tested losses and QBAI return in a CFC with tested income, nonaggregation may be better for the taxpayer.[53]

> Example 6(b) (tested income and tested loss, interest expense offsets QBAI return; nonaggregation is taxpayer-favorable). CFC1 has $100 of tested income and $100 of QBAI return. CFC2 has $100 of interest expense and $50 of tested loss. Under nonaggregation, neither M1 nor M2 has any Section 951A inclusion. Under aggregation, the CFC2 interest expense of $100 offsets M's NDTIR from CFC1, so M has a Section 951A inclusion of $50.

(ii) *Tested income can be offset by excess QBAI return of another CFC*

If a Related CFC has QBAI return in excess of its tested income, such excess will reduce the Section 951A inclusion of its shareholder arising from other Related CFCs. This provides a benefit of aggregation.

> Example 7 (excess QBAI return of one CFC offsets tested income of another CFC; aggregation is taxpayer-favorable). Assume CFC1 has $100 of tested income and no QBAI return, and CFC2 has $10 of tested income and $100 of QBAI return. Absent aggregation, M1 has a Section 951A inclusion of $100, and M2 has no inclusion. With

[53] This example assumes that interest expense in a Related CFC with tested losses reduces the U.S. shareholder's NDTIR from other CFCs with QBAI return. *See* discussion in Part IV.D.6.

aggregation, M has a Section 951A inclusion of $10.

(iii) *Tested loss offsets tested income but also reduces the inclusion percentage*

As illustrated in Example 6(a), a tested loss of one CFC has the benefit of offsetting tested income of other CFCs in the same aggregation group. However, a tested loss also reduces the inclusion percentage for FTCs paid by other CFCs in the same aggregation group. Aggregation can help or hurt the taxpayer depending on whether the tested loss offsets tested income of a high-taxed or low-taxed CFC.

<u>Example 8(a) (base case with aggregation: tested loss offsets high- and low-taxed tested income)</u>. Assume (1) CFC1 has $100 of tested income net of foreign taxes and a foreign tax rate of 13.125%, (2) CFC2 has $100 of tested income and foreign tax of $0, and (3) the group also owns CFC3 with a $100 tested loss. With aggregation, the Section 951A inclusion is $100 and the inclusion percentage is 50%, regardless of who owns CFC3.[54]

<u>Example 8(b) (no aggregation, tested loss only offsets high-taxed income; result is worse for taxpayers than aggregation)</u>. Same facts as Example 8(a), but assume CFC3 is owned by M1. Absent aggregation of M1 and M2, M1 has no Section 951A inclusion and an inclusion percentage of 0%. M2 has a Section 951A inclusion of $100 and no FTC. The result is worse than under aggregation because the tested loss of CFC3 is "wasted" when used against high-taxed income in CFC1.[55]

Example 8(c) <u>(no aggregation, tested loss only offsets low-taxed income; result is better for taxpayers than under aggregation)</u>. Same facts as Example 8(a), but assume CFC3 is owned by M2.

[54] The Section 951A inclusion is equal to CFC1's $100 of tested income, plus CFC2's $100 of tested income, minus CFC3's $100 of tested loss, or $100. The inclusion percentage is the $100 Section 951A inclusion, divided by the sum of CFC1's $100 of tested income and CFC2's $100 of tested income, or 50%. A portion of CFC1's foreign taxes is available to M for use as a FTC because the inclusion percentage is 50%.

[55] None of CFC1's foreign taxes is available as an FTC because M1 has no inclusion under Section 951A. M2 has an inclusion under Section 951A but no FTCs because CFC2 paid no foreign taxes.

Then, M1 has a Section 951A inclusion of $100 and a 100% inclusion percentage, so no tax is due. M2 has no inclusion, and no tax. Full use has been obtained for both the tested loss in one GILTI group, and the FTC in a different GILTI group.

(iv) *NDTIR reduces the Section 951A inclusion, which then reduces the FTC inclusion percentage*

When NDTIR reduces the Section 951A inclusion, the result is a *pro rata* cutback of FTCs based on the reduction of the Section 951A inclusion, without regard to which CFC had QBAI return. If one CFC has QBAI return and the other does not, and tax rates on the CFCs are different, the single calculation of the inclusion percentage under aggregation can be better or worse for taxpayers than the separate calculations of the inclusion percentage under nonaggregation.

In the three examples below, the FTCs are half utilized under aggregation (Example 9(a)), fully utilized under one fact pattern involving nonaggregation (Example 9(b)), and not utilized at all under another fact pattern involving nonaggregation (Example 9(c)).

<u>Example 9(a) (base case with aggregation; NDTIR reduces inclusion percentage).</u> Assume (1) CFC1 has $100 of tested income net of foreign taxes, and no QBAI return, and (2) CFC2 has $100 of tested income net of foreign taxes, and $100 of QBAI return. Also assume that either CFC1 or CFC2 has a foreign tax rate of 13.125%, and the other has a 0% rate. Under aggregation, M has $200 of tested income, a Section 951A inclusion of $100 ($200 minus $100 of NDTIR), and an inclusion percentage of 50%.

<u>Example 9(b) (no aggregation; lower foreign tax on QBAI return; result is taxpayer-favorable compared to aggregation).</u> Assume the same facts as Example 9(a), but with the foreign taxes being imposed on CFC1. Under nonaggregation, M1 has a Section 951A inclusion of $100 and an inclusion percentage of 100%, while M2 has a Section 951A inclusion of $0. This allows for full usage of FTC on the non-exempt income in CFC1, while aggregation "wastes" half of the FTC on the QBAI return in CFC2.

> Example 9(c) (no aggregation; higher foreign tax on QBAI return; result is taxpayer-unfavorable compared to aggregation). Same facts as in Example 9(a), but the foreign taxes are imposed on CFC2. Under nonaggregation, M1 has a $100 Section 951A inclusion, with no FTC offset, and M2 has no Section 951A inclusion. This is worse for taxpayers than the aggregation case because the FTC in CFC2 is totally "wasted".

(v) *Interest expense reduces NDTIR of the U.S. shareholder unless paid to a Related CFC of the same U.S. Shareholder*

Gross interest expense of a CFC reduces NDTIR of the U.S. shareholder unless the corresponding interest income is taken into account in determining the U.S. shareholder's net CFC tested income. This can make aggregation or nonaggregation more favorable depending on the facts.

Suppose CFC1 has interest expense to a third party and no QBAI return, and CFC2 has no interest expense but has QBAI return. Under aggregation, the interest expense of CFC1 will reduce M's NDTIR. Without aggregation, there will be no reduction in M2's NDTIR, so aggregation is worse for the group.

Alternatively, suppose CFC1 has QBAI return and pays interest to CFC2. With aggregation, the interest will have no effect on the group's net CFC tested income or NDTIR. Without aggregation, the interest will reduce M1's NDTIR and net CFC tested income, and increase M2's net CFC tested income. Total net CFC tested income is the same in both cases, but aggregation avoids the reduction in NDTIR and is better for the group in this fact pattern.

(vi) *Investment adjustments in stock of M1 and M2 will differ depending on aggregation or nonaggregation*

Part IV.D.7 discusses issues that arise in making stock basis adjustments to M1 and M2 under the consolidated return regulations. Aggregation or nonaggregation may have different effects on allocating the GILTI inclusions to M1 and M2, even if the total inclusion is the same in both cases. These differences in stock basis could be favorable or unfavorable to the group depending on its future plans to dispose of stock of M1 or M2.

(b) Discussion

These examples illustrate some of the ways in which aggregation of members of a group in calculating GILTI helps taxpayers in certain circumstances and hurts taxpayers in others. As a policy matter, we do not believe the substantive tax results in these examples should differ so dramatically depending on where in a group a particular CFC is held. The statute already provides for a single calculation of the GILTI inclusion for all Related CFCs held by a single group member. Logically, the rule should also apply to all Related CFCs held by all members of a group.

It is often quite arbitrary where in a group a particular CFC is held, and it would be quite unusual for significant tax consequences to depend upon the location of the CFCs within a group. At a minimum, this would create an enormous trap for the unwary taxpayer who simply assumes that it would not make a difference where a particular CFC is held within a group.

Moreover, if regulations do not provide for mandatory aggregation for all Related CFCs held by members of a group, the result will be an effectively elective regime. In many if not most cases, it will make little or no business difference to taxpayers where in a group any particular CFC is held.[56] As a result, in the absence of mandatory aggregation, taxpayers can be expected to obtain aggregation for whichever CFCs it is desirable, by having the relevant CFCs held by a single group member, and to avoid aggregation for whichever CFCs it is desirable, by having individual CFCs each held by a separate group member.

Elaborate computer programs would likely be designed to determine, on an annual basis, the groupings and non-groupings of CFCs that will minimize the overall tax liability of the group for the following year. Likely the only reason a well-advised group would not reach the optimal structure every single year would be if their predictions for the following year were inaccurate. Query whether the use of such a computer program would even violate any anti-abuse rule, given the rather arbitrary nature and murky purpose of some of these rules.

For example, a group could restructure today to cause every member with a Related CFC that it directly holds to transfer it to a single newly-formed U.S. group member ("**CFC Master Holding**") in a series of transfers that qualify for non-recognition of gain and loss under Section 351. Aggregation of all the Related CFCs would therefore apply absent further action.

At the end of this year, the group would determine whether separate treatment of any CFC (along with its CFC subsidiaries) would likely be favorable for next year. If so, CFC Master Holding would transfer each of those CFCs to a new separate wholly owned U.S. subsidiary of CFC Master Holding (each, a "**CFC Subsidiary Holding**"). If a separate grouping of two or more CFCs was desirable, those could be contributed together to a separate CFC Subsidiary Holding.

At the end of each year thereafter, the group would make a new determination for the following year. Depending on the results, any CFC Subsidiary Holding can either be retained as such or else liquidated into CFC Master Holding in a transaction that qualifies for nonrecognition of gain and loss under Section 332. Any CFC already held by CFC Master Holding could either be retained there, or transferred to a new CFC Subsidiary

[56] An exception might be CFCs that are regulated entities, which may be required by law to be held within or outside of specified structures.

Holding or to an existing CFC Subsidiary Holding. The result is a practical election on an annual basis whether each CFC (along with its own CFC subsidiaries) will be treated on a separate or aggregated basis for GILTI purposes, and what the aggregation groups will be for the year.

In reality, this type of structuring would often have little or no business purpose. While existing or newly created anti-abuse doctrines or rules might be employed to attempt to stop the most blatant structuring, such doctrines or rules will be extremely difficult to enforce for a multinational corporation with hundreds if not thousands of CFCs.[57] A lot of pressure will also be put on the ability to make retroactive check the box elections, in order to retroactively combine or separate out companies based on results that are different than the expected results.

As a policy matter, these transactions do not carry out the purposes of the statute and we are not aware of any other reason why they should be permitted. Thus, the statute should not be allowed to distort taxpayer behavior and incentivize these transactions. Moreover, we are not aware of any policy reason why taxpayers should have adverse tax consequences solely because they hold CFCs through multiple members for good business reasons.

More broadly, there is no reason that consolidated groups should obtain significantly different tax results under GILTI depending on where CFCs are held within the group. Indeed, given the statutory aggregation among CFCs owned by a single group member, the single entity principle of consolidated returns supports aggregation among CFCs owned by different group members.

We acknowledge that Section 951A reflects a general similarity between GILTI and Subpart F, and that there is no aggregation of group members in Subpart F. Each U.S. group member calculates its own Subpart F inclusion solely by reference to the CFCs for which it itself is a U.S. shareholder. However, under Subpart F, the U.S. shareholder takes account of each CFC separately, without regard to any other CFCs of which it is a U.S. shareholder. As a result, it would not make a difference whether all group members were aggregated.

On the other hand, the GILTI calculation for a single member of the group already involves considerable aggregation of the tax attributes of the Related CFCs of that member, and it is a logical extension of that procedure to extend the aggregation to CFCs owned by all group members. As a result, we do not find the Subpart F analogy persuasive.

The administrative aspects of aggregation do not appear to add undue complexity. It is true that the group would often have a different Section 951A inclusion than the sum of the separate Section 951A inclusions in the absence of aggregation, but this is the proper result. The overall inclusion would logically first be allocated to members in

[57] None of this restructuring would be affected by Section 367, since the stock of the CFCs remains within the U.S. consolidated group.

proportion to the net CFC tested income that each member would have from its own Related CFCs in the absence of aggregation. This method would disregard members' NDTIR that would reduce their respective Section 951A inclusions on a stand-alone basis. However, it is consistent with the second step of the process based on Section 951A(f)(2), which allocates a member's own Section 951A inclusion (as determined in the first step) among its own Related CFCs with positive tested income in proportion to such income.

Alternatively, the overall inclusion could be allocated to members in proportion to the separate Section 951A inclusions or GILTI inclusions they would have had in the absence of aggregation, although the second step would still be on the basis of tested income. A number of issues under the basis adjustment rules of Treas. Reg. § 1.1502-32 would also arise and are discussed in Part IV.D.7.

In principle, aggregation could be applied to CFCs held by U.S. members of a controlled group that do not file a consolidated return. We do not recommend the expansion of aggregation in this manner, except perhaps as an anti-abuse rule if a principal purpose of having multiple owners of multiple CFCs is to avoid the purposes of the GILTI rules. We note in this regard that Section 5 of Notice 2018-28 states that Treasury does not anticipate that affiliated groups not filing a consolidated return would be aggregated for purposes of Section 163(j).

Even setting aside the question of the government's authority to aggregate more broadly, we think aggregation among consolidated group members is correct because these members are already treated as a single entity for most tax purposes. This is not true for each member of a controlled group that does not file a consolidated return. As a result, there is less policy justification for aggregation. Moreover, mandatory aggregation would be difficult to justify, and elective aggregation does not seem justified. The mechanics of aggregation would also be very difficult to apply, since each U.S. shareholder would have its own taxable income and other tax attributes.

If aggregation among consolidated group members is required, consideration should also be given to whether the same rule should apply to CFCs held by a partnership where a specified percentage of the partnership is owned by group members. For example, if a CFC is held by a partnership and two group members are each a 50% partner, the issue is whether the group's overall GILTI calculation should be made as if the CFC were held directly by group members, or whether the partnership should be respected and the usual rules for partnerships holding CFCs (discussed below) should apply.

In the absence of a look-through rule, it would be possible for a group to take particular CFCs out of its aggregation groups by putting them into a partnership that is wholly or largely owned by group members. Treasury could either adopt an automatic look-through rule, or it might conclude that existing anti-abuse rules such as economic substance and partnership anti-abuse are adequate to police this structure.[58]

## C. Deductions Allowed in Calculating Tested Income

### 1. The Issue

Assume that all the gross income of a CFC is included in tested income. The threshold question is which expenses of a CFC should be allowed as a deduction in calculating tested income.

The statute provides that tested income is "gross income" determined without regard to certain specified items,[59] less deductions (including taxes) "properly allocable to such gross income under rules similar to the rules of section 954(b)(5) (or to which such deductions would be allocable if there were such gross income)".[60] Section 954(b)(5) contains the same reference to deductions "properly allocable" to Subpart F income. However, it refers to the method to allocate known deductions to different categories of income, not the method to determine whether an expense is properly counted as a deduction.[61]

In the absence of guidance from either the statute or the legislative history, we consider three possible methods for determining which expenses of a CFC should be allowed as a deduction from its gross income:

(1) The "**modified taxable income method**". All costs that would be allowable as a deduction to a U.S. corporation would be allowed, except as specifically identified otherwise by Treasury. The CFC must in effect file a hypothetical U.S. tax return reporting taxable income and loss, with any specified adjustments, but only for gross

[58] In our recent report on Section 163(j), we recommended that a partnership among members of a consolidated group be respected as such, although a minority supported the view that aggregate principles should apply. *See* NYSBA Tax Section, "Report on Section 163(j)", Report No. 1393, March 28, 2018 (the "**Report on Section 163(j)**"), Part III.G.5. Arguably Section 951A presents a better case for aggregation because, as noted in that Report, Section 163(j)(4)(A)(i) specifically says that Section 163(j) is to be determined at the partnership level and does not distinguish a partnership among group members.

[59] Section 951A(c)(2)(A)(i).

[60] Section 951A(c)(2)(A)(ii).

[61] Treas. Reg. § 1.954-1(c)(1)(i)(B) refers to allocating expenses under the principles of Sections 861, 864, and 904(d). It appears the drafters of the Act intended Section 954(b)(5) principles to apply for purposes for allocating deductions, rather than determining deductibility: "For purposes of computing deductions (including taxes) properly allocable to gross income included in tested income or tested loss with respect to a CFC, the deductions are allocated to such gross income following rules similar to the rules of section 954(b)(5) (or to which such deductions would be allocable if there were such gross income)." Conference Report at 644.

income that is tested income and deductions allocable to tested income.

(2) The "**Subpart F method**". All costs of the type deductible for Subpart F purposes would be allowed. Allowed deductions are generally amounts deductible under U.S. generally accepted accounting principles ("**GAAP**") for a domestic corporation, unless the use of those principles would have a "material effect" as compared to a calculation under U.S. tax principles.[62] This calculation incorporates by reference the rules for determining e&p of the CFC.[63]

(3) The "**modified Subpart F method**". The Subpart F method would apply, but with the disallowance of particular deductions specified in regulations that are disallowed for U.S. tax purposes.

Under any of these methods, foreign taxes are permitted as deductions in calculating tested income if they are "properly allocable" to gross Section 951A inclusions.[64] The question of what taxes are properly allocable to Section 951A inclusions is discussed in Part IV.E.1(a).

2. Choice of Method

Each of these methods could produce very different outcomes, depending on the particular facts. For example, a nondeductible fine or penalty,[65] a payment under a hybrid instrument,[66] a loss on a sale to a related party,[67] an interest deduction that exceeded the limits under Section 163(j), and a nondeductible business entertainment or meal expense[68] would likely be allowed under the Subpart F method and the modified Subpart F method absent a regulatory exception, but not under the modified taxable income method. "Interest" expense on an instrument treated as debt for GAAP purposes

[62] Treas. Reg. § 1.952-2(b)(1), (c)(2).

[63] *Id.* These rules are in Treas. Reg. § 1.964-1. *See also* Proposed Treas. Reg. § 1.163(j)-8, which provides rules for applying Section 163(j) to a foreign corporation that has "effectively connected income", or "ECI". Arguably this regulation contains a negative inference that Section 163(j) must not apply to a foreign corporation unless it has ECI.

[64] Section 951A(c)(2)(A)(ii).

[65] Section 162(f).

[66] Section 267A.

[67] Section 267.

[68] Section 274.

but not for U.S. tax purposes because of its riskiness might even be allowed under the same circumstances.[69]

(a) The modified taxable income method

We believe that the modified taxable income method is the preferable method as a theoretical matter. Under either of the theories of GILTI discussed above, GILTI is in substance a partial world-wide tax system, with nonexempt income of a CFC effectively taxed at a reduced rate of U.S. tax (in the case of a corporate U.S. shareholder) or at the regular rate of U.S. tax (in the case of all other U.S. shareholders in the absence of a Section 962 election and Section 250 deduction).

Moreover, “gross income”, the initial component of tested income, is based on U.S. tax principles.[70] It would be most logical for the second step, namely the calculation of deductions allocable to gross income, to be calculated in the same manner so that taxable income for GILTI purposes is the same as for U.S. tax purposes generally. We note that the Subpart F rules use a consistent method for calculating gross income and deductions, because it is taxable income (not merely deductions) that is determined on a GAAP basis unless the result has a material effect as compared to the use of U.S. tax principles.[71]

We also do not see a policy justification for deductions not allowed to a U.S. corporation to be allowed to a CFC in calculating tested income. Such a rule would invite “deduction shifting”, since a U.S. corporation could shift nondeductible expenses to a CFC and in effect obtain a deduction at the GILTI tax rate. For example, if Section 163(j) did not apply to a CFC, the U.S. shareholder could avoid the limitations of that section (at the cost of a reduced 10.5% tax benefit) by having its existing debt assumed by the CFC or new borrowings incurred by the CFC. To be sure, such shifting of debt could have significant business consequences, and the application of Section 163(j) might not eliminate the incentive for shifting debt to CFCs.[72] Nevertheless, we do not believe taxpayers should have an incentive to make such shifts.

[69] Under the modified taxable income method, if the CFC makes a locally deductible payment under a hybrid instrument to the U.S. shareholder, there would not be a deduction from tested income, but the payment would be a dividend payment out of previously taxed GILTI inclusion and not taxable in the U.S. As a result, both the local tax deduction and the reduced GILTI rate would apply to the income underlying the hybrid payment.

[70] Section 951A(c)(2)(A)(i) refers to “gross income”, which is necessarily used in the tax rather than accounting sense.

[71] Treas. Reg. § 1.952-2(b)(1), (c)(2).

[72] Since there is no aggregation of CFCs for Section 163(j) purposes, debt could be incurred by particular CFCs with high levels of tested income, even if the Related CFCs in the aggregate had little tested income.

We acknowledge that Section 6 of Notice 2018-28 states that Section 163(j) does not prevent the application of disallowed deductions to reduce e&p, and arguably the same reasoning would disregard Section 163(j) in calculating GILTI. However, we do not think the situations are analogous. Earnings and profits is a measure of economic income or loss, many disallowed deductions reduce e&p, and in particular interest is a true cost regardless of its deductibility. As a result, the position in the Notice makes sense. On the other hand, Section 163(j) is specifically designed to prevent income stripping, and the fact that interest deductions disallowed under Section 163(j) reduce e&p is not a justification for allowing excessive interest expense to strip income out of CFCs with tested income.

Under this method, Treasury would be given the authority to specify particular variances from U.S. taxable income that would apply. This might be done for administrative convenience, such as not requiring an add-back to tested income for disallowed travel and entertainment expenses.

A disadvantage of the modified taxable income method is that it would require a corporate group to create a separate hypothetical U.S. Federal income tax return for each CFC in the group. This could be extremely difficult, since local finance officials in the CFCs are likely unfamiliar with U.S. tax principles.[73] Moreover, even minor variances from U.S. taxable income (as adjusted) could result in audit adjustments.

This difficulty in calculation might be reduced under the Subpart F method or the modified Subpart F method. Those methods begin with U.S. GAAP income, and a U.S. group with CFCs is likely already computing its GAAP income by taking into account the income of its CFCs. On the other hand, these methods would require a determination in each case that the result was not materially different than the result under the modified taxable income method, so some knowledge of U.S. tax principles would be required in any event. In reality, the difficulties in calculation are inherent in the decision by Congress to impose a current U.S. tax on the income of CFCs.

Another disadvantage of the modified taxable income method is that it would result in tested income being calculated on a different basis than Subpart F income. This is literally consistent with Section 951A(c)(2)(A), which defines tested income as gross income not taken into account in determining Subpart F income, minus deductions allocable to such gross income under rules similar to the rules for allocating deductions under Subpart F. This language should prevent a double inclusion of gross income, or a double deduction of the same item. However, Congress may not have contemplated Subpart F and tested income being calculated on a different basis. Moreover, if deductions were allowed for one purpose but not the other, both taxpayers and the IRS would have incentives to shift deductions between the categories.

(b) The Subpart F method

[73] We also note that if U.S. tax principles are to be used in calculating the tested income of CFCs, logically other U.S. tax principles should also apply, such as allowing aggregation of Related CFCs of a U.S. shareholder as if they filed a U.S. consolidated tax return.

The Subpart F method imports Subpart F principles into the GILTI calculations. This is consistent with the general similarity between GILTI and Subpart F. Moreover, tested income is defined in substance as total taxable income reduced by Subpart F income,[74] and it would be peculiar to determine the total on a different basis than the subtraction.[75]

However, we believe that the differences between these two regimes are sufficiently great that the existing application of the Subpart F method does not strongly support the extension of that method to GILTI. GILTI is not based on or limited to e&p, so arguably consistency between Subpart F income and GILTI was not viewed by Congress as important. Moreover, GILTI involves a vastly greater amount of potential income inclusions than Subpart F.[76] Thus, the rule for Subpart F should not be applied to GILTI without an independent policy justification.

In considering whether such policy justification exists, we note that under pre-2018 law, tax on the earnings of CFCs was deferred until e&p generated by the CFC was repatriated in the form of dividends (or deemed dividends under Section 1248 upon a sale of the stock of the CFC). Subpart F represented an exception to deferral for particular categories of income,[77] and it was logically limited to the same e&p that would eventually be taxed on payment of a dividend. Moreover, the calculation of e&p is relatively similar to the calculation of GAAP income, so it made sense to use GAAP income (which would already be known) as a surrogate for e&p as long as the differences were not too great. To the extent that the GAAP calculation resulted in less Subpart F

[74] Section 951A(c)(2)(A).

[75] The Tax Section recently asked Treasury to allow items arising under Section 987 to be determined on a basis similar to GAAP profit and loss rather than U.S. taxable income. NYSBA Tax Section Report No. 1386, *Report on Notice 2017-57: Alternative Rules for Determining Section 987 Gain or Loss*, Jan. 22, 2018.

[76] On the other hand, the prevalence of Subpart F income may increase if taxpayers create it to avoid unfavorable aspects of GILTI. This would make disparities between Subpart F income and GILTI more meaningful than at present, and planning opportunities would arise to take advantages of such disparities.

[77] The Senate Finance Committee made the following comment regarding the 1962 bill that enacted Subpart F: "Under [then] present law foreign corporations, even though they may be American controlled, are not subject to U.S. tax laws on foreign source income. As a result no U.S. tax is imposed with respect to the foreign source earnings of these corporations where they are controlled by Americans until dividends paid by the foreign corporations are received by their American parent corporations or their other American shareholders. The tax at that time is imposed on the American shareholder with respect to the dividend income received, and if this shareholder is a corporation it is eligible for a foreign tax credit with respect to the taxes paid by the foreign subsidiary. In the case of foreign subsidiaries, therefore, this means that foreign income taxes are paid currently, to the extent of the applicable foreign income tax, and not until distributions are made will an additional U.S. tax be imposed, to the extent the U.S. rate is above that applicable in the foreign country. This latter tax effect has been referred to as 'tax deferral.'" The committee went on to describe the ways in which the House bill had sought to eliminate deferral only for "tax haven" devices, and the committee's amendments were "designed to end tax deferral on 'tax haven' operations by U.S. controlled corporations". S. Rep. No. 1881, 87th Cong., 2d Sess., *reprinted at* 1962-3 C.B. 703, 784-785.

income than the e&p calculation, the difference was a timing difference for income inclusion.

By contrast, tested income and GILTI are not based on e&p. If tested income of a CFC is understated under U.S. tax principles, there is a permanent exemption of income of the CFC (calculated under U.S. tax principles) from the U.S. GILTI tax. This result does not seem consistent with the intent of Congress in imposing a tax on GILTI without regard to the e&p of the CFC.

As between the modified taxable income method and the Subpart F method, the former will usually be less favorable to taxpayers because of deductions disallowed for U.S. tax purposes but allowed for GAAP purposes. However, it will sometimes be more favorable to taxpayers. For example, in cases where U.S. tax depreciation is faster than GAAP depreciation, there will be less tested income in earlier years.

We do not believe the Subpart F method should be adopted, because we believe that it is inferior to the modified Subpart F method for the reasons described below.

(c) The modified Subpart F method

In light of the practical concerns raised by general adherence to U.S. tax principles under the modified taxable income method, and the policy concerns raised by disregarding U.S. tax principles under the Subpart F method, we believe the modified Subpart F method is superior to the Subpart F method and is a realistic alternative to the modified taxable income method. The modified Subpart F method would give Treasury the flexibility, for example, to apply the Section 163(j) limits on interest deductions. Permitting departures from the Subpart F method in certain circumstances is also consistent with our position below that carryovers of losses of a CFC should be allowed.

Under the modified Subpart F method, taxpayers would begin with the same type of analysis with respect to each CFC that is already conducted for Subpart F purposes. They would then refer to a list formulated by Treasury of specific deductions that are disallowed to U.S. corporations and would also be disallowed in calculating GILTI regardless of their treatment for GAAP purposes

This method would limit adjustments to GAAP income to the elimination of those deductions that Treasury believes are most important to disallow for GILTI purposes. In particular, it would minimize the need to make minor add-backs such as (if Treasury agreed) for disallowed travel and entertainment expenses.

Under this method, we propose to continue the rule in the existing Subpart F regulations that the result could not be materially different than the calculation of taxable income for U.S. tax purposes. This would prevent abuse of the modified Subpart F method for GILTI purposes, just as for Subpart F purposes today.

Ultimately, a significant disadvantage of this method is that it involves dealing with three different tax systems. First, GAAP income must be determined as in the Subpart F method. Then, adjustments to GAAP income as required by Treasury guidance must be made. Finally, the result must be compared to U.S. taxable income with specified adjustments (the modified taxable income method) to see if the differences are material. On top of this, the statute specifically requires that the tax basis of assets for purposes of the QBAI calculation be determined quarterly under the alternative depreciation system of Section 168(g).[78] It is not clear that this process is any simpler than beginning with the modified taxable income method in the first place. It would also be peculiar for an asset to have a GAAP basis for calculating tested income and a Code-based tax basis for calculating QBAI.

(d) Conclusion

We recommend that Treasury adopt either the modified taxable income method or the modified Subpart F method. These methods are similar. The former starts with taxable income and allows Treasury to make adjustments to bring the result closer to GAAP income. The latter starts with GAAP income and allows Treasury to make adjustments to bring the result closer to taxable income. The choice of method depends upon whether, in the end, the desired result is closer to GAAP income or closer to taxable income. We do not take a position on this issue.

3. Loss and Interest Carryovers

(a) Carryover of operating losses

(i) In general

Under any of the foregoing methods of determining tested income, the question arises as to whether losses can be carried forward. Consider a U.S. shareholder with a single CFC that has no QBAI return, a tested loss in year 1, an equal amount of tested income in year 2, and no foreign tax liability. Absent a loss carryover, the shareholder would have a net GILTI inclusion and resulting tax liability in year 2, in the absence of any economic income over the two year period. This result is unfair, and inconsistent with the flat-rate theory of GILTI, assuming the flat-rate theory is intended to apply over time as opposed to only in years with profits.

As a result, to the extent a U.S. corporation would be entitled to carry over a loss or deduction to a future year, we believe the same should be true under GILTI. Moreover, we believe that rules similar to the existing rules for NOL carryovers should apply. We believe this should be true under any of the methods for determining tested income described above that might be adopted for GILTI purposes.[79]

[78] Sections 951A(d)(1), (d)(3)(A).

[79] We do not recommend that rules similar to the e&p deficit rules apply in calculating tested income (as an alternative to loss carryovers). Many of the complexities described below relating to loss carryovers arise because of the aggregation principles inherent in the GILTI calculations, and many of the same complexities would arise in this alternative system.

The Subpart F regulations provide that net operating losses are not taken into account in calculating taxable income for Subpart F purposes.[80] However, Subpart F income is limited to current year e&p of the applicable CFC[81] and is reduced for certain prior year e&p deficits of the same CFC from Subpart F activities.[82] In some cases, e&p deficits of other CFCs in the same ownership chain may also be used.[83] As a result, in at least some cases, an NOL carryover under such a system is not needed to prevent net Subpart F income from arising in year 2 if there is a loss in year 1 and income in year 2. Moreover, Subpart F losses are not likely to arise very often, so the rule for Subpart F should not as a policy matter determine the rule for GILTI, where tested losses are likely to arise much more frequently.

We also acknowledge that under any method of allowing carryovers, the amount of the carryover is based in part on the tested loss of a CFC. Under any of the methods of determining tested loss, the tested loss might be greater than the NOL that would arise for a domestic corporation. However, because of the restrictions on those methods, the tested loss could not be materially greater. Moreover, given that the full amount of the tested loss is respected as an offset to current year tested income of other CFCs, it should logically be available in full to determine the carryover to future years.

We describe below two alternative methods to implement a system to allow the carryover of unused tested losses, one at the CFC level and the other at the shareholder level. The first method would allow a tested loss of a CFC to carry over at the CFC level to offset future tested income of the CFC, similar to an NOL carryforward of a domestic corporation. As discussed below, this gives rise to extremely complex issues because the income inclusion occurs at the shareholder rather than the CFC level, and the amount of the inclusion is affected by factors arising from other CFCs. As a result, while this approach may be the more theoretically correct one, the resulting complexities make it questionable as a practical matter.

The alternative approach is to "push out" an unused tested loss of a CFC to the shareholder and permit the shareholder to use it to reduce its GILTI inclusions in future years. We prefer this approach because it avoids many, but far from all, of the complexities of loss carryovers at the CFC level.

Both approaches raise the question of whether they could be implemented by regulation, or if legislation would be required. We take no position on this issue,[84] but

[80] Treas. Reg. § 1.952-2(c)(5)(ii).

[81] Section 952(c)(1)(A), Treas. Reg. § 1.952-1(e).

[82] Section 952(c)(1)(B).

[83] Section 952(c)(1)(C).

[84] One issue under the existing statute for allowing losses to carry over at the CFC level is the rule that tested income of a CFC for a taxable year is gross income of the CFC for that year less deductions properly allocable to that gross income. The question is whether a tested loss carried over from a prior year,

we urge that Treasury either adopt our preferred method by regulation, or if it does not believe it has the authority, that legislation be adopted to implement this method.

(ii) Carryover at the CFC level

Under the existing rules, if a Related CFC has a tested loss, all or part of that tested loss is available to shelter tested income of the U.S. shareholder from Related CFCs.[85] To the extent the loss is in fact utilized in this manner, it obviously should not carry over to future years of the CFC.

We would apply this rule even if the U.S. shareholder did not obtain any tax benefit from the use of the tested loss to shelter tested income, either because the tested income had high FTCs or because the shareholder had NDTIR. For example, suppose CFC1 has a tested loss of $100, and CFC2 has tested income of $100. In addition, either CFC2's income is non-NDTIR income taxed at a high foreign tax rate, or else all of CFC2's income is NDTIR.

In either case, the shareholder has no GILTI tax even without regard to the tested loss of CFC1. However, both NDTIR and foreign tax credits are determined at the shareholder level, and in fact can arise from CFCs other than CFC1. Moreover, the application of a tax benefit principle would not be consistent with the normal rule that a loss is absorbed when it offsets taxable income, even if the taxpayer would not have been taxed on the taxable income for a reason such as high FTCs. Application of tax benefit principles would also be enormously complex and require a CFC to obtain far more information from its shareholder. As a result, we believe that a tested loss should be treated as "used" by the shareholder, and unavailable for carry forward by the CFC, whenever it offsets tested income of the shareholder, without regard to a "tax benefit" analysis at the shareholder level.

So far, this approach appears to be fairly straightforward. However, considerable complexity quickly arises.

First, rules would need to address how to determine which tested losses allocable to a particular U.S. shareholder are used to offset tested income of that shareholder. The shareholder might have multiple Related CFCs with tested income and tested loss.

The issue would only arise if the shareholder has a net tested loss, since only in that case are some tested losses from Related CFCs not utilized to offset tested income of other Related CFCs. In that case, the net tested loss at the shareholder level should logically be allocated to the various Related CFCs with tested losses in proportion to the tested loss of each Related CFC. A carryover of tested loss by each Related CFC would

representing expenses in prior years that were allocable to gross income in prior years, can be considered properly allocable to gross income of the current year.

[85] Section 951A(c)(1) states that the U.S. shareholder's *pro rata* shares of tested income and tested losses of all Related CFCs for the current year are aggregated to determine net CFC tested income.

then be allowed to the extent of such allocation. This calculation would be done separately for each U.S. shareholder of a CFC with a tested loss.

Second, if there are multiple unrelated U.S. shareholders of a CFC, it would be necessary for the CFC to determine the extent to which its tested losses were actually used to offset the tested income of each U.S. shareholder. Perhaps a rule could be adopted that unless the CFC could provide proof that its loss was not utilized by a U.S. shareholder, the loss would be deemed to have been so utilized and could not carry over.

Third, suppose some but not all U.S. shareholders of a CFC can use their share of a tested loss in year 1.[86] The non-users would include, for example, all U.S. persons that are not U.S. shareholders of the CFC, all U.S. shareholders that do not have tested income from other CFCs, and all non-U.S. individual and corporate shareholders that directly hold stock in the CFC. The unused portion of the tested loss is the portion allocable to the shareholders in the non-user group.

It would be extraordinarily complicated to allocate the losses carried over to year 2 solely to the non-users in year 1. As a result, whatever portion of the loss is carried over will potentially benefit all U.S. shareholders in future years on a *pro rata* basis, not only the non-users in year 1. This will result in a partial double benefit to the shareholders that used their share of the loss in year 1, at the expense of the non-users in year 1 who can use the loss in a later year.[87]

For example, suppose a CFC has a tested loss of $100 in year 1, and the CFC is owned 50% by a U.S. corporation and 50% by a non-U.S. corporation.[88] If the U.S. corporation can use $50 of tested losses in year 1, then $50 of tested losses would carry over to year 2. The U.S. corporation would obtain 50% of the benefit of this $50 carryover if either (i) the CFC had $50 of tested income in year 2, or (ii) the CFC had no tested income in year 2 but the U.S. corporation had $25 of unrelated tested income in year 2.

In either case, the U.S. corporation obtains 75% of the benefit of the $100 tested loss in year 1. This result might be considered particularly surprising, if, say, the non-U.S. corporate shareholder owned 100% of the U.S. corporate shareholder. In that case, 75% of the tax benefits would be shifted to the 50% U.S. shareholder. The same allocation of 75% of the tax benefits to a related U.S. party would arise if a U.S. individual owned a U.S. corporation, each owned 50% of the CFC, the CFC had a tested loss of $100 in year 1, and either the U.S. individual or the U.S. corporation, but not both, could use $50 of tested losses in year 1.

[86] For simplicity, disregard shareholders who can use part but not all of their share of the tested loss.

[87] The shifting of tested losses among possibly unrelated shareholders would also raise complex basis and e&p issues similar to those discussed in Part IV.D.7 where the shareholders are related.

[88] Fifty percent U.S. ownership is used for simplicity. The CFC might be a CFC because the non-U.S. corporation has a U.S. subsidiary, or because the U.S. corporation owns 50.01% of the stock or holds stock with over 50% of the vote.

The results can be even more extreme. In the example, assume the U.S. corporation can use unlimited tested losses, the other shareholder cannot use any tested losses, and the CFC has $0 tested income in each year after year 1. As above, the U.S. shareholder uses $50 of tested losses in year 1. Then, of the $50 that carries over to year 2, the U.S. shareholder uses its $25 share. Then, the remaining $25 of tested loss carries over to year 3, the U.S. shareholder uses $12.50 of that loss, and so on literally forever.

One possible way to avoid these results in some cases would be to limit the carryover of tested losses of a CFC to losses allocable to U.S. corporate shareholders that could not use their share of the tested losses, or to U.S. individuals that could not use their share and were not related to a U.S. corporate shareholder. This would prevent the shifting of the benefit of tested losses from non-U.S. persons to U.S. persons, or among individuals and related U.S. corporations.

However, this approach could give uneconomic results for U.S. shareholders that could not use their share of the loss in year 1. They would obtain no benefit in year 1 and might receive only a *pro rata* share of a reduced tested loss in year 2.

Consider the example above with a 50% U.S. corporate shareholder and 50% non-U.S. corporate shareholder. If the U.S. corporate shareholder could use $50 of the $100 tested loss in year 1, no tested loss would carry over and the result seems correct. However, if the U.S. corporate shareholder could not use any of the tested loss in year 1, only its $50 share of tested loss would carry over, and the U.S. corporate shareholder could obtain the benefit of only $25 of that amount in year 2.

This result seems unfair. However, arguably it is justifiable on the ground that the U.S. corporate shareholder is in no worse a position than if the other shareholder was another U.S. corporate shareholder that could use its $50 share of the tested loss in year 1.

Fourth, under current law, NOL carryforwards to a taxable year can offset only 80% of taxable income for the year.[89] Tested loss carryforwards should likewise be limited to offsetting only 80% of tested income in future years. However, consider the case where in the future year the CFC has QBAI return:

> Example 10(a): Carryover of tested loss to year with QBAI return. A U.S. shareholder owns 100% of a single CFC, and the CFC has a tested loss of $100 in year 1. In year 2, the CFC has $100 of tested income, of which $20 is QBAI return. Absent the loss carryover, the shareholder would have a Section 951A inclusion of $80.

If the loss carryover is allowed in the amount of 80% of the year 2 tested income, the shareholder's net CFC tested income will be $100 minus $80, or $20, and its Section

[89] Section 172(a).

951A inclusion will be $20 of net CFC tested income minus $20 of NDTIR, or $0. Thus, the loss carryover eliminates 100% of the Section 951A inclusion.

The elimination of 100% of the Section 951A inclusion for year 2 is arguably inconsistent with the purpose of the 80% limitation for domestic corporations. That rule does not allow a carryover to year 2 to eliminate 100% of the taxable income in year 2. Under this theory, the carryover should be limited to 80% of the Section 951A inclusion in year 2.

On the other hand, allowing a carryover of $80 only reduces tested income in year 2 by 80%, consistent with Section 172(a). Moreover, tested income is determined on a completely separate basis than are NDTIR and Section 951A inclusions. As a result, if the goal is to reduce the Section 951A inclusion to the U.S. shareholder by no more than 80%, it is impossible even in theory to determine at the CFC level how much of a carryover should be allowed. For example, another CFC held by the same U.S. shareholder might have QBAI return that offsets the tested income of this CFC, or might have interest expense that offsets the QBAI return of this CFC. If the CFC has more than one U.S. shareholder, then any loss carryover allowed at the CFC level will likely result in different percentage reductions to each U.S. shareholder's Section 951A inclusion.

The allowance of the loss carryover equal to 80% of tested income in year 2, without regard to QBAI return, is helpful to the taxpayer in Example 10(a). However, it can also be very adverse to taxpayers.

> <u>Example 10(b): Carryover of tested loss to year with QBAI return</u>. Same facts as Example 10(a), but in year 2, the CFC has $100 of tested income, of which all $100 is QBAI return. Even without the loss carryover, the Section 951A inclusion is $0. If $80 of the loss carryover is allowed in year 2, it has been absorbed with no tax benefit to the U.S. shareholder.

The avoidance of the 80% limitation in Example 10(a), and the wasting of loss carryovers in Example 10(b), would not arise if the loss carryover is limited to 80% of the excess of tested income over QBAI return in the carryover year. In that case (i) the carryover utilized in Example 10(a) will be 80% of ($100 minus $20), or $64, (ii) tested income and net CFC tested income will be $36, (iii) the Section 951A inclusion will be $36 minus $20, or $16, and (iv) $36 of the $100 of tested loss from year 1 will be carried forward to year 3. The Section 951A inclusion is reduced by 80%, arguably the correct result. No carryover would be utilized in Example 10(b), and the entire $100 carryover would be available in future years.

However, as discussed above, this limitation on carryovers could reduce the Section 951A inclusion by either more or less than 80% if the U.S. shareholder had other CFCs whose attributes were included in the Section 951A calculation. Moreover, the structure of the statute seems to contemplate that tested losses will be absorbed with no tax benefit in a situation such as Example 10(b) where they shelter QBAI return. It would be peculiar (and an opportunity for tax planning) if loss carryovers gave a more favorable result.

Finally, a rule for carryovers would normally treat a carryover in the same manner as a loss realized in the subsequent year.[90] However, this principle does not resolve the present issue. The ability to use carryovers to offset only 80% of current-year income necessarily means that a carryover is not as beneficial as a current year loss. Rather, the issue here is 80% *of what*, *i.e.*, tested income or tested income reduced by QBAI return.

Fifth, even in the absence of QBAI return, the 80% limit on carryovers raises uncertainties if the U.S. shareholder has more than one Related CFC. For example, as illustrated in Examples 6 and 7 above, the shareholder's Section 951A inclusion is determined by reference to net CFC tested income and NDTIR, which take into account not only the tested income and QBAI return of a particular Related CFC, but also the tested income and losses, QBAI return or interest expense of other Related CFCs.

> <u>Example 11. NOL carryover to year in which tested income is offset by tested loss of another CFC.</u> In year 1, CFC1 has a tested loss of $100 that is not used by its 100% U.S. shareholder. In year 2, CFC1 has tested income of $100, and the U.S. shareholder also owns CFC2 that has a tested loss of $20. Assume there is no NDTIR. The Section 951A inclusion aside from the loss carryover is $80.

If the loss carryover to year 2 is allowed to offset 80% of the $100 of tested income of CFC1, then CFC1 will have tested income of $20 in year 2 and the Section 951A inclusion will be reduced from $80 to $0 as a result of the carryover. Arguably this is inconsistent with the 80% limitation on loss carryovers, although it can be argued that the carryover is at the CFC1 level and any attributes of CFC2 are irrelevant. Allowing this result would also put a premium on shifting tested income from CFC2 to CFC1 in year 2 (and, depending on the rule adopted in Example 10, shifting QBAI return from CFC1 to CFC2 in year 2), in order to maximize the utilization of the loss carryover.

Alternatively, a rule could be considered that all loss carryovers from all Related CFCs of a particular U.S. shareholder should only be allowed to offset 80% of the net Section 951A inclusion of the particular U.S. shareholder, taking into account all tested

[90] *See, e.g.*, the discussion of Example 12 in Part IV.3.C(2) below, where we state that carryovers of disallowed interest under Section 163(j) to a year with QBAI return should not be treated more favorably than interest expense actually incurred in the later year. The distinction is that Section 163(j) treats current and carryover interest the same in limiting the deduction to a percentage of adjusted taxable income of any taxable year, while Section 172(a) only limits NOL carryovers to a percentage of taxable income in the carryover year.

income, tested loss, and NDTIR of that shareholder. This rule would be simple when there was a single U.S. shareholder.

However, this rule would not work when there were multiple U.S. shareholders with different Section 951A inclusions from different CFCs. The reason is that only a single specified amount of the carryover can be used to offset tested income of CFC1 in year 2, and that reduction in tested income would flow through *pro rata* to all shareholders. That *pro rata* amount would normally cause a different percentage reduction of the Section 951A inclusion for different U.S. shareholders with different holdings in other CFCs.

Sixth, if carryovers of tested loss are allowed, presumably Section 382 would apply to limit loss trafficking just as it does to domestic losses. This would introduce another layer of complexity, particularly among CFCs with multiple non-affiliated owners.

Finally, the allowance of carryover of tested losses at the CFC level might be quite disadvantageous to taxpayers in some situations, especially if the law is changed in the future so that NOL carryovers can offset 100% of taxable income. If this rule was applied to allow tested losses of a CFC to offset 100% of tested income of the CFC in future years, the benefits of FTCs and QBAI return of the CFC in the future year would be eliminated, just as they are today for a CFC with no positive tested income. Such a result could be much worse for taxpayers than the disallowance of the loss carryover, since the FTCs and QBAI return in a particular CFC could be more valuable than the tax cost of the tested income in the CFC.[91]

This issue would not arise or would be less significant under the current rule limiting the reduction in tested income by 80%, to 20% of tested income. This would always leave *some* positive tested income, which would allow full retention of FTCs and QBAI return of the CFC. However, the FTC inclusion percentage could be reduced because of the reduction in positive tested income, *e.g.*, because the QBAI return would be a greater percentage of the total positive tested income.

(iii) Carryover at the US shareholder level

We consider now the alternative approach of having tested losses arising from a CFC carry over at the shareholder level. As a reminder, tested losses of a CFC are taken into account in reducing the U.S. shareholder's income inclusion under Section 951A(a). A U.S. shareholder's Section 951A inclusion is the excess (if any) of the shareholder's net CFC tested income for the year over its NDTIR for the year.[92] Net CFC tested income is the excess (if any) of the aggregate of its *pro rata* shares of its Related CFCs'

[91] Presumably losses from pre-2018 years would not carry over into 2018 because the expenses giving rise to the losses were not attributable to tested income in those years.

[92] Section 951A(b)(1).

tested income over the aggregate of its *pro rata* shares of its Related CFCs' tested losses.[93]

We propose that in the first instance, all tested losses of a CFC move up to the U.S. shareholder and be taken into account by the U.S. shareholder, whether or not this gives the shareholder a net negative tested loss. These tested losses then become tax attributes of the U.S. shareholder, and are treated just like other tax attributes for all purposes, such as Section 381. The possible consequences to the U.S. shareholder's tax basis in the CFC are briefly discussed in Part IV.D.7.

Then, the question is how the tested losses that move up to the shareholder are "absorbed" in the current year and affect the amount of the carryover to future years (or are absorbed in future years and unavailable for further carryover).

The following example illustrates two methods for calculating carryovers. Assume a U.S. shareholder has two CFCs ("**CFC1**" and "**CFC2**"), CFC1 has $100 of tested income and $150 of QBAI return. CFC2 has $100 of tested loss. Under the statute, the U.S. shareholder has $0 tested income and $150 of NDTIR. As will be seen below, the two approaches give carryovers from year 1 of $0 and $150.

Under one approach (the "**tested loss carryover approach**"), $100 of tested losses would be absorbed by the $100 of tested income, and there would be no carryover of tested loss. More generally, the carryover amount would be the "**net CFC tested loss**", which would be defined in the same manner as net CFC tested income, except tested losses of some CFCs could exceed tested income of other CFCs. Likewise, in future years, the carryover would reduce, and be reduced by, the net CFC tested income, subject to the 80% limit. This approach is consistent with carrying over tested losses at the CFC level, since as discussed above tested losses would logically offset future tested income of the CFC without any adjustment for QBAI return in the future year.

The alternative approach (the "**shareholder calculation carryover approach**") applies the entire calculation at the shareholder level. If the Section 951A formula for inclusion would result in a negative number, aside from the prohibition of a negative result, that amount could be carried over, just like any excess of taxable expenses over taxable income. In the example, the Section 951A formula would result in minus $150 in year 1 (net tested income of $0 and NDTIR of $150), and this could be carried over.

This approach allows NDTIR not only to offset net CFC tested income, but also allows NDTIR to create its own carryover if it exceeds net CFC tested income. Specifically, the carryover of the negative amount in the GILTI formula is equal to net CFC tested income minus NDTIR, to the extent this number is negative and without regard to whether it exceeds aggregate tested losses of loss CFCs for the year. This approach, like the tested loss carryover approach, does not provide any benefit from shifting income and deduction among CFCs, since only net CFC tested income (or loss) is relevant.

[93] Section 951A(c)(1).

This approach in effect treats NDTIR as exempt income earned on tangible assets, whether or not that is true in fact. It assumes that, say, a CFC with $100 of tested income and $150 of QBAI return *really* had a $50 tested loss on intangible assets and $150 of income on tangible assets, whether or not that is true as a factual matter. The shareholder obtains "credit" for the deemed $50 loss on intangible assets by being allowed a loss carryover of $50.

On the other hand, even aside from carryovers, the statute does a poor job of treating NDTIR as exempt income, such as by not providing any current year tax benefit for NDTIR when tested loss equals tested income. Moreover, this discussion began with the idea that tested losses of a CFC should be allowed to carry over if they are not utilized currently by the shareholder. It is a considerable leap from that position to the idea that the Section 951A calculation should be allowed to become negative and result in a loss carryover even in the absence of a net CFC tested loss. As a result, this approach would be a more significant conceptual change from the existing statute.[94]

We turn now to a separate issue. Either of the approaches for allowing a loss carryover at the U.S. shareholder level would raise a number of questions.

First, a U.S. shareholder could have a regular NOL carryover and a GILTI NOL carryover (aside from any Section 163(j) carryover from its own activities). GILTI NOLs would not offset non-GILTI income, just like a negative GILTI inclusion for the current year cannot offset non-GILTI income of the shareholder. However, non-GILTI loss carryovers should be available to offset GILTI inclusions, just like current non-GILTI losses can offset GILTI inclusions.

As a result, an ordering principle would be needed to establish which losses are used first. For example, current year losses are typically used before loss carryforwards. However, if the current year has a GILTI inclusion and a non-GILTI loss, and there is a GILTI loss carryforward, arguably the carryforward should be used first since it is of more limited use. Likewise, loss carryovers are usually utilized earliest year first. However, if there is a GILTI inclusion in the current year, arguably all GILTI carryovers should be used before any non-GILTI carryovers, for the same reason.

Second, the GILTI loss carryover (however defined) would presumably be subject to the same 80% limit for use against future GILTI income as are regular NOLs. There is no reason that these carryovers should be exempt from the rule. Suppose that there is both a GILTI inclusion and non-GILTI income in the year, and sufficient carryovers of

[94] We considered a third, intermediate, approach under which NDTIR would offset tested income from CFCs with positive tested income, freeing up such amount of tested losses from CFCs with tested losses to be used currently against remaining tested income or to carry over. Only tested losses could carry over. However, this approach would allow the benefit of NDTIR to increase through the shifting of income and deduction within the group. In fact, if income and deduction items were shifted so that CFCs with positive tested income had total tested income equal to NDTIR, the group would achieve the result of the shareholder calculation carryover approach.

both types. The question is whether each type of carryover should be limited to offsetting 80% of its respective income type.

The alternative would be an aggregate limitation on carryovers equal to 80% of total income, with a preference given to the GILTI carryovers. For example, if there was $100 of GILTI inclusion and $100 of non-GILTI income and sufficient carryovers of both types, the net result could be either (1) $20 of GILTI inclusion and $20 of non-GILTI income, or (2) $0 of GILTI inclusion and $40 of non-GILTI income.

Third, having GILTI and non-GILTI carryovers would raise issues under Section 382. Suppose a corporation had $100 of each type of carryover, and a Section 382 event occurred that limited annual use of NOLs to $20. There are at least three possibilities:

- The aggregate limit of $20 would be available for any $20 of carryovers, and if the usual priority was for GILTI carryovers, that priority would continue to apply until the entire $20 was used up.

- The annual limit of $20 would be divided up *pro rata* between GILTI and non-GILTI carryovers based on their relative size.

- The annual limit of $20 would be divided between GILTI and non-GILTI carryovers based on the relative value of the assets generating GILTI inclusions and other assets.

The third alternative is supported by the fact that the Section 382 limit is equal to a percentage of the value of the stock of the shareholder at the time of the change in ownership.[95]

Yet another issue arises because under Notice 2003-65,[96] the Section 382 limit is adjusted by "recognized built in gain and loss". The question arises if the second or third alternative in the preceding paragraph is used. In those cases, the Notice 2003-65 amount could be calculated separately to adjust the GILTI and non-GILTI carryovers, or it could be done for the corporation as a whole and then allocated between the two carryovers in the same manner as the rest of the NOL limitation.

We note that while these issues appear to be complicated, in reality they are primarily design choices. Once the choice is made by regulations or legislation, the rules appear to operate relatively simply, in contrast to the operational effects of carrying over losses at the CFC level.

(b) Section 163(j) carryovers

[95] Section 382(b)(1).

[96] 2003-2 C.B. 747.

We discuss in Part IV.C.2 the method for determining the taxable income of a CFC. Under our proposal, Treasury would have the authority to determine whether Section 163(j) applies to a CFC. If the limitations of Section 163(j) apply, we believe that all of Section 163(j) should apply, including the carryover of unused interest deductions in the same manner as for a domestic corporation. As in the case of tested loss carryovers, we urge that either regulations or legislation provide for Section 163(j) carryovers.

We have the following reasons for this conclusion. The interest deductions that are disallowed currently under Section 163(j) are for interest that would reduce tested income if it was allowed. A taxpayer should not be in a worse position if an interest deduction is disallowed under Section 163(j) than if the interest deduction was allowed and created a tested loss that was permitted to be carried over. Moreover, absent a carryover rule, a CFC could have plenty of tested income over a period of two or more years, but because the income is bunched into a few of the years, interest deductions would be permanently disallowed. This result is unfair to taxpayers, a trap for the unwary, and an incentive to engage in nonproductive activities to equalize income over a period of years.

In addition, a carryover is necessary to mitigate the consequences of "phantom income" or "phantom tested income" that can arise from a Section 163(j) disallowance for interest paid between related parties. Suppose a CFC ("**CFC1**") pays interest to a related CFC ("**CFC2**") and the interest deduction is disallowed under Section 163(j). Then, CFC2 has an increase in tested income from the receipt of the interest payment, but CFC1 does not have a reduction in tested income. The group has net positive tested income, which may result in a Section 951A inclusion, without any cash profit.[97] Similarly, if a CFC pays interest to its U.S. shareholder and the interest deduction is disallowed under Section 163(j), the U.S. shareholder has taxable interest income but the CFC does not have a reduction in tested income.[98]

Of course, this result could also arise for an interest payment between two related but nonconsolidated U.S. corporations. In that case, however, the interest disallowed under Section 163(j) can be carried forward to reduce future tax liability. A carryover at the CFC level would ameliorate the same risk in the GILTI regime.

Although we recommend applying loss carryovers at the U.S. shareholder level, we recommend applying Section 163(j) carryovers at the CFC level. This is most consistent with the language of Section 163(j)(2), which treats the carried over amount as paid or accrued in the succeeding taxable year.

[97] Alternatively, the interest income might be foreign personal holding company income to CFC2, which could give rise to a better or worse result depending on the group's FTC position. *See* L.G. "Chip" Harter and Rebecca E. Lee, *A Brave New World—The Application of code Sec. 267(a)(3)(B) to Expenses Accrued by Controlled Foreign Corporations*, CCH Int'l Tax. J. May-June 2008, at 5.

[98] In the absence of a rule allowing carryovers in these cases, relief could only be provided by a rule treating non-consolidated affiliates as a single corporation.

Moreover, many of the difficulties that arise in the context of a carryover of tested losses at the CFC level do not arise in the context of Section 163(j) carryovers. The reason is that tested loss is determined at the CFC level but used at the U.S. shareholder level, while both Section 163(j) limitations and carryovers of disallowed interest deductions are determined and used at the CFC level. As a result, there is no need to reduce carryovers that have been used by shareholders, and no possibility of some shareholders receiving a double benefit from a carryover. Attempting to apply Section 163(j) carryovers at the U.S. shareholder level would introduce unnecessary complexity.

We note that the Code already applies Section 382 to Section 163(j) carryovers,[99] so this limitation is already built into the system and should apply equally to domestic and foreign corporations. In contrast to tested losses, no regulations or statutory amendment would be required to achieve this result.

As in the case of the 80% limit for NOL carryovers, there is a question as to how the 30% limit on Section 163(j) carryovers should apply to the tested income of the CFC that also has QBAI return in the carryover year. Consider the following variation on Example 10(a) above.

> <u>Example 12: Carryover of Section 163(j) deduction to year with QBAI return</u>. A U.S. shareholder owns 100% of a single CFC, and the CFC has an excess Section 163(j) deduction of $100 in year 1. In year 2, the CFC has $100 of tested income, of which $30 is QBAI return. Absent the loss carryover, the shareholder would have a Section 951A inclusion of $70.

If the carryover is limited to 30% of tested income, or $30, then tested income is reduced to $70. Then, the U.S. shareholder's NDTIR is reduced by the $30 of allowed interest, namely to $0, since interest expense first reduces NDTIR until NDTIR is reduced to $0.[100] As a result, the U.S. shareholder's Section 951A inclusion is still $70, and the $30 interest carryover is absorbed but provides no tax benefit.

Arguably the allowed carryover should be increased by $21, to $51, to reduce the Section 951A inclusion by 30%, to $49. However, if the interest expense of $100 had actually been incurred in year 2, $30 would be allowed under Section 163(j), tested income would be $70, NDTIR would be $0, and the Section 951A inclusion would be $70. Under Section 163(j)(2), a carryover is to be treated the same as, not better than, interest actually incurred in year 2. Moreover, interest expense and QBAI return in another related CFC of the same U.S. shareholder can affect the Section 951A inclusion of the U.S. shareholder. As a result, any Section 163(j) limitation based on QBAI return

[99] Section 382(d)(3), added by the Act.

[100] Section 951A(b)(2)(B).

of the particular CFC with carryovers will have varying effects on the Section 951A inclusion depending on the attributes of the other CFCs and, in the case of a CFC with more than one U.S. shareholder, will have varying effects for different U.S. shareholders.

The combined effect of (1) limiting current or carryover interest expense to 30% of tested income, and (2) disallowing any benefit of the interest expense to the extent of NDTIR, is a rather extreme result. However, this clearly is the result under the statute if the interest expense was incurred in the current year. It would not even help materially if regulations limited the Section 163(j) current or carryover amount to 30% of the excess of tested income over QBAI return of the particular CFC, since the allowed deduction would still reduce NDTIR before providing any tax benefit.

The Section 163(j) carryover also raises the question of how to deal with a situation similar to that raised in Example 11.

> <u>Example 13: Section 163(j) carryover to year in which tested income is offset by tested loss of another CFC.</u> In year 1, CFC1 has a Section 163(j) carryover of $100 to year 2. In year 2, CFC1 has tested income of $100, and the U.S. shareholder also owns CFC2 that has a tested loss of $70. The Section 951A inclusion aside from the carryover is $30.

If the carryover to year 2 is allowed to the extent of 30% of the $100 of tested income of CFC1 in year 2, then tested income of CFC1 will be $70 and the Section 951A inclusion will be $0. The reduction in Section 951A inclusion from $30 to $0 is arguably not consistent with the intent of the 30% limitation in Section 163(j).[101]

On the other hand, it can be argued that the result is correct, since the Section 163(j) limit is properly determined at the level of the particular CFC. Moreover, attempting to limit the carryover that is used by CFC1 to 30% of the Section 951A inclusion for year 2 would raise the same issues discussed in the previous examples if the U.S. shareholder had other CFCs with interest expense, QBAI return, etc., or if CFC1 had more than one U.S. shareholder.

## D. Other Computational Issues for GILTI Inclusions

### 1. Order of GILTI versus Section 956 Inclusions

Regulations should confirm that tested income of a CFC is determined before Section 956 inclusions.

[101] Under this theory, the carryover is limited to 30% of the Section 951A inclusion of $30, so the allowed carryover is $9, net tested income of CFC1 is $91, and the Section 951A inclusion is $91 less $70, or $21.

It is clear from the Code that Subpart F income is determined before Section 956 inclusions.[102] Treasury Regulations confirm this result.[103] Moreover, the definition of tested income specifically excludes Subpart F income,[104] so Subpart F income must be determined before tested income can be determined.

Section 951A(f)(1)(A) states that Section 951A inclusions are to be treated as Subpart F inclusions for purposes of Section 959. Therefore, since Subpart F inclusions come before Section 956, tested income should also come before Section 956. Under this interpretation, which we refer to as "**GILTI First**", the U.S. shareholder would first report a GILTI inclusion, and this inclusion would create a PTI account.[105] Investment by the CFC in U.S. property under Section 956 would give rise to incremental income inclusions only to the extent it exceeded the PTI account and there was additional e&p available. This result avoids any double inclusion of income of the CFC into the income of the U.S. shareholder.

By contrast, if Section 956 inclusions were determined before tested income is calculated ("**Section 956 First**"), any Section 956 income inclusion (up to e&p) would first create a PTI account. Then, since tested income is not reduced by Section 956 inclusions and (crucially) is not limited to e&p, tested income would be determined completely without regard to the Section 956 inclusion. This would result in a double inclusion of the income of the CFC into the income of the U.S. shareholder.

To be sure, each inclusion would create its own PTI account and basis increase.[106] As a result, the second inclusion in income might provide a tax benefit to the U.S. shareholder on a future distribution from the CFC or on sale of the CFC stock. However, this benefit might be far in the future, and the benefit could be in the form of a future capital loss with a tax benefit of less than the current cost of ordinary income. In any event it would be quite anomalous for $1 of earnings to create $2 of PTI and $2 of basis increase.

[102] Subpart F income is included under Section 951(a)(1)(A) and Section 956 amounts are included under Section 951(a)(1)(B). Section 956 inclusions under Section 951(a)(1)(B) are specifically limited by Section 959(a)(2), which states that e&p attributable to PTI is not included in income again either as a Subpart F inclusion or a Section 956 inclusion. Section 959(f)(1) says that amounts that would be Section 956 inclusions are attributable to PTI to the extent of prior Subpart F inclusions. By contrast, Section 951(a)(1)(A) includes no similar PTI-based limitation for Subpart F inclusions. As a result, Subpart F income causes a Subpart F inclusion, which creates PTI and (assuming the income is not distributed) thereby limits Section 956 inclusions to the extent of that PTI.

[103] Treas. Reg. § 1.959-1(a).

[104] Section 951A(c)(2)(A)(i)(II).

[105] Sections 951A(f)(1)(A), 959. We assume for simplicity that the CFC has a single U.S. shareholder and that there is no Subpart F income.

[106] Sections 951A(f)(1)(A), 959 and 961(a).

We do not believe Congress intended these results. Consequently, we believe that GILTI First is more consistent with both the plain meaning of the statute and the intent of Congress.

In principle, it would be possible for "Section 956 First" to apply, with tested income being reduced for Section 956 inclusions. However, actual distributions do not reduce tested income, so it would be inconsistent for deemed distributions from Section 956 inclusions to do so.

Moreover, in some cases taxpayers will prefer Section 956 inclusions and in other cases they will prefer tested income, in part because of very different FTC rules. This modified version of "Section 956 First" would effectively create an elective regime where well-advised taxpayers could choose between Section 956 and tested income by having CFCs making (or not making) loans to U.S. shareholders or otherwise investing in U.S. property. On the other hand, the same rule would create a trap for the unwary for less well advised taxpayers.

We observe that in applying GILTI First, a U.S. shareholder's income inclusion is based first on the CFC's Subpart F income (which is limited to e&p), then on its tested income and NDTIR (which are not based on e&p), and finally by Section 956 (which is limited to e&p). This ordering is not intuitive, but for the reasons described above, it seems most consistent with the language and purpose of the statute.

2. GILTI and Subpart F Inclusions in a Year When CFC Stock is Sold

When stock of a CFC is sold in the middle of a taxable year, in some cases the Subpart F income and GILTI inclusions allocable to the selling shareholder for the pre-sale portion of the year of the sale are permanently eliminated from the U.S. tax base. These results arise because of the enactment of Section 245A.[107] We discuss ways in which legislation or regulations could prevent these results. However, we do not take a position on whether any such legislation or regulations should be adopted.

(a) Background

The Section 951A inclusion applies only to a U.S. shareholder of a CFC that owns (directly or indirectly through a foreign entity) stock in the CFC on the last day of the taxable year of the CFC that it is a CFC (the "**last CFC date**").[108] The same rule applies to a Subpart F inclusion.[109] The U.S. shareholder's Section 951A inclusion is based on its *pro rata* share of the CFC's tested income for the CFC's taxable year.[110] The U.S. shareholder's *pro rata* share of tested income, tested loss, and QBAI is determined

[107] The Tax Section is preparing a separate report on Section 245A.

[108] Section 951A(e)(1) and (2). This rule is also expressly stated in the Conference Report at 645.

[109] Section 951(a)(1).

[110] Section 951A(a), (b)(1)(A) and (c)(1)(A).

"under the rules of section 951(a)(2) in the same manner as such section applies to subpart F income".[111]

Assume that a U.S. shareholder owns X% of the CFC stock on the last CFC date, and the CFC is a CFC for Y% of the year. Under Section 951(a)(2), the U.S. shareholder's *pro rata* share of the Subpart F income for the year is equal to:

- X% times Y% times the Subpart F income for the entire year, including periods after the last CFC date, *see* Section 951(a)(2)(A), *minus*

- actual dividends paid by the CFC during the tax year to other holders of the stock (or deemed dividends under Section 1248(a) on a sale of the stock by another holder), but not in excess of the product of (i) X% (the ownership percentage), (ii) the Subpart F income for the year, and (iii) the percentage of the year that the U.S. shareholder did not own the stock, *see* Section 951(a)(2)(B).

In other words, the *pro rata* share of the U.S. shareholder on the last CFC date is first determined as if the U.S. shareholder had held the stock for the entire period of the year through the last CFC date. That amount is then reduced by dividends to another holder of the same stock during the year, but only to the extent those dividends do not exceed the Subpart F income attributable on a *pro rata* basis to the period that the U.S. shareholder did not own the stock.

As will be seen below, these rules worked well under the prior law rules for Subpart F. However, they can now allow Subpart F income and tested income allocable to a U.S. shareholder for the portion of the taxable year before the shareholder sells its stock to avoid being a Subpart F or GILTI inclusion or ever being included in U.S. taxable income to anyone.

(b) Fact patterns and results

(i) *Sale of a CFC from one Section 958(a) U.S. Shareholder to another Section 958(a) U.S. Shareholder*

Consider first the case where a CFC is a CFC throughout the year and has 100% U.S. shareholders throughout the year that are subject to Subpart F or GILTI inclusions, *i.e.*, they are shareholders under Section 958(a) ("**Section 958(a) U.S. Shareholders**"). Assume in all cases that the relevant CFCs have no PTI as of the beginning of the year in question, there is no gain in the CFC stock on January 1 of the year in question, the U.S. shareholder's holding period for the CFC stock satisfies the Section 245A holding period

[111] Section 951A(e)(1). This section is written in a rather peculiar way because it refers separately to tested income, tested loss, and QBAI, but since these three items are in effect combined to determine the Section 951A inclusion, we assume it is intended to apply the *pro rata* rule to the Section 951A inclusion.

requirement,[112] the U.S. shareholder holds no other CFCs and none of the relevant CFCs has any QBAI return.

> <u>Example 14(a) (CFC with Section 958(a) U.S. shareholders throughout the year)</u>: A U.S. shareholder (US1) owns the CFC. During the year, the CFC has $1000 of earnings. On June 30, the CFC pays a dividend of $500 to US1, and immediately thereafter US1 sells the stock to another Section 958(a) U.S. shareholder (US2) at no gain or loss. US2 continues to own the stock until the end of the year, so the last CFC date is December 31.

Consider first this fact pattern under prior law, and assume that the $1000 of earnings is all Subpart F income. US1 did not have any Subpart F inclusion because it was not a shareholder on the last CFC date. Thus, it did not have any PTI account, and the $500 dividend it received was taxable at ordinary rates. US2 had Subpart F income of $1000 under Section 951(a)(2)(A), but this was reduced by $500 under Section 951(a)(2)(B). Thus, the total inclusion was $1000, the full amount of Subpart F income for the year.

The same result would arise if there had been no dividend, but US1 had sold the stock of the CFC to US2 on June 30 for a gain of $500. Then, the gain would be a deemed dividend under Section 1248 subject to the same rules. Section 951(a)(2)(B) is essential in these cases to avoid double taxation of $500 of Subpart F income, since otherwise $500 would be taxed to US1 and $1000 would be taxed to US2.

Consider now the same fact pattern under current law. Just as under prior law, US1 does not have a Subpart F inclusion or PTI account, US1 has dividend income of $500, and US2 has Subpart F income of $1000 minus $500, or $500. However, now the dividend of $500 received by US1 is eligible for the 100% dividends received deduction under Section 245A. Likewise, if US1 sold the stock at a $500 gain without taking out the dividend, new Section 1248(j) provides that the deemed dividend under Section 1248 is eligible for the Section 245A deduction.

In either of these cases, US2 would obtain a PTI account of $500 by the first day of the CFC's next taxable year and could withdraw that amount tax free under Sections 959(a) and (e)**.** As a result, in both the dividend and Section 1248 cases, $500 of Subpart F income permanently goes untaxed. Section 951(a)(2)(B), which was originally intended and needed to avoid double taxation of Subpart F income, is now eliminating even a single level of taxation of Subpart F income.

Since the Section 951A rules incorporate the Subpart F rules, the same results arise if income of the CFC is tested income rather than Subpart F income. Again, since

[112] *See* Section 246(c).

US1 is not a shareholder on the last CFC date, it does not have a Section 951A inclusion. US2's *pro rata* share of tested income is $1000 minus the distribution or deemed distribution to US1 of $500, or $500. US1 has a taxable dividend or deemed dividend of $500 and a Section 245A deduction of $500. The CFC has $1000 of tested income for the year, but only $500 of it is taxable (to US2).

These results arise even if US2 is related to US1 (assuming no Section 304 transaction). In addition, an even more taxpayer-favorable result arises if the sale is near the end of the taxable year of the CFC, and so there will be tax benefits to deferring a sale until that time of year. In some cases it might also be possible for US1 to change the taxable year of the CFC to be the 12-month period ending shortly after the sale, to fix the amount of income in the previous portion of the year that would not be taxed under Subpart F or Section 951A.

This elimination of tax on Subpart F income or GILTI inclusions arises because Section 951(a)(2)(B) reduces the Subpart F inclusion (and because of the cross-reference in Section 951A(e)(1) to Section 951(a)(2), the tested income) regardless of whether the dividends to prior shareholders are subject to U.S. tax. In particular, the elimination of tax arises because Section 951(a)(2)(B) applies to dividends paid in the year of sale even if the dividends are eligible for the Section 245A deduction to the shareholder.[113]

(ii) *Sale of CFC stock from a Section 958(a) U.S. Shareholder to a Non-U.S. Shareholder; CFC ceases to be a CFC*

We now consider how existing law applies when the CFC ceases to be a CFC on the sale date.

> <u>Example 14(b) (CFC for only part of year).</u> A Section 958(a) U.S. shareholder (US1) owns the CFC on January 1. During the year, the CFC has $1000 of earnings. On June 30, the CFC pays a dividend of $500 to US1, and immediately thereafter US1 sells the stock to a non-U.S. shareholder (F1) at no gain or loss on the stock. F1 continues to own the stock until the end of the year. Assume no attribution rules apply, so the last CFC date is June 30.

In this case, US1 is a Section 958(a) U.S. shareholder on the last CFC date. As a result, US1 has Subpart F income or a Section 951A inclusion, and PTI, equal to the Subpart F income or tested income for the year, or $500, as well as a Section 250 deduction if the income is tested income. Section 951(a)(2)(B) never applies, since there is no prior shareholder of the relevant stock. The $500 dividend to US1 is out of PTI, and so there is a single inclusion of $500 of Subpart F income or a net Section 951A inclusion

[113] If the distribution to US1 is not taxable because of a preexisting PTI account, such as on account of a prior Section 965 inclusion, it is not a dividend covered by Section 951(a)(2)(B).

of \$250. The statute reaches the correct result without regard to Section 951(a)(2)(B). The same result arises if there is no dividend on June 30, but instead the stock is sold at a gain of \$500. There is still a Subpart F inclusion of \$500 on June 30 and Section 1248(d)(1) excludes such amount from being taxed again under Section 1248.

However, there is one further issue. Section 951A(e)(3) states that for purposes of Section 951A, "a foreign corporation shall be treated as a controlled foreign corporation for any taxable year if such foreign corporation is a controlled foreign corporation at any time during such taxable year." This rule was apparently intended to conform the Section 951A rules to the repeal of the rule that had been in Section 951(a) and that had prevented the application of Subpart F to a corporation that was a CFC for less than 30 days during the year.

Yet it is possible to read this provision as stating that in Example 14(b), the CFC is treated as a CFC for the entire year even though it has no actual or constructive U.S. owners in the second half of the year. We do not think this result was intended, since it would make meaningless the rules in Section 951 that look to the last day of the year on which the CFC is a CFC. Such last day would always be the last day of the taxable year. We recommend that regulations clarify that this provision is merely stating that there is no minimum period of time for a CFC to qualify as a CFC in order for it to be a CFC during its qualification period.

(iii) *Sale of CFC Stock from a Section 958(a) U.S. Shareholder to a non-U.S. Shareholder; CFC remains a CFC*

We now turn to another case where, as in Example 14(a), the CFC remains a CFC until the end of its tax year.

> <u>Example 14(c) (CFC for whole year, taxable Section 958(a) U.S. shareholder for only part of year)</u>. U.S. shareholder (US1) owns the CFC on January 1. During the year, the CFC has \$1000 of earnings. On June 30, the CFC pays a dividend of \$500 to US1, and immediately thereafter US1 sells the stock to a buyer (F1) at no gain or loss. Assume F1 continues to own the stock until the end of the year, and the CFC remains a CFC through the end of the year.

Suppose the prior Subpart F rules apply, the income was Subpart F income, and there was no Subpart F inclusion for the year to any U.S. taxpayer because there was no U.S. taxpayer with Section 958(a) ownership on December 31, the last CFC date. This fact pattern would have arisen, for example, if F1 was a U.S. partnership with all foreign partners.[114] While the partnership would have the Subpart F inclusion as a U.S.

[114] This fact pattern would also have arisen as to, say, 49% of the stock of the CFC if US1 sold 49% of the stock of the CFC to a foreign corporation and retained the rest. The CFC would have remained a CFC

shareholder on the last CFC date, none of its partners would be subject to U.S. tax. Section 951(a)(2)(B) was irrelevant because it merely reduces a Subpart F inclusion. However, US1 had a taxable dividend of $500 on June 30, which was taxable because US1 had no PTI. The same is true if there was no dividend and US1 sold the stock on June 30 at a gain of $500, since Section 1248(a) would apply to the gain.

Now assume these facts arise in 2018, and the income is either Subpart F income or tested income. The CFC will remain a CFC following the sale to F1 far more often under current law than before the Act. The reason is that the Act repealed Section 958(b)(4), which prevented a U.S. corporation from being considered a U.S. shareholder by virtue of attribution from a related foreign person.[115] Now, the CFC will continue to be a CFC through the end of the year even if F1 is a foreign corporation, as long as F1 has at least one U.S. subsidiary, since the subsidiary will constructively own the CFC stock owned by F1.

As before, there is no Subpart F or Section 951A inclusion, because the last CFC date is December 31 and there is no Section 958(a) U.S. shareholder on that date.[116] Section 951(a)(2)(B) is irrelevant because it merely reduces a Subpart F (and now a Section 951A) inclusion. The dividend to US1 is included in its gross income since the CFC has e&p and there is no PTI. However, the dividend is eligible for the Section 245A deduction, so there is no net income inclusion. The same is true if there was no dividend and the stock was sold at a gain of $500, since Section 1248(j) treats the Section 1248(a) gain as a dividend for purposes of Section 245A.

Thus, the Subpart F income or tested income allocable to US1, the selling U.S. shareholder of the CFC with Section 958(a) ownership, has permanently avoided U.S. tax by being converted into a tax-free dividend.[117] Moreover, no interpretation or amendment of Section 951(a)(2)(B) will change this result, since there is no inclusion of Subpart F or tested income that is being reduced by that provision. As before, the goal of US1 would be to sell the stock shortly before the end of the tax year of the CFC, and either take out a tax-free dividend shortly before the sale or else recognize a corresponding tax-free dividend under Section 1248.

throughout the year with a 51% U.S. shareholder, but there would have been no Subpart F inclusion on December 31 as to the 49% purchased interest.

[115] The scope of the repeal of Section 958(b)(4) is discussed in Part IV.G.3.

[116] Even if the CFC remains a CFC because F1 has a U.S. subsidiary that is a U.S. shareholder for determining CFC status, the subsidiary is not a U.S. shareholder under Section 958(a) and therefore has neither a GILTI inclusion (Section 951A(e)(2)) nor a Subpart F inclusion (Section 951(a)(1)).

[117] The converse situation would arise in Example 14(c) if F1 owned the stock in the first part of the year and sold it (without a distribution) to US1 on June 30. US1 would have a Subpart F or tested income inclusion on December 31 equal to the CFC's income for the entire year, and it is doubtful that an offset would be allowed under Section 951(a)(2)(B). The offset is only allowed for an amount included in gross income under Section 1248, and a non-U.S. person such as F1 would not have any gross income under Section 1248 or otherwise. A pre-sale dividend to F1 would avoid this problem.

As noted above, this permanent elimination of tax on Subpart F income and Section 951A inclusions will be more common in light of the repeal of Section 958(b)(4), since there will now be many more situations where a CFC remains a CFC even though it does not have a taxable Section 958(a) U.S. shareholder. However, the issue is conceptually distinct from such repeal, since the issue could arise even if Section 958(b)(4) were fully restored. For example, as in the discussion of prior law above, the same issue would arise (a) if the sale of 100% of the stock was to a U.S. partnership to the extent the partnership had foreign partners that would not be required to report their share of partnership income, or (b) as to 49% of the tested income of a CFC, if a 51% direct U.S. shareholder retained its stock for the entire year, and a 49% direct U.S. shareholder sold its stock in the middle of the year to a non-U.S. person.

(iv) *Sale of stock of second tier CFC where ownership of top CFC does not change*

Similar issues arise when a first tier CFC receives a dividend from, or sells the stock of, a second tier CFC during a taxable year, where the ownership of the first tier CFC does not change. This transaction is identical as an economic matter to the situation in Examples 14(a), (b), and (c) if the first tier CFC is a shell company, and if the buyer of the CFC stock is the same in each case. The result is in substance the same as in the previous situations.

The different fact patterns discussed above are now discussed in this lower-tier CFC context. In the examples, a U.S. shareholder ("**US1**") directly owns all the stock of a top tier CFC ("**CFC1**"), CFC1 directly owns all the stock of the lower tier CFC ("**CFC2**"), and CFC1 has no income or assets other than the stock of CFC2. As before, assume in all cases that the relevant CFCs have no PTI as of the beginning of the year in question, there is no gain in the CFC stock on January 1 of the year in question, the U.S. shareholder's holding period for the CFC stock satisfies the Section 245A holding period requirement,[118] the U.S. shareholder holds no other CFCs and none of the relevant CFCs has any QBAI return.

> <u>Example 14(d) (Second Tier: CFC2 has Section 958(a) U.S. shareholders throughout the year)</u>: During the year, CFC2 has $1000 of earnings. On June 30, CFC2 pays a dividend of $500 to CFC1, and immediately thereafter CFC1 sells the stock of CFC2 to a Section 958(a) U.S. shareholder ("**US2**") at no gain or loss on the stock. US2 continues to own the stock until the end of the year, so the last CFC date for CFC2 is December 31.

[118] *See* Section 246(c).

Consider first this fact pattern under prior law, and assume that the $1000 of earnings is all Subpart F income. US1 did not have any Subpart F inclusion from CFC2 because it was not a shareholder on the last CFC date. US2 had Subpart F income of $1000 from CFC2 under Section 951(a)(2)(A), but this was reduced by $500 under Section 951(a)(2)(B). However, US1 would have an additional $500 of income either when CFC1 received the dividend as Subpart F income (*i.e.*, if the same country exception did not apply), or (if not Subpart F income initially) when CFC1 paid the cash to US1 or when US1 sold the stock of CFC1. Thus, the total inclusion was $1000, the full amount of Subpart F income for the year.

The same result would have arisen if there had been no dividend, but CFC1 had sold the stock of CFC2 to US2 on June 30 for a gain of $500. Under Section 964(e)(1), CFC1 would have a deemed dividend as if Section 1248(a) applied, and the foregoing results would be unchanged. Note that Section 951(a)(2)(B) is essential in these cases to reduce US2's Subpart F inclusion from $1000 to $500, since otherwise $500 would be taxed to US1 and $1000 would be taxed to US2.

Now consider the effects of the Act. The Act added new Section 964(e)(4), which provides that when CFC1 sells the stock of CFC2, the Section 1248(a) amount created by Section 964(e)(1) is Subpart F income to CFC1, is includible in the income of US1, and is eligible for the Section 245A deduction in the same manner as if the Subpart F income were a dividend from CFC1 to US1.

Return now to Example 14(d) under current law, and assume the $1000 of income of CFC2 is Subpart F income or tested income. The dividend to CFC1 would not be Subpart F income or tested income in CFC1's hands.[119] CFC1 could pass on the dividend to US1, and US1 would be eligible for the Section 245A deduction. If instead CFC1 sells the CFC2 stock at a gain of $500, under Section 964(e)(4), US1 will have a deemed Subpart F inclusion that is eligible for the Section 245A deduction.[120] In addition, in either case, US2 will continue to have $1000 of Subpart F income or Section 951A inclusion that is reduced, under Section 951(a)(2)(B), by an actual dividend of $500 paid by CFC2 to CFC1, or by "any gain included in the gross income of any person as a dividend under section 1248". If CFC2 paid an actual dividend of $500, US2's CFC inclusion would be $500, and the clear intent is that the same result arises if CFC1 sold the stock for gain of $500.[121]

[119] Under Section 951A(c)(2)(A)(i)(IV), a dividend from a related party is not tested income. The dividend might be exempt from Subpart F income to CFC1 under Section 954(c)(3) (same country exception) or Section 954(c)(6) (look-through rule). Note that the look-through rule does not apply if the underlying income is Subpart F income, but there is no exclusion if the underlying income is tested income. At least if the underlying income is Subpart F income and the same-country exception does not apply, CFC1 would apparently be entitled to the Section 245A deduction, *see* Conference Report at 599 n. 1486.

[120] Note that Section 964(e)(4) applies "notwithstanding any other provision of this title".

[121] Section 964(e)(4) does not say that CFC1's gain on the sale of the CFC2 stock is "included in the gross income of any person" as a Section 1248 dividend, but the intent is clear.

These results are similar to the results today under Example 14(a) when the stock of a first tier CFC is sold in the middle of the year to another U.S. shareholder. Here, if CFC2 has $1000 of tested income, the Section 951A inclusion reported for the year is $500. Likewise, if CFC2 has $1000 of Subpart F income, the Subpart F inclusion for the year is $500. In both the GILTI and Subpart F cases, the Act has conformed the results of the sale of stock of a second tier CFC to the results of a sale of a first tier CFC.

Next, consider the analog to Example 14(c), where CFC1 sells the stock of CFC2 to F1 and CFC2 continues as a CFC until the end of the year. Regardless of whether the $500 is paid up as a dividend or the stock is sold at a gain of $500, the results to CFC1 and US1 are the same as in the second preceding paragraph. Moreover, there is no U.S. shareholder that pays tax on any Subpart F income or Section 951A inclusions on the last CFC date. Just as in Example 14(c), $500 of Section 951A inclusion or Subpart F income attributable to US1 has avoided U.S. tax, and just as in that example, the reason has nothing to do with Section 951(a)(2)(B).

Finally, consider the results under the Act if the CFC2 income is either GILTI or Subpart F, CFC1 sells the stock of CFC2 to a non-U.S. person, and the CFC ceases to be a CFC. This is the analog to Example 14(b) but in the context of a sale of a second tier subsidiary. Now, US1 is a U.S. shareholder of CFC2 on the last CFC date. As a result, US1 has Subpart F income or a Section 951A inclusion of $500 on that date, regardless of whether the $500 is paid up as a dividend or the stock is sold at a gain of $500. The non-U.S. purchaser of CFC2 is not a U.S. shareholder and has no inclusion. As a result, the total inclusion is $500, just as in Example 14(b), and the result conforms to the amount of Subpart F income or GILTI allocable to the selling shareholder.

(c) Discussion

It is clear from the foregoing that on a sale of a first tier or second tier CFC in the middle of a taxable year, the Subpart F income or Section 951A inclusion attributable to the selling shareholder for the pre-sale portion of the taxable year of sale will now permanently avoid tax because of Section 245A.

Absent a stock sale, it is clear that the payment of a dividend eligible for Section 245A does not reduce the amount of Subpart F income or Section 951A inclusion for the year. The policy question is whether a dividend eligible for Section 245A should reduce the amount of the inclusion if it occurs in the year the stock of a first-tier or second-tier CFC is sold.

On the one hand, it can be argued that Congress did not intend to allow for such an easy avoidance of Subpart F income or Section 951A inclusion. In addition, the fact that the Act conforms the treatment of a first and second tier subsidiary does not mean that it intended to allow such avoidance in either case. Moreover, such an avoidance of tax on a Section 951A inclusion is inconsistent with the theory that GILTI is a flat tax on foreign earnings. This result also allows for considerable tax planning to reduce the taxation of GILTI or Subpart F income. For example, a sale can occur near the end of the year to maximize the amount of excluded income, and the sale can be made to a U.S. or non-U.S. affiliate in a manner that avoids Section 304.

On the other hand, arguably Congress was not concerned about these results. The Act adds both Section 951A and Section 964(e)(4), and both sections refer to Section 951(a)(2). Moreover, the new rule in Section 964(e)(4), combined with new Section 245A, expands the scope of tax free treatment of GILTI and Subpart F income to second tier subsidiaries. Arguably Congress must have determined that the operation of Section 951(a)(2), in conjunction with Section 245A, was consistent with its intent or at least not important enough to fix. In addition, if Congress was satisfied with the operation of Section 951(a)(2) and Section 245A when the sale of stock was to a Section 958 U.S. shareholder, presumably it was satisfied with the equivalent result when the sale was to a non-Section 958 U.S. shareholder.

Moreover, Section 951(a)(2)(B) arguably allowed the elimination of Subpart F income in the year of a sale even before the Act. Return to Example 14(b), where the CFC ceased to be a CFC on June 30. Assume in addition that the CFC paid F1 a dividend of $500 on December 31. US1 is a U.S. shareholder on the last CFC date. Under a literal reading of Section 951(a)(2)(B), US1 has a Subpart F inclusion of (i) $500 (*pro rata* share of Subpart F income for the full taxable year of the CFC) minus (ii) $500 (distribution to F1 not in excess of F1's share of Subpart F income for the year), or $0. At least one Technical Advice Memorandum from 1995 confirms this result.[122] No legislative or regulatory action has been taken to change this result.

We take no position on whether these results should be changed by legislation or, if there is authority to do so, regulations. However, we point out some possible approaches if a change is desired.

First, Section 245A could be amended to provide that when stock of a CFC is sold during a taxable year, and the CFC continues to be a CFC after the sale, dividends paid on that stock out of Subpart F income or Section 951A inclusions for that year are not eligible for Section 245A. However, this would be a basic structural change to the Subpart F and GILTI rules, as well as Section 245A, and would create other complexities.

Second, Section 951(a)(2)(B) could be modified to reduce a Subpart F inclusion only for distributions not eligible for Section 245A. This approach would result in inclusion for the full amount of Subpart F income or GILTI for the year of the stock sale if the CFC continued to be a CFC with a continuing Section 958(a) U.S. shareholder. However, it would not result in full inclusion if the CFC continued as a CFC without a Section 958(a) U.S. shareholder. Moreover, it could be viewed as unfair to the Section 958(a) U.S. shareholder that buys the stock, since it would have a Section 951A inclusion of $1000 (without reduction for the $500 distribution to the seller eligible for Section

[122] TAM 9538002 (May 16, 1995).

245A) even though it only held the stock for half the year. This is penalizing the buyer because of the under-taxation of the seller.

Third, a new rule could apply on any sale of stock by a U.S. shareholder where the tax year does not end and the CFC remains a CFC, regardless of the buyer. In that event, the taxable year of the CFC would be deemed to end, with respect to the sold stock only, on the sale date. This would result in full inclusion to the seller for the year of the sale, as in Example 14(b), regardless of whether the buyer was a Section 958(a) U.S. shareholder.

The notional ending of the tax year could, like today, result in a *pro rata* allocation of income for the full year to the periods before and after the sale date, as opposed to a factual determination of income before and after the sale date. However, if the closing of the tax year applied for all purposes, it would result in short tax years for the sold stock. This would exacerbate the tax detriments under GILTI that arise from tax years with tested losses, and the fact that FTCs do not carry over.

3. Relationship between Section 163(j) and Section 250

As indicated in Part III.E.3 of the Section 163(j) Report, regulations should address the relationship between Section 163(j) and Section 250. Notice 2018-28, relating to Section 163(j), is silent on this question. A taxpayer could first apply the Section 250(a)(1) deduction in determining "adjusted taxable income" under Section 163(j)(8), then determine allowed interest deductions under Section 163(j), and then apply the Section 250(a)(2) limitation of the Section 250 deduction to taxable income. However, a reduction in deductions under Section 250(a)(2) would "retroactively" increase "adjusted taxable income" under Section 163(j)(8), which would require re-calculating allowed interest deductions under Section 163(j), which, in turn, would require re-calculating the reduction in deductions under Section 250(a)(2), and so on and so forth. When Section 250(a)(2) applies, simultaneous equations might be required in order to replicate the effect of this iterative process.

4. Limit on Section 250 Deduction

Regulations should clarify that, for purposes of the limit on the Section 250 deduction under Section 250(a)(2), "taxable income of the domestic corporation" includes all income, including Subpart F, Section 951A, Section 78, and FDII inclusions, determined without regard to the Section 250(a)(1) deduction.

In addition, regulations should clarify whether the Section 250(a)(2) carve-back applies to the Section 78 gross-up amount for a Section 951A inclusion. For example, assume the U.S. shareholder has no income or loss except for a Section 951A inclusion of $50, a Section 78 gross-up amount of $20, and a current NOL of $60. Tentative taxable income before Section 250 is $10. Section 250(a)(2) might require the $70 base for the 50% Section 250(a)(1) deduction to be reduced to either:

(a) $10, *i.e.*, the total Section 951A and Section 78 inclusions of $70 are reduced by the excess of such inclusions ($70) over tentative taxable income ($10), a reduction of $60, resulting in a Section 250 deduction of $5, or

(b) $30, *i.e.*, the Section 951A inclusion of $50 is reduced by the excess of such inclusion ($50) over tentative taxable income ($10), a reduction of $40, to $10, but there is no reduction in the Section 78 amount of $20, resulting in a Section 250 deduction of $15.

Under alternative (a), the Section 250 deduction reduces the tentative taxable income by 50%, from $10 to $5. Under alternative (b), the Section 250 deduction eliminates all of the tentative taxable income and results in a loss of $5. Section 172(d)(9) would prevent this loss from being carried forward.

The two methods give the same result if the loss (after reduction for non-GILTI income) exceeds the sum of the Section 951A and Section 78 inclusions. In that case, any Section 250 deduction will only result in a loss that cannot be carried over because of Section 172(d)(9). The two methods also give the same result if the loss is no greater than the Section 951A inclusion, since the reduction of the Section 951A inclusion itself by the loss will give the same result as if both inclusions are reduced by the loss. The two methods only give different results if, as in the example, the loss is greater than the Section 951A inclusion but less than the sum of the two inclusions.

The uncertainty in the statute arises because under Section 250(a)(2)(A), the reduction in the GILTI amount taken into account under Section 250(a)(1) is equal to the excess of the GILTI amount "otherwise taken into account by the domestic corporation under [Section 250(a)(1)]" over the tentative taxable income of the corporation. Section 250(a)(1)(B) refers separately to the GILTI inclusion under Section 951A and the Section 78 gross-up attributable to such inclusion. It is not clear whether the reference in Section 250(a)(2)(A) is only to the Section 951A inclusion, or whether it is also intended to include the Section 78 gross-up. However, Section 250(a)(2)(B)(ii), which allocates the carve-back between GILTI and FDII, tracks the language of Section 250(a)(1)(B)(i) and implies that only the Section 951A inclusion and not the Section 78 gross-up can be cut back by Section 250(a)(2).

5. Allocation to Preferred Stock

We consider now the proper allocation of tested income to a U.S. shareholder that holds preferred stock of a CFC. Section 951A(e)(1) states that a U.S. shareholder's *pro rata* share of tested income of a CFC is determined under the rules of Section 951(a)(2). The regulations under Section 951(a)(2) determine how to allocate Subpart F income among classes of stock of a CFC.

Under those regulations, if preferred stock has a fixed term and all dividend arrearages accrue and compound at a rate at least equal to the applicable Federal rate at the time of issuance ("**fixed yield preferred stock**"), the stock is not allocated any Subpart F income in excess of accrued and unpaid dividends (referred to here as the "**fixed allocation method**").[123] However, stock that is subject to discretionary distributions, specifically including preferred stock that is perpetual or that does not provide for the compounding of dividend arrearages, is allocated Subpart F income under a different method (referred to here as the "**proportionate allocation method**").[124] Under that method, there is first an initial allocation to accrued and unpaid dividends, and any remaining Subpart F income is then allocated to each class of stock, including the preferred stock, in proportion to the fair market value of all classes of stock of the CFC.[125] The regulations do not contain any special rule for convertible preferred stock, although preferred stock with a participating dividend is subject to the proportionate allocation method.[126]

Regulations should determine the application of these rules to allocations of tested income to a U.S. shareholder holding preferred stock. If the stock is nonconvertible fixed yield preferred stock, we believe that the fixed allocation method that applies for Subpart F purposes should apply. Such stock is not entitled at any point in time to more income than its accrued dividends to date, and there is no logical reason to allocate to it a greater amount of tested income.

Contrary to the Subpart F regulations, the same logic applies to stock that would be nonconvertible fixed yield preferred stock except that it does not provide for compounding of dividend arrearages. If anything, this stock should be allocated *less* rather than more Subpart F income or tested income than fixed yield preferred stock, since the present value of its future fixed dividends will be lower than in the case of fixed yield preferred stock.[127] As a result, we believe that in determining tested income allocable to nonparticipating, nonconvertible preferred stock that would be fixed yield preferred stock except for the lack of compounding of dividend arrearages, the allocation should at least not exceed the allocation under Subpart F for fixed yield preferred stock. We believe this change could be made by regulations, at least if the regulations under Subpart F are changed accordingly.

[123] Treas. Reg. §§ 1.951-1(e)(3)(i) (unless an exception applies, when there are multiple classes of stock, the *pro rata* share of each class for Subpart F purposes is based on proportion of the distributions that would be made to each class if all e&p for the year was distributed on the last day of the year); -1(e)(4)(ii) (an exception that applies the proportionate allocation method described below in the text does not apply to fixed yield preferred stock).

[124] *Id.*

[125] Treas. Reg. §§ 1.951-1(e)(3)(ii)(A); -1(e)(4)(ii).

[126] Treas. Reg. § 1.951-1(e)(6) Ex. 5.

[127] The Tax Section made the same point in commenting on the proposed regulations that led to these final regulations. See NYSBA Tax Section, Report No. 1079, *Report on Proposed Regulations Regarding The Determination of a Shareholder's "Pro Rata Share" Under Section 951* (Feb. 11, 2005), at 20-21 (expressing concern that an uneconomically high allocation of Subpart F income to such preferred stock could lead to abuse).

Turn now to convertible preferred stock that, absent the conversion feature, would be eligible for the fixed allocation method. It does not appear that the conversion feature causes it to be subject to the proportionate allocation method under the Subpart F regulations. Nevertheless, if the fixed allocation method applies to such stock, it would be possible to avoid Section 951A inclusions on tested income. The stock will be allocated tested income equal to the dividend paid or (apparently) accruing on the stock.[128] However, the dividend rate will be below the market rate on comparable nonconvertible preferred stock to reflect the conversion feature. In fact, assuming a purchase price at the face amount of the preferred stock, the greater the initial value of the conversion feature, the lower the dividend rate.

As a result, there may be no tested income allocated to any U.S. shareholder to reflect the "bargain" element of the dividend rate. In addition, when the stock is converted, it will represent a percentage interest in the CFC's existing assets, including PTI for which the holder has never been allocated tested income.

Taxpayers could take advantage of these rules to defer or eliminate tax on tested income. For example, a U.S. shareholder could purchase convertible preferred stock of a CFC, or exchange its common stock for convertible preferred stock with the same value. The common stock might be held by an unrelated U.S. or non-U.S. person, or by the foreign parent of the U.S. shareholder.[129] An individual U.S. shareholder might also own convertible preferred stock, with a wholly owned corporation owning common stock.

It would be possible to treat convertible preferred stock as subject to the proportionate allocation method because of its conversion feature. Alternatively, at least when the stock is "in the money", it could be treated as converted. However, any such rule could lead to widely varying results from year to year. In any event, regulations should clarify the result in these cases.

6. Interest Expense of CFC with Tested Loss

It is not clear whether the gross interest expense of a CFC with a tested loss reduces NDTIR of the shareholder. Section 951A(b)(2)(B) reduces NDTIR by interest expense taken into account under Section 951A(c)(2)(A)(ii) in determining net CFC tested income, and the tested loss of a CFC reduces net CFC tested income. However, while tested losses are calculated under Section 951A(c)(2)(B)(i) by taking into account expenses described in Section 951A(c)(2)(A)(ii), strictly speaking, the expense is taken into account under Section 951A(c)(2)(B)(i) rather than Section 951A(c)(2)(A)(ii) in reducing net CFC tested income.[130]

[128] Treas. Reg. § 1.951-1(e)(3)(i). *See also* Treas. Reg. § 1.951-1(e)(3)(ii) (clause (i) applies to preferred stock entitled to a fixed return).

[129] This assumes no previous inversion transaction. *See* Treas. Reg. § 1.7701(l)-4T.

[130] The House bill took account of all QBAI in determining NDTIR, without regard to whether a CFC had tested income or tested loss, and it was therefore logical to reduce NDTIR by interest expense of all CFCs. The Senate amendment took into account only QBAI used in the production of tested income but

First, assume the CFC with the tested loss and interest expense does not have any notional QBAI return. For example, suppose CFC1 has $100 of tested income and $100 of QBAI return, so there is no Section 951A inclusion for income from CFC1 on a stand-alone basis. CFC2 has $100 of interest expense, $1 of tested loss, and no notional QBAI return. The question is whether the shareholder's NDTIR of $100 from CFC1 is offset by the interest expense in CFC2, so there is net CFC tested income of $99 and a Section 951A inclusion of $99.

Next, even if the interest expense in CFC2 reduces the shareholder's NDTIR in this situation, consider the above fact pattern where CFC2 also has $100 of notional QBAI return. The notional QBAI return of CFC2 does not increase the shareholder's NDTIR, because CFC2 has a tested loss. The question now is whether the shareholder's NDTIR of $100 from CFC1 is still offset by the interest expense in CFC2, even though the $100 of notional QBAI return in CFC2 is disregarded in determining the shareholder's NDTIR. If so, there would be a Section 951A inclusion of $99, the net CFC tested income from CFC1 and CFC2, with no NDTIR.

This would be a very anomalous result, and quite adverse to the taxpayer. Logically, even if interest expense in a CFC with tested losses such as CFC2 is generally required to offset NDTIR, the interest expense should *first* offset the notional QBAI return in CFC2 itself. After all, the purpose of the reduction of NDTIR for interest expense is a presumption that the debt on which the interest is paid was used to buy an asset generating QBAI return. If CFC2 has its own assets that generate notional QBAI return, there is no logical reason for that return to be ignored, and for the interest expense of CFC2 to offset the QBAI return of CFC1 without regard to the notional QBAI return of CFC2.

Regulations should clarify this point.

7. Tax Basis and E&P Issues

A number of issues concerning tax basis and e&p are raised by the GILTI rules. We only mention these briefly, since many of these issues will be discussed in a more extensive report that the Tax Section will be submitting on the subject.

Outside of consolidation, suppose US1 owns all of CFC1 and other CFCs. Assume no NDTIR, and that in year 1, CFC1 has tested income and the other CFCs break even. US1's tax basis in CFC1 will increase by the Section 951A inclusion, which is CFC1's tested income. Now suppose that in year 2, CFC1 has a tested loss equal to its

did not reduce NDTIR by any interest expense of CFCs. The conference agreement adopted the Senate amendment with modifications, including reducing QBAI for interest expense taken into account "under [section 951A(c)(2)(A)(ii)] in determining the shareholder's net CFC tested income....". However, because the Senate provision was not amended to also take into account QBAI in a CFC with tested loss, it is not clear whether the amendment was intended to only account for interest expense of a CFC with tested income.

year 1 tested income, but US1 has another CFC with an equal amount of tested income, so there is no Section 951A inclusion in year 2.

Regulations should clarify whether US1 still has a PTI account of $100 in US1 based on the year 1 Section 951A inclusion, even though CFC1 has no net tested income over the two year period. The existence of such a PTI account would be consistent with the fact that US1's tax basis in CFC1 is apparently not reduced in year 2 notwithstanding the tested loss of CFC1 in year 2. There may be additional consequences arising from the fact that CFC1's loss in year 2 has saved US1 tax on the tested income of CFC2 in year 2.

Next, suppose US1 holds CFC1 and CFC2, CFC1 has tested income of $100, and CFC2 has a tested loss of $100. Section 951A(f)(2) states that if the Section 951A inclusion is less than the sum of the positive tested incomes of the shareholder's CFCs, the inclusion is allocated to the CFCs in proportion to the positive tested income of each CFC. Here, there is no Section 951A inclusion, no basis adjustment to the stock of CFC1 or CFC2, and no PTI is created. However, a dividend of $100 from CFC1 would apparently be eligible for the 100% deduction under Section 245A, and $100 of gain on the sale of the CFC1 stock would be exempt under Section 1248(a). Regulations should confirm these results.

Moreover, on this fact pattern, CFC2's loss has saved US1 $10.50 of GILTI tax, but there is apparently no adjustment to the tax basis of either CFC or to the e&p of the CFC with tested income. A similar issue arises if CFC2 has positive tested income but generates NDTIR in excess of that income, thereby offsetting tested income of CFC1 and causing US1 to save GILTI tax. The basis results in these examples can be uneconomic because the formula under Section 951A(f)(2) can cause a Section 951A inclusion to be allocated to a CFC that generated little or none of the actual Section 951A inclusion amount.

Finally, suppose that under our proposal in Part IV.C.3(a), the tested loss (and possibly QBAI return) of a CFC is shifted to the U.S. shareholder for carryover to future years of the shareholder. Logically there should be a basis decrease at the time of the shift, since the tested loss attribute has permanently left the CFC at that time. Regulations should clarify this point if the statute or regulations adopt this proposal for carryovers.

Many issues also arise under the consolidated return investment adjustment rules. Suppose one member (M1) owns the stock of another member (M2), and M2 has a Section 951A inclusion of $100 and a related Section 250 deduction of $50. Regulations should confirm that M1's stock basis in M2 increases by M2's Section 951A inclusion and is not reduced by M2's related Section 250 deduction. This result is supported by the rule for the dividends received deduction for dividends received by M2, by the analogous rule for partnerships discussed below that is contemplated by the Conference Report, and by the fact that the Section 250 deduction is intended as a rate reduction on GILTI inclusions rather than an economic deduction involving out of pocket costs.

Failure to give M1 a \$100 basis increase in M2 would eliminate the benefit of the reduced GILTI tax rate when M1 sells the stock of M2, since M1 would then have a \$50 capital gain on a sale attributable to the Section 250 deduction.

Additional issues arise under the investment adjustment regulations if, as we propose, members of a group are treated as a single corporation for purposes of GILTI inclusions and Section 250 deductions. As a result of such aggregation, members with Related CFCs may have different PTI accounts in those CFCs than in the absence of aggregation (although as discussed above, mismatches arise even in the absence of aggregation).

For example, suppose CFC1 and CFC2 are owned by different members M1 and M2, CFC1 has tested income, CFC2 has an equal amount of tested loss, and therefore there is no GILTI inclusion for the group.

For example, it is not clear if there is any tiering up or shifting of basis in the stock of M1 and M2, as there would be if CFC1 and CFC2 were domestic members of the group and the CFC2 losses were used to shelter CFC1 income. It is also not clear if any account is taken of the fact that CFC2's loss results in a loss of the Section 250 deduction for the group. The same issues arise if CFC1 has tested income, CFC2 has \$1 of tested income and large QBAI return, and there is little or no GILTI inclusion as a result of the offset for NDTIR.

Finally, in a consolidated return context, the foregoing fact patterns raise questions as to how e&p is to be allocated among members of the group. Our forthcoming report will discuss both basis and e&p issues.

Additional issues also arise in the partnership context. As contemplated by the Conference Report, regulations should confirm that a corporate partner's outside basis in its partnership interest is increased by the GILTI inclusion of income to the partner, but not reduced by the Section 250 deduction. Such a reduction would mean that the deduction would represent a deferral, rather than a permanent decrease, in the tax rate on GILTI income to the corporate partner.

In addition, suppose a U.S. person is a partner in a partnership that owns a CFC, and the partner has a GILTI inclusion. Regulations should clarify whether there is an adjustment to the tax basis of the partnership in the CFC. Regulations should also address the more complex issues that can arise when interests in a CFC are held through tiered partnerships.

## E. Foreign Tax Credit Issues

1. Determination of Allowed FTC

(a) Tracing versus proration

If a CFC has tested income, the foreign taxes paid by the CFC are entitled to the deemed paid FTC for GILTI purposes if they are "tested foreign income taxes". This means they must be "properly attributable to the tested income of such foreign corporation taken into account by such domestic corporation under Section 951A."[131] If the CFC has both tested income and other income, the Conference Report[132] indicates that regulations should apply principles from Treas. Reg. § 1.904-6. That regulation applies tracing if different categories of income are subject to foreign taxes imposed on different tax bases, but a *pro rata* rule based on net income if two categories of income are subject to the same foreign tax regime. We support regulations under GILTI that incorporate this aspect of the existing regulation.[133]

Once foreign taxes are determined to be attributable to tested income, regulations should clarify that it is not necessary to trace the taxes to particular dollars of tested income, as long as the items of tested income are included in the foreign tax base. For example, the CFC as a whole might have tested income, but foreign taxes might be paid by a branch or disregarded subsidiary that would have a tested loss on a stand-alone basis.

> <u>Example 15(a): Two divisions of a single CFC</u>. Assume a CFC has two divisions, A and B. Division A generates $100 of tested income, while division B generates $99 of tested loss in a business whose income would be tested income. As a result, the CFC has $1 of tested income. Assume that income of division B is subject to foreign income tax, notwithstanding the tested loss under U.S. tax principles.
>
> <u>Example 15(b): Disregarded subsidiary of a CFC</u>: Same facts as Example 15(a), but the CFC transfers division B to a newly-formed legal entity and "checks the box" to cause the entity to be disregarded.

As noted above, the FTC allowance is for FTCs "properly attributable" to tested income. As a result, it could be argued that in both of these cases, the foreign taxes borne by division B should not be eligible for the FTC. This position is arguably supported by the rule that if division B was a separate CFC, its foreign taxes would not be creditable to the U.S. shareholder.

[131] Section 960(d)(3).

[132] Conference Report at 628 (describing House bill), 630 (stating that conference agreement follows House bill).

[133] See Part IV.E.2(f), where we suggest modification of the regulation where tax is imposed on an item of income that is not included in the U.S. tax base.

We believe, however, that regulations should confirm that the FTC is available for foreign taxes borne by division B. The statute does not provide for any "tracing" of particular taxes to particular dollars of tested income. Rather, a CFC has a single specified amount of tested income, which is taken into account by the shareholder in determining its Section 951A inclusion. Income and loss of all the assets of the CFC that can generate tested income go into the calculation of its tested income, even if some groups of assets standing alone generate a loss for U.S. tax purposes. We therefore believe that all the foreign taxes of the CFC are attributable to "the tested income" of the CFC. This position is consistent with the fact that Section 960(d)(3) (requiring that the foreign taxes be "properly attributable to the tested income") is written in a broader fashion than the item-by-item approach of Section 960(a) (requiring that the foreign taxes be properly attributable to "any item of income under Section 951(a)").

Moreover, if a CFC has an overall tested loss, no tracing is *allowed* to *permit* FTCs for taxes paid on profitable activities of the CFC. Since tracing is disallowed in that case, tracing should not be *required* so as to *disallow* FTCs for unprofitable activities of a CFC that has overall tested income. This is a matter of policy rather than administrative convenience (although we note that item by item tracing would often be very burdensome and impracticable). Thus, we believe tracing should not be required even in Example 15(b), where tracing might be relatively simple.

(b) Timing differences

Tested income will often arise in the same taxable period as the foreign taxes that are attributable to that tested income. However, timing mismatches can arise in a number of situations, including (a) tested income arises in the current year under U.S. tax principles, but the corresponding income inclusion (and therefore tax accruals) occurs in an earlier or later year under foreign tax principles, *e.g.*, because of different depreciation schedules or different taxable years under U.S. and foreign tax law, or (b) audit adjustments.

The first question in these situations is whether foreign taxes can qualify as tested foreign income taxes if they accrue in a year that is different than the year that the underlying income is included in tested income for U.S. tax purposes. Timing differences do not disqualify a tax for the foreign tax credit for purpose of the non-GILTI baskets.[134]

As noted above, a tested foreign income tax must be "properly attributable to the tested income of such foreign corporation" taken into account by the U.S. shareholder under Section 951A. The concern is that the reference to "the tested income" means "the tested income" *for the year in which the foreign tax accrues*.

[134] Treas. Reg. § 1.904-6(a)(1)(iv) (stating that timing differences do not change the basket in which a foreign tax is allocated); Rev. Rul. 74-310, 74-2 C.B. 205 (total foreign taxes of CFC imposed on profit on contract is eligible for Section 902 credit, even though timing of income was different under U.S. principles; requirement that foreign taxes be "attributable to" U.S. accumulated profits is satisfied).

Regulations should confirm that the reference to "the tested income" of the CFC is not so narrow, and that a foreign tax is a tested foreign income tax as long as the underlying income giving rise to the foreign tax is included in the tested income of the CFC for *any* year.[135]

We believe this interpretation is fully consistent with the language of the statute. Moreover, a contrary rule would require the tracing of every item of tested income to every item of foreign tax, to make sure they arose in the same taxable year. This would not be administrable and would result in large amounts of foreign taxes being disqualified as tested foreign income taxes because of minor timing differences between U.S. and foreign law. As noted above, this would also be inconsistent with the law for foreign taxes allocable to non-GILTI baskets, where timing differences are disregarded.

Assume now that a foreign tax qualifies as a tested foreign income tax. Such a tax is creditable in the year it is paid or accrued by the CFC.[136] Normally this would be the taxable year that the liability arises under foreign law, namely the year that the underlying income is taken into account for foreign tax purposes. In the case of timing differences, this year would be different than the year that the CFC had the underlying tested income. This could result in loss of the benefit of the FTC altogether, because there is no carryover or carryback of GILTI credits, even to the year in which the underlying tested income arises.

Relief from this timing mismatch is provided under certain circumstances by Section 905(c)(2)(B), as amended by the Act. That section provides that if accrued foreign taxes are not paid within two years after the end of the taxable year to which the taxes relate, or are refunded after being paid, then they are taken into account in the taxable year to which they relate. Previously the section provided that taxes in this situation were taken into account when paid. The scope of the old provision was not clear,[137] and many of the uncertainties remain.

Nevertheless, the provision is directed primarily at the situation where an audit adjustment causes foreign taxes to accrue in an earlier year, but payment does not occur until the close of the audit. Regulations should confirm that Section 905(c)(2)(B) applies to audit adjustments relating to tested income under these circumstances, and clarify the application of that provision. This is especially important because of the lack of carryovers and carrybacks of GILTI credits.

In cases where Section 905(c)(2)(B) does not apply, the Code does not provide relief from timing mismatches. Relief may not be needed for routine mismatches that

[135] If a foreign corporation is a not a CFC in 2018 but is one in 2019, regulations should clarify whether a foreign tax payable in 2019 on 2018 income is a tested foreign income tax, given that the definition of tested income refers to income of CFCs. Section 951A(c)(2)(A).

[136] Section 960(d)(1)(B).

[137] *See* Alan Fischl, Elizabeth Nelson, and Anisa Afshar, *Section 905(c) Mysteries*, J. Int'l Tax, July 2017 at 22.

cancel each other out from year to year, or even for routine annual audit adjustments that are settled quickly after a tax return is filed.

However, consider the case of an extraordinary item that involves a timing mismatch for U.S. and foreign income inclusion. Section 905(c)(2)(B) will not apply because the tax will accrue for U.S. tax purposes at the time the foreign tax accrues for foreign purposes and is paid, even though the tested income is reported for U.S. purposes in a different year.

Given the lack of carryovers and carrybacks of GILTI FTC, a disparity between the year the tested income is reported and the year that the FTC arises may give rise to significant amounts of FTCs that become unusable. We urge that the principles of Section 905(c)(2)(B) be extended to timing differences arising from the inclusion of items in the U.S. and foreign tax base in different years. The extension could be limited to non-routine items, although this would be difficult to define. An automatic rule that is as broad as possible would be preferable to a facts and circumstances test. In any event, regardless of the scope of the new rule, it should apply without regard to the two-year minimum deferral period in Section 905(c)(2)(B), because the lack of a carryover means that even a single-year timing difference could easily result in a loss of any benefit from FTCs.

We believe that this rule is justifiable because the restriction on carryovers and carrybacks of FTCs was presumably intended to prevent taxes paid in high-tax years from being used to shelter income earned in low-tax years. There is no indication it was intended to cause a loss of the benefit of FTCs as a result of inclusion of income in different years for U.S. and foreign tax purposes.

We recognize that applying an expanded version of Section 905(c)(2)(B) on an item-by-item basis will be administratively difficult. However, we do not see any alternative that would be consistent with the rule that there is no carryover of GILTI FTCs. We believe that the result after applying Section 905(c)(2)(B) should be the same, but no better and no worse, than if the tested income arose in the same year that the foreign tax was paid.

The proposed extension of the principles of Section 905(c)(2)(B) could be limited to GILTI, on the theory that GILTI is in effect a new world-wide tax system and so all preexisting rules should be reconsidered for GILTI. Alternatively, uniform rules under Section 960 could be considered for all foreign income. The reason is that the additional new baskets and lack of GILTI carryover mean that the use of FTCs and carryovers on an overall basis is now much more restricted than before.

(c) Withholding tax on distribution of PTI

Regulations should confirm that if there is withholding tax on a distribution of PTI arising from tested income, 100% rather than 80% of the withholding tax is allowed as a credit under Section 901, and that the FTC is not cut back by the inclusion percentage. Both limitations are imposed by Section 960(d)(1), which applies to tested foreign income taxes, *i.e.*, taxes paid by the CFC on the CFC's tested income. These taxes are imposed on the U.S. shareholder rather than the CFC.[138]

2. Section 904 Issues

(a) Expense allocation

Section 904(d) creates a separate limitation basket for GILTI. As illustrated in Examples 5(a) through 5(c) above, if expenses of the U.S. shareholder are treated as foreign source expenses allocated to the GILTI basket, and if the foreign tax rate is at least 13.125%, expenses of this type cause U.S. tax to be payable on a Section 951A inclusion no matter how far above 13.125% the foreign tax rate is. As shown in Example 5(c), for every $1 of such allocated expenses, foreign source income is reduced by $1, and this reduces the FTC limit by $.21. This in turn increases the U.S. tax liability by $.21, no matter how much the foreign tax rate exceeds 13.125%. If the foreign tax rate is less than 13.125%, any allocated expenses will first increase the effective foreign tax rate (determined under U.S. principles taking the expense allocations into account) to 13.125%, and thereafter any additional $1 of allocated expenses will result in the same $.21 increase in U.S. tax liability.

This section discusses the statutory basis for the allocation of expenses, the ability of Treasury not to allocate any expenses to GILTI, the policy issues concerning allocating or not allocating expenses to GILTI, and possible modification of existing regulations for allocating expenses to GILTI.

Section 904(d)(1)(A) states that Section 904(a) and certain other sections shall be applied separately to Section 951A inclusions. Section 904(a) limits foreign tax credits based on taxable income from foreign sources, so the Section 951A limitation is based on taxable income in the Section 951A basket. Under Sections 861(b), 862(b), and 863(a), taxable income in a category is based on gross income in the category reduced by expenses "properly apportioned or allocated" to such gross income under regulations. Moreover, under existing regulations, the expenses of the U.S. shareholder must be divided between US-source and foreign-source, and then the foreign-source expenses are further divided among the applicable limitation baskets.[139]

In light of this statutory structure, if Treasury determines that no expenses of the U.S. shareholder are "properly allocable" to income in the GILTI basket, Treasury could issue regulations that no allocation of expenses to that basket should be made. Presumably such a determination would be based on the flat-rate theory of GILTI discussed above that the rules are intended as a flat tax of 13.125% on foreign income. As noted above, the Conference Report seems to contemplate no GILTI tax if the foreign

[138] Logically the same rule should apply to withholding tax on a distribution from a subsidiary CFC to a parent CFC, since the U.S. shareholder takes account of tested income of the lower tier CFC, and the distribution to the upper tier CFC creates PTI rather than tested income to the upper tier CFC.

[139] *See generally* Section 861 and Treasury Regulations thereunder.

tax rate is at least 13.125%. This statement is correct only if there are no allocations of U.S. deductions to the GILTI basket for purposes of determining FTC limitations. Moreover, there are other situations where the usual rules for allocating expenses are modified.[140]

On the other hand, arguments can be made that such an interpretation by Treasury would be inconsistent with the structure and purpose of the statute. First, such an interpretation is inconsistent with the notion that the statement in the legislative history is illustrative rather stating a definitive rule. Arguably the allocation of deductions to foreign income is integral to the structure of the FTC rules, and it should take more than this ambiguous statement in the legislative history to override that basic structure.

Second, the statute is most logically read to require that every expense should be allocable to some item of gross income. Therefore, Treasury would have to conclude that expenses otherwise allocable to Section 951A inclusions under the principles of the existing regulations are instead allocable as a matter of law to domestic income or other foreign source income. It is difficult to see how such expenses become "properly allocable" to such other income solely as a result of the enactment of the Act, since there is no more connection between such expenses and such other income after the Act than there was before. Such a nonallocation to Section 951A inclusions is in contrast to other situations where regulations create an exception to allocations of expenses to foreign income, since such exceptions are based on specific fact patterns where an allocation is likely not "proper" as a factual matter.

Third, the statute clearly contemplates a loss of GILTI FTCs in other situations,[141] so perhaps Congress was not concerned about a loss of FTCs in the context of expense allocations. In fact, when Congress desired to change the normal rules for allocations of expenses to categories of income, it has stated so explicitly.

- Section 864(e) contemplates an allocation of interest expense among assets, with a specific exception in Section 864(e)(3) that prevents an allocation of expenses to tax exempt assets (and the income they produce) and the deductible portion of dividends eligible for the DRD.

- New Section 904(b)(4), discussed below, is a special rule for allocating expenses when dividends from a CFC are eligible for Section 245A.

- New Section 965(h)(6) turns off allocation of deductions attributable to dividends from a CFC in determining the net tax liability under Section 965.

[140] *See, e.g.*, Treas. Reg. § 1.861-10T, relating to special rules for allocating interest expense.

[141] For example, FTCs are lost if the foreign taxes are paid by a CFC without tested income, and tested losses of one CFC (or NDTIR of the shareholder) can reduce the shareholder's resulting FTC allocation percentage for FTCs paid by a CFC with tested income.

There is no comparable special rule for the GILTI basket, arguably indicating an intent by Congress that no special expense allocation rules were intended for the GILTI basket. In fact, Section 904(b)(4) by its terms disregards deductions allocable to income from stock of a CFC other than amounts includible in income under Sections 951(a)(1) or 951A(a). This exception clearly implies an understanding that deductions might be allocable to Section 951A inclusions. Similarly, since shareholder level deductions clearly reduce FDII, to the extent FDII and GILTI are considered parallel systems, shareholder deductions should likewise be allocable to GILTI.

In any event, we do not believe as a policy matter that there should be a complete exclusion of shareholder expenses from the GILTI basket.

Such a complete exclusion means that expenses that would be properly allocable to Section 951A inclusions under existing principles should instead *automatically* be treated as properly allocable to other foreign or domestic source income. Yet such expenses reduce U.S. taxable income no matter how they are allocated for FTC purposes. To the extent expenses that are properly allocable to foreign income are in fact allocated to domestic income for FTC purposes, the overall effect is that FTCs are allowed to shelter U.S. tax on U.S. income. This effect also arises if these expenses are not allocated to any basket (a questionable interpretation of the statute in any event), because the full FTC is allowed as long as there is no reduction in foreign source income.

Section 904 was intended to prevent the FTC from having this effect. In addition, this reallocation of deductions encourages foreign countries to raise their tax rates at the expense of the U.S. fisc, because until the Section 904 limits are reached, 80% of the additional foreign tax is creditable.

If the taxpayer had non-GILTI foreign income, it would be possible to avoid all or part of this result by allocating the GILTI-related expenses to other baskets of foreign income, rather than to U.S. income. This may be taxpayer-favorable because it could allow GILTI FTCs to be used currently instead of being permanently lost, and FTCs in other baskets to be carried forward or backward instead of being used currently. However, it could be taxpayer-unfavorable if the taxpayer has, say, high-taxed foreign branch income and low-taxed GILTI, since there would be no effect on GILTI FTCs but the branch FTCs would have to be carried forward or backward rather than being used currently. In either case, it is difficult to see a logical reason for the reallocation of expenses to other baskets.

Moreover, there would be no justification for reallocating GILTI expenses to FDII of the shareholder. The argument for a flat rate of tax based on the Conference Report applies equally to FDII, and so it would be inconsistent with the flat rate theory to increase the effective tax rate on FDII in order to obtain a flat rate on GILTI.

Finally, allocation of GILTI expenses to other baskets of foreign income (with or without FDII) would have no effect if the taxpayer did not have any foreign income in other baskets, and no material effect if the taxpayer did have foreign income in the other baskets but such income was not subject to a material amount of foreign tax. Also, once the allocation eliminated all foreign source income in non-GILTI baskets, any additional expenses otherwise allocable to GILTI would have to be reallocated to GILTI or to U.S. source income.[142] This leads back to the original issue.

Despite these policy arguments against allocating *no* expenses to the GILTI basket, it is important to note that there are significant differences between the GILTI regime and the historic regime for taxing income of CFCs. For example, foreign tax credits in the GILTI basket cannot be carried forward or backward,[143] so the impact on taxpayers of limiting GILTI FTCs is much more severe than limiting non-GILTI FTCs. These limits on GILTI FTCs seem to undercut both theories of the nature of GILTI, since they cause worse results for taxpayers than either the Subpart F rules or the result under a flat rate of tax (at least if the flat rate of tax is intended to be based on true economic income over a period of years).

As a result, we believe that in light of these differences between GILTI and the preexisting tax rules for FTCs, even if expense allocations continue to apply to the GILTI basket under Section 904, the existing Section 861 statutory and regulatory framework should not necessarily be applied wholesale. Moreover, in light of the flat rate theory of GILTI, regulations should modify existing rules to minimize allocations to GILTI inclusions that are not economically justified. In fact, reconsideration might also be given to certain of the allocation rules for Subpart F income allocated to the general and passive FTC baskets.

For example, research expenses of a U.S. corporation are allocated to U.S. and foreign sources under various methods based on sales or gross income.[144] To the extent that gross income is the test, there was little allocation to CFCs in the past because most income of CFCs was not currently included in U.S. gross income. This result seems appropriate because research expenses of the U.S. shareholder increase the royalty or sales income of the shareholder, but the CFC does not benefit. In fact, the CFC would only have increased its income if the resulting intangibles were transferred to the CFC, which could not occur without gain recognition or Section 367(d) royalty income to the U.S. parent corporation.[145]

Now, CFCs will generate a significant amount of gross income to the U.S. shareholder as a result of GILTI inclusions. Moreover, the research expenses of the U.S. shareholder will not generally give rise to tested income to the CFC or GILTI inclusions

[142] Section 904(a) and (f)(5); Treas. Reg. § 1.904-4(c)(2)(ii). Allocations to U.S. source income would also create an overall domestic loss ("**ODL**") to the extent they exceeded U.S. source income.

[143] This means, for example, that if a U.S. shareholder has an NOL or NDTIR that offsets its GILTI inclusion for the year, the NOL or NDTIR is absorbed in the current year and the FTC on the GILTI inclusion provides no benefit in the current year and cannot be carried to a future year.

[144] *See* Treas. Reg. § 1.861-17.

[145] For intangibles developed by cost sharing, each of the U.S. shareholder and the CFC bore its own expenses, so this issue does not arise.

to the shareholder for the reasons stated above.[146] Nevertheless, absent a change in regulations, the GILTI inclusions will result in an allocation of research expenses to the GILTI basket for purposes of Section 904. These allocations do not seem justified as a result of the enactment of the GILTI rules, and we believe these rules should be reconsidered by Treasury.

Likewise, interest expense of the U.S. shareholder is generally allocated to stock of a CFC based on the tax basis of the stock and the accumulated earnings of the CFC.[147] However, under Section 864(e)(3), no expenses may be allocated to stock that gives rise to income that is exempt, excluded, or eliminated from tax, including the portion of stock attributable to the dividends received deduction available under Section 243 or 245 for dividends on that stock.[148] It appears that this rule does not apply to stock of a CFC that gives rise to dividends eligible for the Section 245A deduction, because such dividends are initially included in gross income and the deduction is under a section not specified in Section 864(e)(3). Rather, stock giving rise to such dividends is apparently subject solely to Section 904(b)(4), discussed below. Regulations should confirm this conclusion.

Other allocation questions also arise. Allocations of some expenses such as interest are based on the tax basis of stock of a CFC. The stock may give rise to GILTI inclusions, dividends eligible for Section 245A, or Section 956 inclusions. The allocation each year could be based on the actual GILTI inclusions, Section 956 inclusions, and Section 245A eligible dividends paid during the year. Alternatively, the allocation could be based on GILTI inclusions, Section 956 inclusions, and QBAI return whether or not paid out as dividends during the year. Section 904(b)(4), discussed below, is inconclusive on this question because it contemplates that expenses might be allocable both to stock of a CFC and to exempt dividends paid by a CFC.

We note that the timing of Section 245A dividends is entirely discretionary and could be adjusted to achieve desired allocations each year. As a result, an annual allocation based on Section 245A dividends paid during the year would have little or no economic substance and would create considerable opportunity for tax planning. On the other hand, an allocation based on QBAI return could not take into account the possibility that such return could be paid out in the future as either Section 245A eligible dividends or as Section 956 inclusions. Regulations should clarify this question. In the examples that follow, we assume an allocation based on QBAI return rather than actual cash dividends, but the results would be the same in substance in either case.

[146] An exception would be if royalty income from the CFC was considered a GILTI inclusion to the U.S. shareholder. We believe this should not be the case, as discussed in Part IV.E.2(e), but if this is the case, an expense allocation to such income would be appropriate.

[147] Section 864(e)(4); Treas. Reg. § § 1.861-9T(g), -12(c)(2); new Section 864(e)(2) (requiring use of tax basis rather than fair market value for allocating interest expense).

[148] *See also* Treas. Reg. § 1.861-8T(d)(2)(ii).

Finally, in many situations the allocation of expenses is based on gross income, including in the preceding paragraph where the allocation to categories of income in the CFC is based on different types of income of the CFC. Consideration should be given as to whether these allocations should be based on net GILTI rather than gross GILTI. It can be argued that expenses give rise proportionately to gross income regardless of the different tax rates that might apply to different items of income. However, if the CFC has $100 of passive Subpart F income and $100 of gross GILTI income, an equal allocation of expenses to both items will have a far more adverse effect on the GILTI basket than on the passive basket. This result would exacerbate the negative effect of interest allocations on the GILTI basket. Consequently, it can be argued that a *pro rata* rule based on gross GILTI is unjustified in light of the flat-rate theory of GILTI.

(b) Section 904(b)(4)

Regulations should clarify the application of new Section 904(b)(4).

As background, FTCs are not available for dividends giving rise to a Section 245A deduction.[149] As a result, deductions allocable to such dividends, or to stock giving rise to such dividends, do not cause a tax detriment to the U.S. shareholder of a CFC, since a reduction in foreign source income under Section 904 does not matter when no FTCs are available anyway. It can logically be argued that deductions allocated to such dividends should remain so allocated, as opposed to being reallocated to other baskets, and other aspects of the Section 904 calculations should be unchanged.

After all, the logic that led to the initial allocation of expenses to each FTC basket is not changed as a result of the enactment of Section 245A. For example, if a U.S. shareholder borrows to buy stock in a corporation, the interest expense would logically be allocated to the stock (or not) regardless of whether the stock happens to give rise to taxable or tax-exempt dividends. This result would also be consistent with the general approach of Section 265 , which disallows deductions for expenses allocable to exempt income, and thereby increases taxable income for all purposes of the Code, but does not reallocate any deductions to or from exempt income (the "**no-reallocation approach**").

By contrast, Section 864(e)(3), discussed above, reallocates all expenses initially allocable to tax-exempt income and assets to other income and assets for FTC purposes. This reduces foreign source income in the baskets giving rise to taxable income, and therefore reduces the ability to utilize FTCs arising on taxable income. This approach might be based on the theory that in this situation, unlike under Section 265, the expenses in question are still allowed to the U.S. shareholder as deductible expenses and therefore should still be allocated against taxable income.

Section 904(b)(4) was added by the Act as Section 904(b)(5) and later renumbered in a technical correction bill.[150] The heading is "Treatment of Dividends for

[149] Section 245A(d).

[150] Pub. Law. 115-141, § 401(d)(1)(D)(xiii) repealed former Section 904(b)(4) as deadwood and renumbered Section 904(b)(5), added by the Act, as Section 904(b)(4), effective March 23, 2018.

which Deduction is Allowed Under Section 245A." Since the provision is within Section 904, the purpose is clearly to adopt a rule to deal with the allocation of deductions to dividends that are in substance exempt from tax.

The provision states that for purposes of the Section 904 limitations, the shareholder's foreign source income and entire net income are calculated without regard to (A) the foreign source portion of all dividends from the CFC ("**clause A**"), (B)(i) deductions allocable to non-GILTI, non-Subpart F income from stock of a CFC ("**clause B(i)**"), or (B)(ii) deductions allocable to stock of a CFC to the extent income from the CFC is non-GILTI, non-Subpart F ("**clause B(ii)**"). The identification of these clauses reflects the clause references in Section 904(b)(4).

This provision is similar to Section 864(e)(3) in that it does not deny a deduction for expenses at the shareholder level. On the other hand, on its face, it does not reallocate any expenses to other baskets, as does Section 864(e)(3). Rather, it provides a formula for calculating foreign source income and entire net income for purposes of the Section 904 limitations. As is discussed below, the formula appears to achieve the same result as the no-allocation approach.

Turning to the specifics of the formula, recall that the ratio of foreign source income in a basket to entire net income is multiplied by U.S. tax liability to obtain the FTC limit for the basket. Clause A disregards all foreign source dividends from a CFC. This rule is likely based on the fact that all dividends from a CFC will either be nontaxable PTI from GILTI or Subpart F, and taken into account previously for expense allocation purposes, or else from CFC exempt income and eligible for Section 245A.

Clauses B(i) and B(ii) require the disregard of all expenses allocable to the CFC in baskets other than GILTI and Subpart F. Since a CFC will never give rise to branch income to its U.S. shareholder, the reference can only be to the general basket. However, once those expenses are disregarded, the determination of foreign source income and entire taxable income must be recalculated for purposes of all baskets, including GILTI and Subpart F.

Since the formula disregards both exempt dividend income and expenses allocable to such income, the result is the no-reallocation approach. This increases the ability of the U.S. shareholder to use FTCs when the only foreign income of the U.S. shareholder is (1) dividends from a CFC eligible for Section 245A, and (2) Subpart F income or GILTI inclusions from a CFC.

<u>Example 16(a)</u> (<u>Shareholder has no foreign income except CFC income</u>). U.S. shareholder has:

- $700 of U.S. income offset by $500 of allocable expenses, for U.S. taxable income of $200

- $300 of net GILTI income from a CFC offset by $100 of allocable expenses, for GILTI basket income of $200

- $100 of expenses allocable to QBAI return of the CFC (general basket expenses).

World-wide taxable income is $300. Absent Section 904(b)(4), the foreign tax credit fraction for the GILTI basket would initially be $200 (GILTI income) divided by $300 (worldwide taxable income). However, since there is a $100 loss in the general basket, the GILTI fraction is reduced to $100/$300.[151]

Now applying Section 904(b)(4), clause A says to ignore dividends from the CFC. Regardless of whether any such dividends are paid, they would not be in taxable income (either because they are non-taxable distributions of PTI or because they are fully offset by Section 245A deductions) and so this condition is satisfied. Clauses B(i) and B(ii) say to disregard the $100 of expenses in the general basket in determining foreign source income and entire taxable income (because these expenses are allocable to QBAI return that will give rise to exempt dividends). In calculating the new GILTI limitation, those expenses are ignored in the numerator, meaning that they no longer reduce the $200 of net GILTI income to $100. Moreover, absent those expenses, entire taxable income increases from $300 to $400. As a result, the GILTI FTC fraction becomes $200 (net GILTI income) divided by $400 (entire taxable income with addback of expenses allocable to exempt dividends).

This $200/$400 FTC fraction is an improvement over the $100/$300 fraction that arises in the absence of Section 904(b)(4). In fact, this is the same result that would arise if the expense of $100 had simply not been incurred. Consequently, this result is the same as under the no-reallocation approach.

We now consider a case where the U.S. shareholder has other foreign source income in the general basket at least equal to the expenses in that basket that are allocable to exempt income. In that case, there is no negative balance in the general basket that would reduce the balances in the GILTI or Subpart F baskets. Section 904(b)(4) still reaches the same result as the no-reallocation approach. However, in this case the application of Section 904(b)(4) increases the limitation in the general basket, and decreases the limitations in the GILTI and Subpart F baskets. The following example illustrates these results.[152]

<u>Example 16(b) (shareholder has other general basket income)</u>. A U.S. shareholder has:

- $100 of domestic source business income offset by $40 of allocable expenses,

- $600 of gross GILTI inclusion, offset by $300 of Section 250 deduction and $60 of allocable expenses,

[151] Section 904(f)(5); Treas. Reg. § 1.904-4(c)(2)(ii).

[152] Appendix 1 contains a table illustrating this example.

- $50 of foreign source business income in the general basket, offset by $10 of allocable expenses, and

- $40 of expenses allocable to exempt CFC return of the CFC giving rise to dividends eligible for Section 245A.

On these facts, before applying Section 904(b)(4), the U.S. shareholder has:

- taxable income of $300 ($150 operating income, $300 net GILTI inclusion, $150 expense),

- U.S. source income of $60 ($100 of business income and $40 of expense),

- foreign source GILTI basket income of $240 ($300 inclusion minus $60 expense),

- foreign source general basket income of $0 ($50 of business income, $10 of expense allocated to such income, and $40 of expense allocated to exempt CFC return),

- tentative U.S. tax liability of 21% of $300, or $63.00, and

- a GILTI FTC limit of $63.00 (tentative U.S. tax) times $240 (foreign source GILTI inclusion) divided by $300 (world-wide taxable income), or $50.40.

These results would not change if income from the CFC was distributed, since the GILTI inclusion would be PTI, the exempt CFC return would give rise to gross income eligible for the Section 245A deduction, and as noted above Section 864(e)(3) would not apply. As a result, no taxable income or foreign source income would be created.

In this case, the expense of $40 that is allocated to QBAI return reduces the U.S. shareholder's foreign source income in the general basket from $40 to $0. As a result, unlike in Example 16(a), there is no "negative" balance in the general basket that reduces the GILTI fraction. However, the general basket fraction is reduced from $40 (general basket income outside the CFC) divided by $300 (worldwide income) to $0 divided by $300, or $0. Therefore, no FTCs on the direct foreign source income of $50 are available.

Consider now Section 904(b)(4). It requires disregarding the expenses of $40 allocable to QBAI return in calculating the shareholder's foreign source income and entire taxable income. Therefore, similar to the result in Example 16(a), general basket expenses are calculated without regard to the $40 deduction, so general basket income is increased from $0 to $40. Stopping there, the general basket FTC fraction is $40 (foreign source income) divided by $300 (world-wide income), and the GILTI basket is unaffected.

However, Section 904(b)(4) also requires that the shareholder's "entire taxable income" be determined without regard to the $40 of expense. As a result, the foreign source GILTI inclusion remains at $240. However, the denominator of the general basket fraction and the GILTI fraction, namely world-wide taxable income, is increased by the $40 of lost deductions, to $340.

The general basket FTC fraction is then $40/$340, which is higher than the $0/$300 result absent Section 904(b)(4). The GILTI FTC fraction is then $240/$340, or .71, which is lower than the initial fraction of $240/$300, or .80. The reason for the increase in the general basket fraction is that the increase in the numerator of that fraction by the $40 of exempt expense more than makes up for the increase in the denominator by the same amount. On the other hand, there is no increase in the numerator of the GILTI fraction, only a $40 increase in the denominator. This is in contrast to Example 16(a), where the increase in the numerator of the GILTI fraction (as a result of preventing the income in the basket from being offset by the exempt loss) more than made up for the increase in the denominator of the fraction by the same amount.

In both cases, the result is the same as under the no-reallocation approach. If the U.S. shareholder had not incurred the $40 of expense allocated to the exempt dividend income, entire taxable income would be $340 and the above results would follow.

It can be argued that the initial GILTI fraction of $240/$300 is the "correct" fraction, and that the reduction in the fraction to $240/$340 has the same substantive effect as reallocating part of the $40 of exempt expenses to the GILTI basket to reduce the GILTI fraction. However, if the GILTI fraction remains at $240/$300, the U.S. shareholder has a higher limitation in the GILTI basket than if there had not been any exempt income or expense. This is not consistent with the no-reallocation approach, with the principles of Section 265 or with the statutory directive to disregard the exempt expenses.

We also note that the maximum allowed GILTI FTC is the GILTI fraction multiplied by the tentative U.S. tax liability on world-wide income, and the latter number is reduced as a result of the tax deduction of $40 that was allocated to Section 245A dividends. As a result, the GILTI FTC basket is less than if the $40 had not been incurred and additional U.S. tax had been paid. However, this is a consequence of the allowance of the deduction, unlike the disallowance of deductions allocable to exempt income under Section 265. The deduction reduces the effective U.S. tax rate on worldwide income, and the result under Section 904(b)(4) is consistent with the purpose of Section 904 to limit the credit for FTCs to the effective U.S. tax rate on worldwide income.

Treasury should clarify in regulations whether the above results are correct, and if not, how Section 904(b)(4) should be applied instead.

(c) The Section 250 deduction

Regulations should confirm that the portion of the Section 250 deduction that is allocable to the GILTI inclusion is allocated and apportioned to the GILTI basket.[153] That portion of the deduction is clearly attributable to the foreign-source GILTI inclusion, since the deduction is a percentage of the gross income inclusion and is clearly intended merely to reduce the U.S. tax rate on that income.

If this portion of the Section 250 deduction was allocated and apportioned to the general limitation basket, foreign taxes on tested income at a rate in excess of 13.125% could in effect be used to shelter U.S. tax on U.S. income. Likewise, the allocation might cause a foreign tax on general basket income such as FDII income not to be fully creditable. These results are clearly at odds with Congressional intent.

(d) Section 78 gross-up

We recommend that regulations specify that the Section 78 gross-up for foreign taxes deemed paid under Section 960(d) is in the GILTI basket.

The issue arises for the following reason. Section 78 treats the gross-up amount as a dividend to the U.S. shareholder. However, the amount of foreign tax reduces the tested income of the CFC, and therefore neither the tax nor the gross-up gives rise to a Section 951A inclusion (which is based solely on tested income and QBAI return). Consistent with this, Section 250(a)(1)(B) specifically includes, in the amount eligible for the 50% Section 250 deduction, both the Section 951A inclusion and the Section 78 gross-up of the Section 951A inclusion. Moreover, while the Senate bill explicitly provided that the Section 78 gross-up was in the GILTI basket,[154] this provision was removed in the final bill. The foregoing could potentially indicate a conscious choice by Congress not to include the gross-up as an inclusion in the GILTI basket and to reach the "right" amount of the Section 250 deduction through a separately identified deduction.

However, explicitly providing that the gross-up belongs in the GILTI basket might also have been deemed unnecessary. Section 78 does not specify the appropriate basket for gross-ups on other income, and regulations could address this point in the same manner that it is addressed under Subpart F.[155]

[153] Likewise, the portion of the Section 250 deduction that is allocable to FDII is clearly attributable to FDII and should be allocated solely to the general basket or passive income basket. If the carve-back applies, the deduction should be allocated between GILTI and FDII based on the reduced amounts of each.

[154] *See* Conference Report at 644, describing the Senate Bill ("[T]he taxes deemed to have been paid [under new Section 78] are treated as an increase in GILTI for purposes of section 78...").

[155] Section 904(d)(3)(G), implemented by Treas. Reg. § 1.904-6(b)(3), specifies that amounts included in gross income under Section 78 and attributable to Subpart F income are treated as Subpart F income for purposes of the foreign tax credit limitations. Although the statute addresses only Subpart F income, Section 904(d)(7) delegates broad regulatory authority and the principles of the regulation could be extended to Section 78 amounts attributable to GILTI.

Moreover, it is not logical for the Section 78 gross-up to be in any basket other than the GILTI basket when the underlying income giving rise to the grossed-up taxes was tested income giving rise to an inclusion in the GILTI basket. If the Section 78 amount is not in the GILTI basket, this would reduce foreign source income in the GILTI basket and thus the FTCs allowed in that basket. In fact, reducing foreign source GILTI inclusion by excluding the Section 78 gross-up has a similar effect as reducing foreign source GILTI inclusion by allocating expenses of the U.S. shareholder to GILTI inclusion.

Unless some other items were also shifted out of the GILTI basket (see below), the result is that a blended foreign tax rate of 13.125% on pre-foreign tax tested income would not itself be sufficient to eliminate U.S. tax on such income even after taking the Section 78 gross-up into account. This is so even if no expenses of the U.S. shareholder were allocated to the GILTI basket. Even stranger, the higher the foreign taxes paid, the more pronounced this effect would be because more pre-foreign tax tested income would be shifted out of the GILTI basket. This seems inconsistent with the intent of Congress.

We assume that if a Section 78 gross-up is not included in the GILTI basket, it would be in the general basket.[156] In that case, other adjustments would logically follow.[157] In particular, since the foreign tax reduces tested income, we believe that regulations should provide that the portion of the FTC allocable to the Section 78 gross-up amount (a non-tested income amount) is also in the general basket. For example, suppose the CFC has $100 of income and pays $10 of foreign tax. This results in $90 of tested income, a Section 951A inclusion of $90, a Section 78 gross-up of $10, an FTC under Section 960(d) of $8 and a Section 250 deduction of $50. If the $10 of Section 78 gross-up is in the general basket, then an allocable portion of the Section 250 deduction and shareholder expenses should logically also be allocable to the general basket rather than the GILTI basket. Moreover, the portion of the FTC allocable to the Section 78 gross-up, *i.e.*, 80% of the tax imposed on $10 of general basket income, or $0.80, would logically also be in the general basket.[158]

However, when all of the underlying income of the CFC is tested income included under Section 951A, it would be extremely peculiar for the GILTI rules to give rise to two separate and parallel tax calculations and limitations, one in the GILTI basket and one in the general basket. Illogical pro-taxpayer and pro-government mismatches could

[156] Since tested income excludes Subpart F income, if there were no GILTI basket, all tested income (except for passive income that is not Subpart F income) would be in the general basket.

[157] *See discussion in* Elizabeth J. Stevens and H. David Rosenbloom, GILTI Pleasures, Tax Notes Int’l, Feb. 12, 2018, at 615.

[158] Under principles analogous to Treas. Reg. § 1.904-6(b)(3), the Section 78 gross-up would be in the GILTI basket if the underlying taxes were paid on income in the GILTI basket. Since tested income is only $90, logically only $9 of the foreign taxes were paid on that income, and the other $1 of foreign tax was paid on the $10 of pre-tax foreign income that was paid out in foreign taxes and thereby reduced tested income from $100 to $90. Of that $9 and $1 respectively, $7.20 and $0.80 are allowed as FTCs under Section 960(d) (assuming the inclusion percentage is 100%).

arise. On the pro-taxpayer side, excess general basket FTCs could offset a low-taxed Section 78 gross-up of the Section 951A inclusion. In addition, excess FTCs could be created in the general basket that could carry over. On the pro-government side, excess GILTI FTCs from other CFCs could not offset a low-taxed Section 78 gross-up amount. In that case, GILTI FTCs could be wasted, and tax would be owed on the gross-up amount unless the taxpayer had excess FTCs in the general basket. This issue would be exacerbated if the FTCs proportionately allocated to the Section 78 gross-up income were not placed in the general basket. We do not believe that these results were intended by Congress.

(e) Interest, rent and royalty payments from a CFC to its U.S. shareholder

Regulations should confirm that interest, rent and royalties received by a U.S. shareholder from its Related CFC are not in the GILTI basket for Section 904(d) purposes.

We acknowledge that Section 904(d)(3)(C) states that interest, rents, and royalties paid by a CFC to a U.S. shareholder out of passive category income of the CFC retains its character as passive category income in the hands of the shareholder for Section 904 purposes. By analogy, this could allow these amounts paid out of tested income of a CFC to be in the GILTI basket for Section 904 purposes.

However, for the following reasons, we believe that these payments should not be in the GILTI basket.[159]

First, as a statutory matter, only Section 951A inclusions can give rise to taxes in the GILTI basket, and nothing in Section 951A turns these payments into Section 951A inclusions. Likewise, Section 904(d)(3) was not amended to include GILTI inclusions, and Congress did not include Section 904(d)(3) in the rather long list of sections for which GILTI was to be treated in the same manner as Subpart F income.[160]

Second, rent or royalty income from a CFC to its U.S. shareholder would often be eligible for the FDII deduction. This is inconsistent with those payments being treated as GILTI inclusions.

Third, these payments are deductible for U.S. tax purposes. They reduce the tested income of the CFC, and reduce the U.S. shareholder's Section 951A inclusion in the same manner as payments made by the CFC to third parties. In addition, unlike dividends, these payments are normally deductible for foreign tax purposes and therefore reduce foreign tax liability. Increasing the GILTI basket by an expense that reduces foreign taxes is arguably contrary to the purpose of the FTC baskets.

[159] Assuming these payments are not in the GILTI basket, foreign withholding taxes on these payments should likewise not be GILTI taxes and should not be subject to the 80% limit on GILTI credits.

[160] *See* Section 951A(f)(1)(A).

Fourth, if these payments are in the GILTI basket, the U.S. shareholder of a CFC with high taxed income could use otherwise unusable FTCs to shelter these payments from U.S. tax.

> <u>Example 17 (Royalty income and FTC baskets).</u> Assume a CFC has $200 of gross income, a royalty deduction of $100 to the U.S. shareholder, tested income of $100 before foreign taxes, and foreign tax of $40 (40%). Assume the shareholder has no income other than this royalty income. Then, the shareholder has $100 of GILTI inclusion (including Section 78 gross-up), $50 of Section 250 deduction, and $100 of royalty income. Its tentative U.S. tax is $31.50 ($100 of royalty income, plus $50 of net GILTI, all multiplied by 21%).

If the royalty income is not in the GILTI basket, the Section 904(d) limit on GILTI credits is $10.50 ($50 GILTI inclusion, divided by $150 worldwide income, multiplied by $31.50 tentative U.S. tax). Therefore, the U.S. tax is $21 ($31.50 of tentative tax, less the allowed FTC of $10.50). This $21 is the full U.S. tax on $100 of royalty income.

If the royalty income is a GILTI inclusion for purposes of Section 904(d), the available FTC is 80% of $40, or $32. The Section 904(d) limit is $31.50 ($150 GILTI, divided by $150 worldwide income, multiplied by $31.50 tentative U.S. tax). Therefore, the shareholder can use $31.50 of its FTC to entirely eliminate the tentative U.S. tax of $31.50. As a result, no U.S. tax is owed on receipt of the royalty payment.

The CFC has effectively received the benefit in the foreign jurisdiction of having made a deductible royalty payment while, for U.S. FTC purposes, the U.S. shareholder has been able to treat the payment more like a non-deductible dividend payment. By adding the income to the GILTI basket it has offset the effect of the deduction taken into account in the calculation of tested income. While not actually a hybrid payment, this treatment appears to violate the principles behind anti-hybrid rules.

Finally, if these payments are in the GILTI basket, a U.S. shareholder with U.S. source income and with a high-taxed CFC would be incentivized to "sop up" the excess FTCs by converting its U.S. income into interest, rents or royalties from the CFC.[161] The

[161] For example, if the U.S. shareholder had assets earning $100 of U.S. source income, the shareholder could sell the assets to a third party and loan the proceeds to the CFC for debt paying interest of $100 per year. If the CFC could invest the proceeds and earn $100 on the purchased assets, just as the shareholder did, the foreign taxable income and tax would be unchanged. However, if the interest income to the parent was in the GILTI basket, then just as in Example 17, a sufficiently high foreign tax on the CFC would mean that the interest income would be tax-free to the parent.

result would be the conversion of U.S. taxable income to tax-free interest, rent or royalty income from the CFC.

(f) Basket for base differences

Current law, as amended by the Act, treats foreign taxes on items that are not income for U.S. tax purposes as in the basket for branch income.[162] This rule is the result of a technical error in the Act,[163] and if our suggestion below is not adopted, a statutory amendment should be adopted to restore the prior rule that such taxes are allocated to the general basket.

Allocation of residual taxes to the general basket made sense when the general basket contained most types of non-passive income. However, GILTI inclusions, and FTCs allocable to GILTI inclusions, are very significant today. The same is true for branch income.[164] An allocation of all these foreign taxes to the general basket could therefore have very unjustifiable and adverse results on taxpayers. As a result, we urge that legislation be adopted to provide for an allocation to one or more baskets based on a facts and circumstances test, *i.e.*, based on the basket that the item would be in if it were subject to U.S. tax. If this question was still unanswerable, the allocation could be made to the general basket as today.

For example, the GILTI basket should apply to a foreign income tax imposed on a particular item that is part of an ordinary business that generates tested income, but that is not viewed as income for U.S. tax purposes. In the same situation, the branch basket should apply if the item relates to an underlying business that is operated in a branch. Likewise, withholding tax on exempt PTI from GILTI inclusions could logically be placed in the GILTI basket (see discussion in Part IV.E.2(g)).

We acknowledge that our proposal is arguably inconsistent with language in the Conference Report[165] indicating an expectation that taxes on items excluded from the U.S. tax base would be allocated to the general basket. However, this language is describing the current Code, and we are proposing legislation. Moreover, it is not clear

[162] Section 904(d)(2)(H)(i).

[163] When Section 904(d)(2)(H)(i) was enacted, its cross reference to Section 904(d)(1)(B) was to general limitation income. The Act amended Section 904(d)(1)(B) to refer to the branch basket, but inadvertently neglected to change the cross-reference.

[164] Section 904(d)(1)(B).

[165] Conference Report at 628, describing the House Bill ("It is anticipated that the Secretary would provide regulations with rules for allocating taxes similar to rules in place [under Treas. Reg. § 1.904-6(a)] for purposes of determining the allocation of taxes to specific foreign tax credit baskets. Under such rules, taxes are not attributable to an item of subpart F income if the base upon which the tax was imposed does not include the item of subpart F income. For example, if foreign law exempts a certain type of income from its tax base, no deemed-paid credit results from the inclusion of such income as subpart F. Tax imposed on income that is not included in subpart F income, is not considered attributable to subpart F income." [footnote omitted])

that the drafters of the Conference Report were aware of the severe adverse consequences under the Act from base differences.

Finally, our position is supported by Section 951A(c)(2)(A)(ii), which allows a reduction in tested income for expenses (including taxes) properly allocable to gross income in the tested income category, or “to which such deductions would be allocable if there were such gross income”. This language appears to contemplate a reduction in tested income for foreign taxes imposed on an item relating to tested income even if it is not in the U.S. tax base. It would be most logical for the amount of the deduction for foreign taxes attributable to tested income to be the same amount as the gross-up and FTC for foreign taxes attributable to tested income.

(g) Basket for withholding tax on PTI

If withholding tax applies to the distribution of previously taxed Subpart F income, the withholding tax appears to be in the same basket as the underlying income.[166] Regulations should provide that this treatment applies to withholding tax imposed on distributions by a CFC of previously taxed tested income attributable to GILTI inclusions.

Section 960(c)(1) increases the Section 904 limitation for the applicable FTC basket to account for such withholding tax in the taxable year in which a PTI distribution is made, to the extent there is excess limitation that was not used in prior years. However, Section 951A(f)(1)(A) does not incorporate the principles of Section 960. As a result, under existing regulations, the GILTI limitation for the year would not be increased by excess limitation from prior years.

We believe this “increase by excess limitation” rule should be extended to GILTI by regulations or a statutory amendment. Absent such a rule for GILTI, the FTCs from the GILTI withholding tax would often be unusable because of the lack of income inclusion from the distribution, and the lack of a carryback of FTCs to the year of the GILTI inclusion. Absent this rule, the FTC could only be used if the U.S. shareholder happened to have other low-taxed GILTI inclusions in the year of the PTI distribution.

Even in a GILTI system without a general carryover of FTCs, if the tax on the underlying income is low enough to create excess limitation in the years that income is earned, there is no logical reason that the excess limitation should not be carried forward and made usable against withholding tax on GILTI inclusion when it is distributed. The Section 960(c)(1) rule applies to Subpart F income even though there is also a rule allowing FTC carryovers for Subpart F. There is no logical reason that the same rule should not apply to GILTI even in the absence of GILTI FTC carryovers.

On the other hand, existing Section 960(c)(1) involves the creation of a single cumulative excess limitation account that is drawn upon when needed. That approach appears to be inconsistent with the lack of carryover of GILTI FTCs, since it can put a

[166] Treas. Reg. § 1.904-6(a)(1)(iv).

GILTI taxpayer in a better position by receiving a PTI distribution in a later taxable year than in the year the tested income was earned. As a result, in applying Section 960(c)(1) to GILTI, logically the U.S. shareholder would be required to trace a particular distribution of PTI to particular tested income for a prior taxable year and excess limitation for the same year. Then, only excess limitation from that year would be allowed to shelter withholding taxes on the PTI distribution. We acknowledge that such a rule would be administratively burdensome.

(h) 2017 overall foreign or domestic loss

Regulations should clarify issues that arise under Section 904(f), relating to recapture of overall foreign loss ("**OFL**"), and Section 904(g), relating to recharacterization of ODL, where the respective loss occurred in 2017 or prior years. The question is how recapture or recharacterization of pre-2018 OFLs and ODLs, respectively, should be applied in 2018 and subsequent years. The issue arises because the calculations are done separately for each FTC basket,[167] and most or all income items that were in the pre-2018 general basket may now be in the GILTI and foreign branch baskets that did not exist pre-2018. Also, these sections were designed to reach a proper aggregate result for FTC limits across different tax years, and did not contemplate that a significant portion of FTCs taken into account in 2017 would be eliminated under Section 965(g).

(i) FTC transition issues

Regulations should clarify transition issues involving foreign tax credits that arise because the concept of tested income did not exist before 2018.[168] For example, should foreign taxes payable in 2018 for income of a CFC that accrued under foreign law in 2018 but accrued under U.S. law in 2017 be tested foreign income taxes? What if the foreign tax was payable in 2017 but the tested income accrued under U.S. law in 2018? How should a foreign tax deficiency or refund in 2018 for a foreign tax payable in 2017 or earlier years be treated? The Tax Section expects to prepare a Report on FTC issues arising under the Act that will cover these and other topics.

[167] Treas. Reg. § 1.904(f)-7; Section 904(g)(3).

[168] While not a GILTI question, regulations should also clarify whether excess foreign branch FTCs for 2018 can be carried back under Section 904(c) to 2017 (presumably to the general limitation basket), given that there was no foreign branch basket for 2017.

## F. U.S. Partnership as a U.S. Shareholder in a CFC

### 1. Possible Approaches for Applying GILTI

Suppose a U.S. partnership is a U.S. shareholder of a CFC.[169] It is not clear whether the GILTI calculations are to be made at the partnership level or the partner level. We believe the most logical alternatives are the following.

Under the "**Partnership Level Approach**":

(1) A partnership that is a U.S. shareholder of a CFC calculates its Section 951A inclusion just as any U.S. shareholder. The inclusion is based only on stock in the CFCs owned directly or indirectly under Section 958(a) by the partnership, but the rule applies even if the partnership owns less than 10% directly or indirectly and is a U.S. shareholder solely by reason of owning additional stock by attribution from its partners under Section 958(b).

(2) The partnership notionally calculates a Section 250 deduction equal to the specified percentage of the Section 951A inclusion, but without regard to the nature of its partners or the taxable income limit in Section 250(a)(2). The deduction has no substantial economic effect, and must be allocated to partners in the same manner as the inclusion.

(3) Each partner, whether or not it is itself a U.S. shareholder, includes its share of the Section 951A amount in gross income. Each partner claims the corresponding share of the Section 250 deduction to the extent it is eligible at the partner level. In particular, noncorporate partners do not get the deduction, and corporate partners are subject to the Section 250(a)(2) limit based on their own taxable income, other Section 250 deductions, and FDII deductions.

(4) Section 960(d) by its terms is applied at the level of a domestic corporation. As a result, tested foreign income taxes paid by CFCs owned by the partnership would flow through to each domestic corporate partner based on the Section 951A inclusion of each such partner, whether or not the partner is a U.S. shareholder.[170] The partner calculates its own inclusion percentage, Section 78 gross-up, and Section 904 limitations. A partner can use credits in the GILTI basket not only

[169] A domestic partnership can be a U.S. shareholder of a CFC. Section 7701(a)(30); Treas. Reg. § 1.701-2(f) Example (3). This position was recently reaffirmed in Section 3.05(b) of Notice 2018-26, which treats a U.S. partnership that is a U.S. shareholder of a deferred foreign income corporation as the shareholder required to report the Section 965(a) inclusion amount, with partners in the partnership required to report their share regardless of whether they themselves are U.S. shareholders. If this rule was changed to apply look-through treatment to domestic partnerships in the same way it applies to foreign partnerships, many of the issues in this Report involving partnerships would be avoided. However, that proposal is beyond the scope of this Report.

[170] Section 960(d) allows an FTC to a domestic corporation with a Section 951A inclusion, and does not require that the corporation be a U.S. shareholder.

against the GILTI inclusion passed through from the partnership, but also against other GILTI inclusions from the same or other CFCs or from other partnerships owning CFCs, and *vice versa*.

Alternatively, under the "**Partner Level Approach**":

(1) If the partnership is a U.S. shareholder, tested income, tested loss, QBAI and interest expense of a CFC flow through the partnership directly to the partners and are treated as the partners' *pro rata* shares of such items for purposes of applying Sections 951A(c)(1)(A) and (B) and 951A(b)(2). The flow-through applies whether or not the particular partner is itself a U.S. shareholder.

(2) Each partner combines these items with its own partner-level items in determining its own GILTI inclusion under Section 951A and Section 250 deduction.

(3) The tested foreign income taxes of the CFC also flow through the partnership to the partner. The partner calculates its own inclusion percentage, taking into account items from the partnership as well as its own partner-level items. The partner then determines its FTCs under Section 960(d) and its Section 78 gross-up. The Section 904 limits are determined at the partner level.

2. Discussion

The statute and legislative history are not conclusive on which approach should be adopted. In contrast to new Section 163(j), there is no statutory provision stating that either Section 951A or Section 250 should be determined at the partnership level. As a literal matter, Section 951A requires the U.S. shareholder of the CFC to include GILTI in income. If the partnership is a U.S. shareholder, this seems to require the GILTI inclusion to be at the partnership level.

By contrast, Section 250(a)(1) allows a deduction "to a domestic corporation" for a percentage of the amount included in its gross income under Section 951A. Similarly, Section 250(a)(2) limits the GILTI/FDII combined deduction to "the taxable income of the domestic corporation" determined without regard to this section. These provisions seem to require the Section 250 deduction to be at the level of the corporate partner of a partnership. Confusing matters further, the legislative history implies in two places that Section 250 applies at the partnership level.[171]

[171] Conference Report at 623 n. 1517, describing the Senate Bill ("The Committee intends that the deduction allowed by new Code section 250 be treated as exempting the deducted income from tax. Thus, for example, the deduction for global intangible low-taxed income could give rise to an increase in a domestic corporate partner's basis in a domestic partnership under section 705(a)(1)(B)."); and at 626 n. 1525, describing the Final Bill ("Due to the reduction in the effective U.S. tax rate resulting from the deduction for FDII and GILTI, the conferees expect the Secretary to provide, as appropriate, regulations or other guidance similar to that under amended section 965 with respect to the determination of basis adjustments under section 705(a)(1) and the determination of gain or loss under section 986(c).")

We believe that there are a number of advantages of the Partner Level Approach. First, it taxes a U.S. shareholder on its share of the net CFC tested income minus NDTIR determined by reference to all the CFCs in which it has an interest, regardless of whether the interest is held directly or through a partnership. In particular, this approach allows tested income from all CFCs in which the U.S. shareholder has an interest to be offset by tested loss, NDTIR and FTCs from other CFCs in which it has an interest. We believe this is the proper result.

Second, by contrast, the Partnership Level Approach would encourage tax planning to achieve very different tax results with very little change in economic position. This issue is the same as that for consolidated groups if members are not aggregated, where aggregation can then be achieved electively by restructuring. The Partnership Level Approach is comparable to nonaggregation in the consolidated return context, and the Partner Level Approach is comparable to aggregation in that context.

As discussed in Part IV.B.4(a) in the context of a consolidated group, sometimes aggregation of CFCs helps the taxpayer and sometimes it hurts the taxpayer. For example, the Partnership Level Approach would be adverse to a partner with a GILTI inclusion from a partnership with no ability to offset the inclusion with tested loss or NDTIR from CFCs held directly or through other partnerships. Likewise, a U.S. shareholder could have a GILTI inclusion from CFCs held directly with no offset for such items allocated from one or more partnerships.

In other cases, the Partnership Level Approach is more favorable for taxpayers than the Partner Level Approach. For example, a U.S. shareholder might hold a CFC with high-taxed income through a partnership, and directly hold a low-taxed CFC that generates NDTIR. Assuming the Partnership Level Approach results in a separate inclusion percentage to the corporate partner for Section 951A items from the partnership (*see* discussion below), that approach will prevent the NDTIR from reducing the inclusion percentage for the FTC on the high-taxed income from the partnership. *See* Example 9(b) for the consolidated return analog to this example.

The Partnership Level Approach in effect makes aggregation elective, except possibly for FTCs, since a U.S. shareholder with multiple CFCs could transfer some of them to (say) a 99% owned partnership and achieve very different results. Likewise, it would often be advantageous for a partnership to transfer its interest in one or more CFCs to its partners. There is no logical reason that the GILTI results should differ in these situations.

Third, the Partnership Level Approach can give rise to very counter-intuitive results. Suppose a U.S. partner directly holds 10% of the equity in a CFC and indirectly holds the same or a different class of equity in the same CFC through a U.S. partnership that is a U.S. shareholder. The partner could then have both GILTI inclusions and tested income from the same CFC, with the latter but not the former being offset by tested losses and NDTIR of other CFCs owned by the partner. This is a very peculiar result.

Fourth, the Partnership Level Approach could not apply to a foreign partnership, since it cannot be a "U.S. shareholder" of a CFC. As a result, the Partnership Level Approach results in large differences in tax treatment of tested income depending upon whether the shareholder partnership is a U.S. or foreign partnership. While this is already true to some extent today, there is no good policy reason to increase these differences even further.

Fifth, the Partnership Level Approach is necessarily a hybrid of the two approaches, because under Section 960(d), the calculation of the inclusion percentage must be made at the level of the corporate partner. This in effect requires the entire FTC calculation to be made at the level of the corporate partner.

In fact, Section 960(d)(2) is unclear as to whether any corporation can only have a single inclusion percentage or can have multiple inclusion percentages. Under the former interpretation, all partnership level items must be aggregated with all nonpartnership items of the corporation to determine a single inclusion percentage. Under the latter interpretation, a corporate partner has a separate inclusion percentage for its share of a Section 951A inclusion passed through from any particular partnership, and another inclusion percentage for any nonpartnership Section 951A inclusion. Under either interpretation, however, the Partnership Level Approach has the disadvantage of being a rather complex hybrid approach.

Finally, the Partner Level Approach is supported by analogy to other situations where regulations apply that approach. The so-called "Brown Group" regulations look through partnerships for various purposes in applying Subpart F.[172] Under the portfolio interest rules,[173] the status of being a 10% shareholder of the issuer (and thus ineligible for the portfolio interest exception to withholding tax) applies at the partner level, rather than the partnership level, when the partnership holds debt of the issuer.[174]

On the other hand, the Partnership Level Approach is consistent with Section 3.05(b) of Notice 2018-26. This section states that if a partnership is a U.S. shareholder of a deferred foreign income corporation, the Section 965 calculations are made at the partnership level. U.S. partners are required to report their share of the partnership's inclusion amount, regardless of whether they themselves are U.S. shareholders.

However, applying Section 965 at the partnership level does not involve inter-relationships with partner level items comparable to the issues in applying GILTI at the partnership level. Moreover, Section 965 is a one-time provision. As a result, we do not believe the rules under that section should control the rules that will apply permanently under GILTI.

[172] T.D. 9008, July 22, 2002.

[173] Sections 871(h), 881(c).

[174] Treas. Reg. § 1.871-14(g)(3)(i).

A benefit of the Partnership Level Approach is that, in contrast to the Partner Level Approach, it does *not* provide a U.S. shareholder in a CFC with a greater Section 163(j) limitation if the U.S. shareholder holds a CFC inside rather than outside a partnership. There is no policy justification for this distinction that arises under the Partner Level Approach. Moreover, the increased Section 163(j) limitation that arises under the Partner Level Approach is inconsistent with applying the Section 250 deduction before the Section 163(j) limitation. *See* Part IV.D.3.

To illustrate, assume that outside a partnership, the Section 250 deduction applies before the Section 163(j) limitation. The same result would arise under the Partnership Level Approach, since all calculations under both GILTI and Section 163(j) are made at the partnership level. Yet under the Partner Level Approach, Section 163(j) is still required by statute to be applied first at the partnership level, and then Section 951A and Section 250 are applied at the partner level. This allows a larger Section 163(j) limitation because the partnership taxable income is computed without taking into account the Section 250 deduction.

> <u>Example 18(a): Partner directly holds CFC and has Section 163(j) limitation.</u> Assume a corporation is engaged in business and directly owns a CFC, the CFC gives rise to $100 of Section 951A inclusion, and the corporation has $50 of interest expense and $50 of net profit (aside from the inclusion) before taking account of this interest expense. The corporation has a Section 250(a)(1) deduction of $50, leaving it with taxable income of $100 before interest expense. Under Section 163(j), the interest deduction is limited to $30, so net taxable income is $70. Section 250(a)(2) does not apply because taxable income before the Section 250(a)(1) deduction is $120.
>
> <u>Example 18(b): The business, the CFC and Section 163(j) interest are at partnership level</u>. Same facts as Example 18(a), except the business, the CFC and the debt are held through a partnership.

In Example 18(b), under the Partnership Level Approach, the partnership has $100 of Section 951A inclusion and $50 of Section 250 deduction, leaving taxable income before interest expense of $100 and a Section 163(j) limit on interest of $30. The partnership passes through $70 of taxable income to the partner, the same result as in Example 18(a).

In Example 18(b), under the Partner Level Approach, the partnership has $100 of tested income, no Section 250 deduction, and $50 of business income. The Section 163(j) limit must be applied at the partnership level and is $45. The partnership passes through $100 of tested income, $50 of business income and a $45 interest deduction to the partner. The partner has a Section 951A inclusion of $100, a Section 250 deduction of $50, and an interest deduction of $45, and business income of $50. Taxable income is $55, as compared to $70 in the other cases.

In summary, under the Partner Level Approach, Section 163(j) applied at the partnership level before Section 250 applied at the partner level. The result is that the interest allowed was 30% of $150, rather than 30% of $100, for a reduction in taxable income of $15. If this ordering rule is not allowed outside a partnership, there is no policy reason for it to be allowed merely because the CFC and debt are held by a partnership engaged in a trade or business.

3. Conclusions

We believe that regulations or legislation should adopt the Partner Level Approach. In general, this involves applying aggregate rather than entity principles to partnerships for GILTI purposes. Aggregate principles generally reach results that are more economically correct than if a partnership is treated as an entity. Here, in particular, the results make sense by avoiding arbitrary effects of the entity approach, and by preventing taxpayers from selectively grouping and ungrouping CFCs under partnerships to maximize tax benefits.

The results under Section 163(j) do not make sense under this approach, but we are reluctant to change our recommended approach to solve this narrow issue. Rather, we believe it is important to adopt, along with the Partner Level Approach, one of the approaches to Section 163(j) described below to avoid the undue benefit from applying Section 163(j) at the partnership level and Section 250 at the partner level.[175]

One way to reach a sensible result under Section 163(j) under the Partner Level Approach would be a rule that solely for purposes of applying that section at the partnership level, a notional Section 250 deduction must be applied before Section 163(j), based on the hypothetical Section 951A inclusion and resulting Section 250 deduction that the partnership would have if it was a corporation. This would limit the ability of taxpayers to increase the Section 163(j) limit merely by putting the CFC and the debt into a partnership rather than holding the CFC and being liable for the debt directly.

[175] In the Report on Section 163(j), we accepted as a policy matter the fact that if a partnership receives dividends, the DRD applies at the level of a corporate partner, yet the Section 163(j) deduction is calculated at the partnership level without regard to the deduction. We stated this result was a “direct consequence” of the decision by Congress to apply Section 163(j) at the partnership level.

There, the mismatch between DRD and Section 163(j) was clearly mandated by the statute. Here, although only corporations obtain the benefit of the Section 250 deduction, the statute does not state whether the Section 250 deduction should be at the partner or partnership level. In fact, as noted in the text, the Conference Report implies that the Section 250 deduction will be taken at the partnership level, and we can speculate that the reason was to avoid an undue benefit under Section 163(j) that would arise if the Section 250 deduction were at the partner level. We believe that in the GILTI context, the proposal in the text best carries out the intent of Congress.

If Treasury does not believe it has the authority to adopt these positions in regulations, it should request a statutory amendment. We note, however, that there is no provision in the statute mandating the Section 951A inclusion or the Section 250 deduction be at the partnership level. While the Conference Report assumes the deduction is taken at the partnership level, it does not say so directly, and the notional deduction under Section 250 at the partnership level that we propose could be viewed as a partial implementation of that legislative history.

This approach appears to us to be a reasonable way to accommodate the policies of GILTI and Section 163(j). We also note that Section 7 of Notice 2018-28 requires certain aspects of the partnership-level calculation under Section 163(j) to be taken into account by the partner in doing its own Section 163(j) calculation, to avoid a double benefit from partnership interest income. That result does not go as far as our proposal for a notional Section 250 deduction at the partnership level. However, it indicates a view that elements of a particular calculation may be relevant at both the partner and partnership levels in order to avoid unjustified results.

Another way to reach a sensible result for Section 163(j) and Section 250 under the Partner Level Approach would start with a rule that the Section 951A inclusion and the Section 250 deduction are taken entirely at the partner level. Then, a rule would be adopted that if a partnership is a shareholder owning 10% or more of the stock of a corporation, that stock would automatically be considered as held for investment rather than as a business asset, and no interest expense of the partnership on debt allocable to that stock would be considered business interest expense under Section 163(j). As a result, if the partnership was a U.S. shareholder of a CFC, any inclusion by the partnership of tested income from the CFC would be investment income, and any interest expense of the partnership allocable to stock of the CFC would not be business interest expense. As a result, Section 163(j) would apply at the partnership level without regard to either such item.

Tested income and interest expense would then presumably pass through to a corporate partner as business income and business interest expense, respectively, and would be subject to Section 163(j) at the partner level. As a result, both Section 250 and Section 163(j) would apply at the partner level, with the same result as if the partner held the CFC stock directly.[176]

This approach requires treating all 10% shareholdings by partnerships as investment assets under Section 163(j). This would be difficult to justify as a factual matter in many circumstances. As a result, a *per se* rule would be necessary to achieve the desired coordination with Section 250 in all cases. Lack of a *per se* rule would also allow considerable electivity by taxpayers who could combine or disaggregate

[176] *See* the Report on Section 163(j), at 41-42, for a discussion of the consequences under Section 163(j) when a partnership holds investment assets. This approach would also reach a similar result under the Partnership Level Approach. In that case, the Section 250 deduction would be taken at the partnership level and pass through to the partner, and Section 163(j) would also apply at the partner level because the interest expense would not be business interest expense at the partnership level.

partnership business activity and ownership of subsidiaries. In addition, there is no logical reason for the *per se* rule to apply only to 10% holdings in CFCs as opposed to holdings in any domestic or foreign corporation. Consequently, this proposal would have significance in the domestic context well beyond GILTI, and would require further consideration that is beyond the scope of this Report.

4. Related Issues

If (contrary to our proposal) the Partnership Level Approach is adopted, regulations should clarify how it is applied in certain ownership situations described below. In that connection, note that under Sections 958(b) and 318(a)(3)(A), in testing whether a U.S. partnership is a U.S. shareholder of a CFC, and in testing for CFC status, a partnership is deemed to own the stock in a foreign corporation owned by the partners in the partnership. We believe regulations should confirm the following:

(1) If a U.S. partnership owns directly (or indirectly under Section 958(a)) 10% of a CFC, then the partnership is a U.S. shareholder and its GILTI calculation should be based on such ownership in the CFC.

(2) Suppose a U.S. partnership owns directly (or indirectly under Section 958(a)) less than 10% of a CFC, but owns 10% after taking into account constructive ownership of CFC stock owned by its partners under Section 958(b). The partnership is a U.S. shareholder, but its inclusion under Section 951A is limited to its *pro rata* share of the tested income of the CFC based on its direct and Section 958(a) indirect ownership.

(3) Suppose a partnership owns 100% of a CFC, and it has two 50% U.S. partners. The partnership and each partner are U.S. shareholders of the CFC. However, as in (2), the income inclusion is at the partnership level, so the calculations should still be made at the partnership level rather than the partner level.

(4) In all of these cases, the Section 250 deduction would be available even to a corporate partner that was not itself a U.S. shareholder of the CFC. Section 250 is triggered by a Section 951A inclusion by a domestic corporation, regardless of the status of the corporation as a U.S. shareholder.

Regulations should also state whether, under the Partnership Level Approach, the Section 250(a)(2) limit is determined at the partnership level or the partner level. If it is determined at the partnership level, the partnership might obtain a Section 250 deduction and pass it through to a partner that did not itself have sufficient taxable income to be entitled to the deduction directly. In this situation, regulations should also state whether Section 172(d)(9) would apply to limit the partner from using the passed-through Section 250 deduction in calculating its own NOL carryover.

Moreover, as discussed above, under the Partnership Level Approach, regulations should clarify whether under Section 960(d), a domestic corporation with Section 951A inclusions from more than one partnership, or from one or more partnerships and from any directly held CFCs, will have a single or multiple inclusion percentages. Also, even if a corporation has only a single Section 951A inclusion from a single partnership, regulations should also clarify how the inclusion percentage is determined under the Partnership Level Approach. The Section 951A inclusion at the partnership level is based on items that go into the calculation of the inclusion percentage (*e.g.*, NDTIR, interest expense, tested income and tested losses of each CFC). Regulations should clarify whether there is a "look-through" of some or all of these items directly to the corporate partner, or whether there is a netting of any of these items (*e.g.*, tested income and tested loss) at the partnership level before the net amount is passed through to the corporate partner.

In addition, regulations should confirm certain additional aspects of the relationship between the Section 250 deduction and the Section 163(j) limit. Under our proposal for both the Partnership Level Approach and the Partner Level Approach, the Section 250 deduction would be calculated either actually or notionally at the partnership level before the Section 163(j) deduction is determined at the partnership level. However, individuals and non-U.S. corporations are not eligible for the Section 250 deduction. As a result, presumably only the usable portion of the Section 250 deduction should be taken into account in calculating the Section 163(j) limit. To illustrate, if all the partners are individuals, it would not make sense for the Section 163(j) limit to assume a 50% deduction to all partners, when none in fact are entitled to the deduction.

The partnership should therefore obtain an "extra" Section 163(j) deduction on account of its individual partners who are not entitled to a Section 250 deduction. Presumably such extra deduction would be required to be allocated to the individual partners. This would reduce the partnership's carryforward of Section 163(j) deductions.

Regulations should clarify that the partnership must limit the extra allocation of interest deduction to a partner to the interest deductions that are allowable to the partnership under Section 163(j) only because the partner's share of partnership income is not reduced by the Section 250 deduction at the partnership level with respect to that partner. The extra allocation should reduce the portion of the carryover that is allocated to the partner. Absent such a rule, a partnership could allocate a disproportionate amount of its total interest deductions to partners that could not use a Section 250 deduction, and there would not be substantial economic effect to such an allocation. Such a special allocation also seems inconsistent with the statutory requirement that the Section 163(j) limit be determined at the partnership level.

Logically, the same approach of an increased Section 163(j) allocation should apply for a corporate partner that could not use its entire Section 250 deduction because of the taxable income limit in Section 250(a)(2). However, partners of a partnership might not be willing to inform the partnership about whether their Section 250 deduction would be so limited. As to partners such as direct non-U.S. partners who would not obtain a Section 250 deduction, presumably the Section 163(j) deduction would be determined without regard to an actual or notional Section 250 deduction at the partnership level, although it would be necessary to look through a partner that is a partnership to determine the nature of the ultimate partners.

Finally, Part IV.D.7 discusses certain issues concerning tax basis in a partnership interest.

## G. Other Issues

### 1. Section 962 Election

If an individual U.S. shareholder directly holds stock in a CFC, the individual has an income inclusion under Section 951A without a deduction under Section 250. As a result, the maximum tax rate on the GILTI inclusion is 37%. No foreign tax credit is allowed, although foreign taxes reduce tested income and therefore the GILTI inclusion. In the past, the shareholder was not taxed on current earnings except for Subpart F income, and if the CFC was in a treaty country, a dividend was QDI taxed at the rate of 20% (disregarding Medicare tax).[177] As a result, the Act imposes a significant tax increase on a U.S. shareholder in this situation.

Section 962 is designed to allow an individual U.S. shareholder of a CFC to elect to be placed in approximately the same position for Subpart F inclusions as if the CFC stock was held through a domestic corporation. Moreover, Section 951A(f)(1)(A) states that for purposes of Section 962, the Section 951A inclusion is to be included in income in the same manner as a Section 951(a) inclusion under Subpart F. Therefore, Congress clearly contemplated that an individual could obtain relief from the GILTI consequences above by making the Section 962 election.

Section 962(a) imposes tax on the electing individual shareholder at the corporate rate on the "amounts which are included in his gross income under section 951(a)" if the shareholder were a corporation. The gross income inclusion for GILTI is the Section 951A inclusion (including the Section 78 gross-up if an FTC is being claimed) without regard to the Section 250 deduction. Moreover, the regulations make clear that the corporate tax is imposed on Subpart F income without the allowance of any deductions.[178]

The no-deduction rule makes sense for purposes of Subpart F, since the tax is being imposed as if the CFC was held by a hypothetical domestic corporation having no assets other than CFC stock. However, this rationale does not apply to the Section 250 deduction, and it seems doubtful that Congress intended to require that Section 962 apply without the deduction. The deduction is intended to create a reduced effective tax rate, rather than operate as a typical deduction that involves an outlay of funds.[179] The fact that Congress chose to achieve a reduced tax rate on foreign earnings by means of a gross income inclusion and a deduction, rather than a reduced tax rate, should have no effect on

[177] Section 1(h)(11).

[178] Treas. Reg. § 1.962-1(b)(1)(i).

[179] *See, e.g.*, Conference Report at 623 n. 1517 ("The Committee intends that the deduction allowed by new Code section 250 be treated as exempting the deducted income from tax.").

the policy of Section 962 of treating the shareholder as owning the CFC stock through a corporation.

To be sure, the language of Section 951A(f)(1)(A) does not itself seem broad enough to authorize the Section 250 deduction. In addition, Section 5 of Notice 2018-26 allows a shareholder making a Section 962 election to obtain the Section 965(c) deduction at the shareholder level. However, the Notice is expressly limited to Section 965 and relies in part on the fact that individuals are themselves eligible for the Section 965 deduction for dividends received directly.

Nevertheless, we believe that Treasury should issue regulations confirming that the Section 250 deduction is available for a Section 962 election. If Treasury does not believe it has the authority to do so, we recommend an amendment to the statute.

Next, when the CFC distributes PTI to the U.S. shareholder, the distribution is included in the shareholder's income under Section 962(d). Treasury should clarify whether the income is QDI. Allowing treatment as QDI is necessary to achieve the purpose of Section 962 of treating an individual shareholder of a CFC approximately the same as if the CFC stock had been held by a domestic corporation owned by the U.S. shareholder. Under this construct, the CFC's distribution of PTI to the U.S. shareholder is treated as a distribution by the CFC of PTI to the domestic corporation, followed by a dividend from the domestic corporation to the U.S. shareholder.[180] We note that resolution of this issue has broader implications than GILTI.

Finally, the statute and regulation[181] state that only an individual U.S. shareholder (*i.e.*, with 10% ownership in the CFC) can make the election. Section 5 of Notice 2018-26 states that for purposes of Section 951, only an individual that is a U.S. shareholder of a CFC, whether by virtue of directly held stock, stock held through a partnership, or both, can make the Section 962 election. In such case, the election applies both to directly owned stock in the CFC as well as the individual's share of partnership income earned through the CFC. If a U.S. partnership is a U.S. shareholder of a CFC but an individual partner is not, the individual cannot make the election. These rules automatically apply to Section 951A by cross-reference.

We believe these positions are reasonable. We note that an individual partner in a foreign partnership clearly looks through the foreign partnership under the usual rules, in determining whether the individual is a U.S. shareholder of the CFC eligible for the election.[182]

[180] Treas. Reg. § 1.962-3(b)(4) achieves similar parity by treating a redemption of stock by the CFC as eligible for capital gain treatment to the U.S. shareholder, rather than being considered a partial taxable distribution of earnings and profits.

[181] Treas. Reg. § 1.962-2(a).

[182] *See* Treas. Reg. § 1.962-2(b)(1), requiring the reporting of any intermediate partnership through which the individual holds the interest in the CFC.

2. Fiscal Transition Year 2017-2018

If a CFC has a fiscal year, income earned in the 2017-2018 fiscal year is exempt from GILTI.[183] This gives rise to opportunities for avoiding Section 951A inclusions in subsequent taxable years. For example, a CFC might sell an appreciated asset to an affiliate during this period, in which case the affiliate can take depreciation or amortization deductions in future periods to reduce its tested income in those years. If the asset is a depreciable tangible asset, this transaction may also increase the overall QBAI in the system, which will increase future NDTIR. If the affiliate has a calendar year tax year, it can also take a current deduction from tested income for interest expense, royalties, etc. paid during this period to a fiscal year affiliate.

The statute[184] contemplates a broad delegation of authority to Treasury to adopt anti-abuse rules for transactions intended to increase QBAI, including during the transition period. The legislative history[185] contemplates a much broader delegation of authority to disregard all noneconomic transactions intended to minimize tax under the GILTI rules, not only during the transition period. We have been asked by government representatives to consider the possible scope of regulations to exercise this authority.

Suppose a transaction during the transition period between affiliates gives rise to exempt income in the current year, and a deduction from tested income in the current year or a future year (*e.g.*, through use of tax basis created in the transition year). Possible tests for disallowance of the deduction from tested income are the following, from the most permissive to the most restrictive:

(1) No disallowance.

(2) Presumptive allowance overcome by government showing of a bad purpose.

(3) Presumptive disallowance overcome with a showing of a good business purpose.

(4) Disallowance if "the principal purpose" of the transaction was to obtain exempt income and a deduction from tested income.

(5) Disallowance if "a principal purpose" of the transaction was to obtain exempt income and a deduction from tested income.

(6) Automatic disallowance.

[183] Section 951A applies to taxable years of a foreign corporation beginning after December 31, 2017.

[184] Section 951A(d)(4).

[185] Conference Report at 645.

Any of these standards could be enforced in the case of an asset sale by mandating a carryover basis for calculating tested income. Moreover, similar standards might apply to acceleration of income into the transition period, such as prepayments from customers or sale/leasebacks of property with third parties, or to deferral of deductions until after the transition period.

We note that in the context of transactions that reduce Section 965 tax liability, Section 3.04(a) of Notice 2018-26 adopts alternative (5) as a general matter, with several of the other alternatives applying in the case of various specified categories of transactions. In addition, Section 3.04(b) of the Notice disregards any change in method of accounting on or after November 2, 2017 for purposes of Section 965, regardless of the purpose of the change. It is not clear whether Treasury will adopt similar anti-abuse rules for GILTI, although we note that the statutory basis for anti-abuse rules under Section 951A is narrower than the broad grant of authority for anti-abuse rules under Section 965(o).

If Treasury does not believe that the statute and the Conference Report give it the authority to issue regulations of the type described in the Conference Report and that it believes are necessary to eliminate abuses during or after the transition period, it should request an amendment to the statute to conform its authority to that described in the Conference Report.

3. Effect of Section 958(b)(4) Repeal

The Act repealed Section 958(b)(4), which prohibited the "downward attribution" rules from treating stock that is owned by a non-U.S. person as being owned by a U.S. person.[186] While the repeal is unconditional, a colloquy (the "**colloquy**") on the Senate floor states that the repeal was not intended to apply to a U.S. shareholder of a CFC if the CFC qualifies as such only because of downward attribution to a U.S. person that is not related to the U.S. shareholder.[187] It further states that Treasury Regulations should interpret the provision accordingly.[188] The Senate Finance Committee's explanation of the corresponding provision in the Senate Bill is to the same effect,[189] and there is no indication that Congress intended repeal to have broader consequences.

[186] Act § 14213.

[187] 163 Cong. Rec. No. 207 (Dec. 19, 2017) at p. S8110 (colloquy between Senator Hatch, Chairman of the Senate Finance Committee and Senator Perdue).

[188] *Id.*

[189] "This provision is not intended to cause a foreign corporation to be treated as a controlled foreign corporation with respect to a U.S. shareholder as a result of attribution of ownership under section 318(a)(3) to a U.S. person that is not a related person (within the meaning of section 954(d)(3)) to such U.S. shareholder as a result of the repeal of section 958(b)(4)." Committee Print, *Reconciliation Recommendations Pursuant to H. Con. Res. 71*, S. Prt. 115–20, (December 2017), p. 378, as reprinted on the website of the Senate Budget Committee, available at *https://www.budget.senate.gov/taxreform*.

The unconditional repeal of Section 958(b)(4) could create Section 951A inclusions in the following situations. According to the colloquy, such inclusions were not intended to be created by such repeal.

- A U.S. corporation or partnership (D1) owns 10% of the stock of foreign corporation (F1), and the other 90% of F1 is owned by an unrelated foreign corporation with no U.S. shareholders but with a U.S. subsidiary (D2). Then, D2 constructively owns 90% of F1, F1 would be a CFC, and D1 would have a Section 951A (and Subpart F) inclusion from F1. If D1 was a partnership, its partners would have a Section 951A inclusion and its individual partners would not have a Section 250 deduction.

- D1 owns 10% of F1, and F1 owns 100% of both a domestic subsidiary D2 and a foreign subsidiary F2. Then, D2 constructively owns 100% of F2, F2 is a CFC, and D1 has a Section 951A inclusion from F2.

We do not believe that these results should arise. There is no logic to a U.S. person being treated as a U.S. shareholder of a CFC merely because an unrelated foreign shareholder of the purported CFC happens to have a U.S. subsidiary with no direct ownership interest in the CFC.

We therefore believe that the consequences of the repeal of Section 958(b)(4) should be limited to conform to the apparent Congressional intent as expressed in the colloquy, either by regulations or an amendment to the statute. Section 3.01 of Notice 2018-26 gives very limited relief from the repeal of Section 958(b)(4) in applying the constructive ownership rules to partnerships for purposes of Section 965. This may indicate that Treasury does not believe it has the authority to further limit the consequences of repeal, in which case we recommend requesting an amendment to the statute.

Of course, limiting the consequences of the repeal would have significance well beyond GILTI. Thus, any regulations or statutory amendment should take into account the intended results not just for GILTI, but also for other Code sections that were affected by the repeal.

In addition, even as to GILTI, the colloquy does not deal with the case where the tax treatment of a U.S. shareholder depends upon the status of a corporation as a CFC (or not) before or after the U.S. shareholder became a U.S. shareholder. Return to two cases discussed in Part IV.D.2.

- Similar to footnote 117: A foreign corporation (F) has a foreign subsidiary (F1) and a U.S. subsidiary (US1). U.S. corporation (P) buys the stock of F1 from F in the middle of the year. Then, US1 constructively owned all of F1 for the period before the sale, so F1 is a CFC for the entire year. P apparently has a Section 951A or Subpart F inclusion for the entire year rather than only for the post-sale portion of the year.

- Same as Example 14(c): A U.S. shareholder (US1) of a CFC sells stock in the CFC to a non-U.S. person F, but F has a U.S. subsidiary (FSub) so the CFC remains a CFC for the entire year. As a result, there is no Section 951A inclusion or Subpart F income reported for the year of the sale.

In the first case, the overinclusion in income to P does not arise because F1 was a CFC *as to P* during the first part of the year, but rather because it was a CFC at all in the first part of the year (when P was not a shareholder). Likewise, in the second case, the underinclusion arises because the CFC remained a CFC during the second half of the year, at a time when US1 was not a shareholder. As a result, additional changes beyond the colloquy would be necessary if the intent was to change the result in these situations.

4. Overlap Between Section 250(a)(2) and Section 172(d)(9)

Section 172(d)(9) states that the Section 250 deduction is not allowed in calculating a net operating loss. Regulations should clarify the situations where this provision becomes relevant in light of Section 250(a)(2), which limits the combined GILTI/FDII deduction to a percentage of taxable income determined without regard to Section 250. On its face, Section 172(d)(9) could never become applicable, since limiting the Section 250 deduction to a percentage of taxable income (otherwise determined) would by itself prevent the Section 250 deduction from creating or increasing a net operating loss that would be limited under Section 172(d)(9). Moreover, Section 250(a)(2) must apply before Section 172(d)(9), since the former affects deductions allowed in the current year and the latter only affects carryovers to future years.

However, in Part IV.D.4, we discuss the possibility that the Section 250(a)(2) carve-back does not limit the Section 250(a)(1) deduction for the Section 78 gross-up amount, in which case the Section 250(a)(1) deduction might create a taxable loss for the year. Moreover, in Part IV.F.4, we propose a possible occasion for Section 172(d)(9) to apply in the partnership context. It is not clear whether the drafters had either of these situation in mind, so it would be helpful for regulations to clarify cases in which Section 172(d)(9) would be applicable.

5. Medicare Tax (Section 1411)

Regulations should clarify whether GILTI inclusions are investment income under Section 1411.

6. REIT Income

Regulations should clarify the extent to which GILTI inclusions are qualified income for REIT purposes.[190] There is clear statutory authority for such regulations.[191]

[190] Section 856(c).

[191] Section 856(c)(5)(J).

The current Treasury/IRS Priority Guidance Plan already includes a project to determine whether Subpart F income is qualifying income under Section 856(c),[192] and this project should logically be extended to GILTI inclusions. Some PLRs have applied look-through treatment for passive income of a CFC that is Subpart F income.[193]

7. RIC Income

Section 951A(f)(1)(A) treats GILTI inclusions as Subpart F income for purposes of Section 851(b). Section 851(b) (flush language) states that Subpart F inclusions are not treated as qualifying dividends unless there is an actual distribution that corresponds to the inclusion. Proposed regulations state that Subpart F inclusions do not qualify as other income derived with respect to the business of investing in stock.[194] In a prior Report, we stated our disagreement with this aspect of the proposed regulations.[195] Regulations should clarify the rules for a RIC that has a GILTI inclusion.

8. UBTI

We believe that GILTI inclusions are not unrelated business taxable income to tax-exempt U.S. shareholders under the terms of Section 512. Nevertheless, we believe that published guidance to confirm this would be helpful because of the importance of the issue to tax-exempts and the lack of published guidance in analogous areas such as Subpart F. The Tax Section is preparing a broader Report on tax-exempt issues that will address this issue in greater detail.

## H. Proposed Aggregation of CFCs held by a U.S. Shareholder

This section proposes legislation to treat all Related CFCs of a particular U.S. shareholder as a single corporation for purposes of the GILTI calculations. We believe that the existing rules that treat each CFC separately are unjustified as a policy matter, are very unfair to taxpayers, and invite restructurings solely for tax purposes. We acknowledge that the existing rules are clear and are supported by the legislative history of the Act. Nevertheless, we urge the Congress to reconsider these provisions and for Treasury to support such reconsideration.

Under Sections 951A and 250, if a single U.S. corporation is a U.S. shareholder in more than one Related CFC, several uneconomic results arise from the separate treatment of each CFC.

[192] Department of the Treasury, 2017-2018 Priority Guidance Plan, as updated February 7, 2018.

[193] *See, e.g.*, PLRs 201605005 (addressing REIT qualification), 201430017 (addressing UBTI for a tax-exempt organization), and 201043041 (addressing UBTI for a charitable remainder unitrust).

[194] REG-123600-16, Sept. 28, 2016.

[195] NYSBA Tax Section Report Number 1359, *Report on Proposed Regulations under Section 851 Dealing with Imputations from CFCs and PFICs,* Nov. 29, 2016.

First, QBAI can create NDTIR only to the extent the underlying property is "tangible properly used in the production of tested income".[196] A CFC with a tested loss does not literally have tested income, and so QBAI of any CFC with a tested loss can never create NDTIR. This QBAI is "wasted" and never provides any tax benefit to a U.S. shareholder.

The mere possibility of wasted QBAI could have a significant effect on supply chain planning. For example, a business model might contemplate manufacturing in one CFC and sales by another CFC. All the QBAI is in the first CFC. If there is a risk that the first CFC will have a tested loss, this model becomes uneconomic and the taxpayer is forced to combine both CFCs, either in actuality or through check the box. It is doubtful that Congress intended this to be a result of the GILTI rules.

The statute might be read broadly to say that QBAI qualifies if it produces income that *would be* tested income if the corporation in question had positive tested income. However, the legislative history is clear that this is not the intended interpretation of the statute.[197]

Second, foreign taxes are taken into account to the extent they are "properly attributable" to tested income.[198] The legislative history is clear that this prevents the U.S. shareholder from receiving an FTC for taxes paid by a CFC with a tested loss.[199] As a result, even if a CFC has income that is treated as income for both U.S. and foreign tax purposes, and is subject to foreign tax, an offsetting loss in the CFC that produces an overall tested loss in the CFC precludes an FTC.

This result may be particularly unfair to taxpayers when a CFC has an overall tested loss, but a branch or a disregarded subsidiary has, on a stand-alone basis, tested income and pays foreign taxes. The branch income reduces the shareholder's tested loss from the CFC, which may increase the shareholder's net CFC tested income and Section 951A inclusion. The foreign taxes paid by the branch are a real cost of the increase in tested income, but no FTCs are available.

As noted above, the legislative history makes clear that the lack of FTCs for a CFC with no tested income was intended by Congress. Therefore, we do not suggest that Treasury should change this result by regulation. However, we urge Congress to reconsider these rules since they give very arbitrary results and invite restructurings solely to minimize tax liability.

[196] Section 951A(d)(2)(A).

[197] Conference Report at 642 n. 1536 ("Specified tangible property does not include property used in the production of tested loss, so that a CFC that has a tested loss in a taxable year does not have QBAI for the taxable year".).

[198] Section 960(d)(3).

[199] Conference Report at 643 n. 1538 ("Tested foreign income taxes do not include any foreign income tax paid or accrued by a CFC that is properly attributable to the CFC's tested loss (if any)").

Moreover, these rules give extremely arbitrary results that can be very unfair to taxpayers. Consider a U.S. shareholder that holds two CFCs, CFC1 and CFC2. If CFC1 has tested income for a year and CFC2 has a tested loss, the tested loss will reduce the net CFC tested income of the U.S. shareholder. However, the U.S. shareholder will obtain no benefit from any FTCs or notional QBAI return of CFC2. This is true whether CFC2's tested loss is $1 or $1 billion.

On the other hand, if CFC2 has $1 of tested income, all of its FTCs and QBAI return would be taken into account by the U.S. shareholder. It is difficult to understand why there should be such a vastly different outcome depending on whether CFC2 has income or loss under U.S. tax principles – a distinction that could turn on less than $1.

These rules also cause very formalistic results. Turn back to Example 15(a), where CFC1 has two divisions, division 1 generates tested income, division 2 generates tested loss, there is overall net positive tested income, and division 2 bears a foreign tax. We conclude that there should not be a tracing of FTC to particular dollars of tested income, so the FTC should be allowed for division 2 even though it generates a tested loss on a stand-alone basis. Moreover, we reach the same conclusion in Example 15(b), where division 2 is transferred to a disregarded subsidiary.

Assume now that CFC1 transfers division 2 to a subsidiary entity, CFC2, that is a corporation for U.S. tax purposes. Now, CFC2 has a tested loss and bears a foreign tax. However, since it is a separate corporation, the U.S. shareholder does not receive any FTC for that foreign tax.

There is no logical reason for this distinction. Moreover, the same distinction arises if division 2 has QBAI return rather than FTC. As in Examples 15(a) and 15(b), it is clear that if a particular CFC has any tested income, the QBAI return of that CFC is not limited to the return on particular assets that generate positive tested income. Rather, the deduction for NDTIR under Section 951A(b)(1)(B) aggregates all QBAI returns of all CFCs with positive tested income, without any tracing of QBAI return of a CFC to particular tested income of the same CFC.

Similarly, suppose CFC1 has a tested loss, interest expense, and notional QBAI return, and CFC2 has tested income and QBAI return. The notional QBAI return of CFC1 is disregarded, yet it is unclear whether the interest expense of CFC1 reduces the NDTIR generated by CFC2's QBAI (*see* discussion in Part IV.D.6). If this interest expense did reduce the NDTIR, all the notional QBAI return of CFC1, and the QBAI return of CFC2 up to CFC1's interest expense, would both be "wasted". This result would make no sense at all.

Finally, suppose CFC1 has $100 of tested income and pays foreign taxes, and CFC2 has a tested loss. If CFC2's tested loss is less than $100, the U.S. shareholder will have net CFC tested income, but the inclusion percentage for the FTC will be reduced on account of the tested loss. If instead CFC2 was a branch of CFC1, the net CFC tested income would be the same, but the inclusion percentage would be 100% (assume no NDTIR), so there would be no cutback on the FTC. On the other hand, if the CFC2 tested loss was $100 or more, the U.S. shareholder would be worse off if CFC2 was a branch of CFC1 than a separate CFC, because as a branch, the disadvantages of a CFC without tested income would then encompass CFC1 as well as CFC2.

These results are arbitrary and counter-intuitive, and encourage restructuring of business organizations purely for tax reasons. In particular, Related CFCs of a U.S. shareholder will be separated or combined (including by using "check-the-box" elections) to distribute tested income among CFCs in a manner so as to minimize the likelihood that CFCs with meaningful QBAI and/or FTCs will have tested losses. It might also become desirable to artificially accelerate income at year end in particular CFCs to prevent the existence of a tax loss for the year. Taxpayers will also attempt to rely on the administrative relief to make retroactive check the box elections, if events do not turn out as expected.

The need for such tax planning would be reduced or eliminated if all Related CFCs of a particular U.S. shareholder were treated as a single corporation for purposes of the GILTI calculations. The rule would apply regardless of whether the CFCs were each directly held by the shareholder or if they were in chains of ownership. Then, the tested income or tested loss of a particular CFC would not matter, and FTCs and QBAI return of all CFCs would be available as long as there was overall tested income. This result would not be unduly favorable to taxpayers, since it can be created by self-help today if the U.S. shareholder puts all its CFCs under a single CFC holding company and checks the box on all the subsidiary CFCs. In fact, mandatory aggregation can be viewed as anti-taxpayer, because the well-advised taxpayer today has the choice of aggregation or nonaggregation by simple tax planning, and nonaggregation is often more favorable.

Such aggregation is clearly at odds with Congressional intent in drafting Section 951A. However, it is not clear that Congress realized the anomalous results created by nonaggregation and how self-help could achieve results similar to aggregation.

If this proposal was enacted, and regulations were adopted to treat all members of a consolidated group as a single corporation for purposes of Section 951A,[200] the result would be the aggregation of all Related CFCs of all members of a consolidated group. We believe this would greatly simplify the GILTI rules, be much fairer to taxpayers, and avoid the need for uneconomic tax planning by taxpayers.

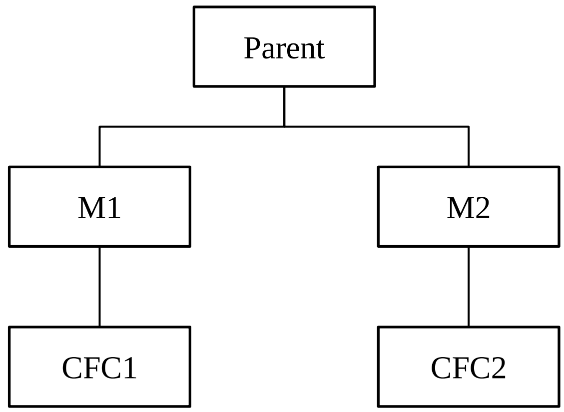
We are not suggesting, however, that all Related CFCs owned by a single U.S. shareholder (or members of a single consolidated group) should be treated as a single corporation for all purposes, so that all transactions between them should be disregarded in calculating tested income. This would, for example, eliminate tested income when one CFC sells an asset to another CFC at a gain. While elements of such a rule apply under Subpart F for transactions between CFCs, such a rule would require considerably more analysis.

[200] *See* Part IV.B.4.

## APPENDIX 1

The charts and calculations on the following pages illustrate certain of the examples in the Report.

*Example 6(a)*



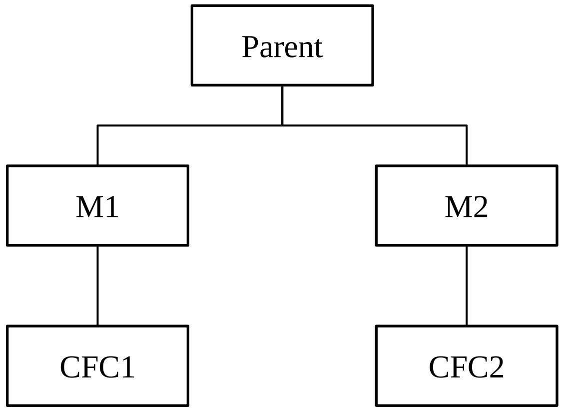

Tested income / (loss) = 100
QBAI return = 0
Foreign tax rate = 0%
Foreign taxes = 0

Tested income / (loss) = (100)
QBAI return = 0
Foreign tax rate = 0%
Foreign taxes = 0

| | **Nonaggregation** | | **Aggregation** |
|---|---|---|---|
| | **M1** | **M2** | **M** |
| Net CFC tested income | 100 | 0 | 0 |
| NDTIR | 0 | 0 | 0 |
| Section 951A inclusion | 100 | 0 | 0 |
| Aggregate of Related CFCs' tested income | 100 | 0 | 100 |
| Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income) | 100% | 0% | 0% |
| Foreign tax paid by Related CFCs with tested income | 0 | 0 | 0 |
| FTCs (80% * Inclusion percentage * Foreign tax) | 0 | 0 | 0 |
| Section 78 amount (Inclusion percentage * Foreign tax) | 0 | 0 | 0 |
| GILTI inclusion (Section 951A inclusion + Section 78 amount) | 100 | 0 | 0 |
| US tax before FTCs (GILTI inclusion * 50%[201] * 21%) | 10.50 | 0 | 0 |
| Incremental US tax, taking into account FTCs (US tax before FTCs - FTCs) | 10.50 | 0 | 0 |
| Aggregate tax (Foreign tax + Incremental US tax) | 10.50 | 0 | 0 |
| **Aggregate tax for consolidated group** | **10.50** | | **0** |

[201] Assumes full Section 250 deduction for GILTI is available.

***Example 6(b)***[202]




Tested income / (loss) = 100
QBAI return = 100
Foreign tax rate = 0%
Foreign taxes = 0

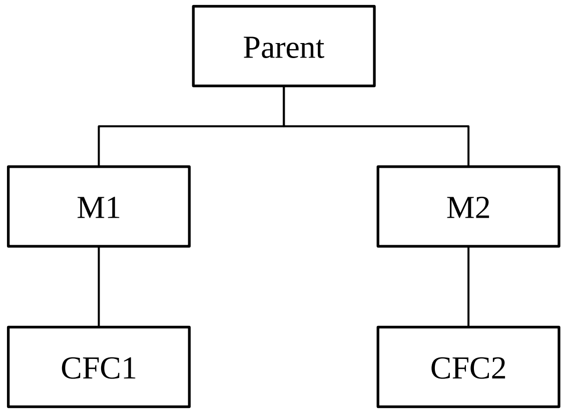
Tested income / (loss) = (50)
Interest expense = (100)
QBAI return = 0
Foreign tax rate = 0%
Foreign taxes = 0

| | **Nonaggregation** | | **Aggregation** |
|---|---|---|---|
| | **M1** | **M2** | **M** |
| Net CFC tested income | 100 | 0 | 50 |
| NDTIR | 100 | 0 | 0 |
| Section 951A inclusion | 0 | 0 | 50 |
| Aggregate of Related CFCs’ tested income | 100 | 0 | 100 |
| Inclusion percentage<br>(Section 951A incl. / Agg. Rel. CFCs' tested income) | 0% | 0% | 50% |
| Foreign tax paid by Related CFCs with tested income | 0 | 0 | 0 |
| FTCs (80% * Inclusion percentage * Foreign tax) | 0 | 0 | 0 |
| Section 78 amount (Inclusion percentage * Foreign tax) | 0 | 0 | 0 |
| GILTI inclusion<br>(Section 951A inclusion + Section 78 amount) | 0 | 0 | 50 |
| US tax before FTCs (GILTI inclusion * 50%[203] * 21%) | 0 | 0 | 5.25 |
| Incremental US tax, taking into account FTCs<br>(US tax before FTCs - FTCs) | 0 | 0 | 5.25 |
| Aggregate tax (Foreign tax + Incremental US tax) | 0 | 0 | 5.25 |
| **Aggregate tax for consolidated group** | **0** | | **5.25** |

[202] This example assumes that interest expense in a Related CFC with tested losses reduces the U.S. shareholder’s NDTIR from other CFCs with QBAI return. See discussion in Part IV.D.6.

[203] Assumes full Section 250 deduction for GILTI is available.

***Example 7***



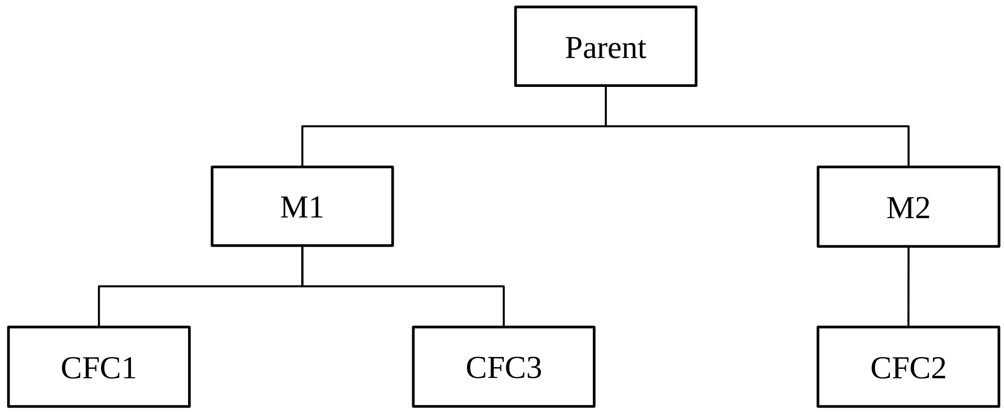

Tested income / (loss) = 100
QBAI return = 0
Foreign tax rate = 0%
Foreign taxes = 0

Tested income / (loss) = 10
QBAI return = 100
Foreign tax rate = 0%
Foreign taxes = 0

| | **Nonaggregation** | | **Aggregation** |
|---|---|---|---|
| | **M1** | **M2** | **M** |
| Net CFC tested income | 100 | 10 | 110 |
| NDTIR | 0 | 100 | 100 |
| Section 951A inclusion | 100 | 0 | 10 |
| Aggregate of Related CFCs' tested income | 100 | 10 | 110 |
| Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income) | 100% | 0% | 9% |
| Foreign tax paid by Related CFCs with tested income | 0 | 0 | 0 |
| FTCs (80% * Inclusion percentage * Foreign tax) | 0 | 0 | 0 |
| Section 78 amount (Inclusion percentage * Foreign tax) | 0 | 0 | 0 |
| GILTI inclusion (Section 951A inclusion + Section 78 amount) | 100 | 0 | 10 |
| US tax before FTCs (GILTI inclusion * 50%[204] * 21%) | 10.50 | 0 | 1.05 |
| Incremental US tax, taking into account FTCs (US tax before FTCs - FTCs) | 10.50 | 0 | 1.05 |
| Aggregate tax (Foreign tax + Incremental US tax) | 10.50 | 0 | 1.05 |
| **Aggregate tax for consolidated group** | **10.50** | | **1.05** |

[204] Assumes full Section 250 deduction for GILTI is available.

*Example 8(b)*




Tested income / (loss) = 100
QBAI return = 0
Foreign tax rate = 13.125%
Foreign taxes = 15.11

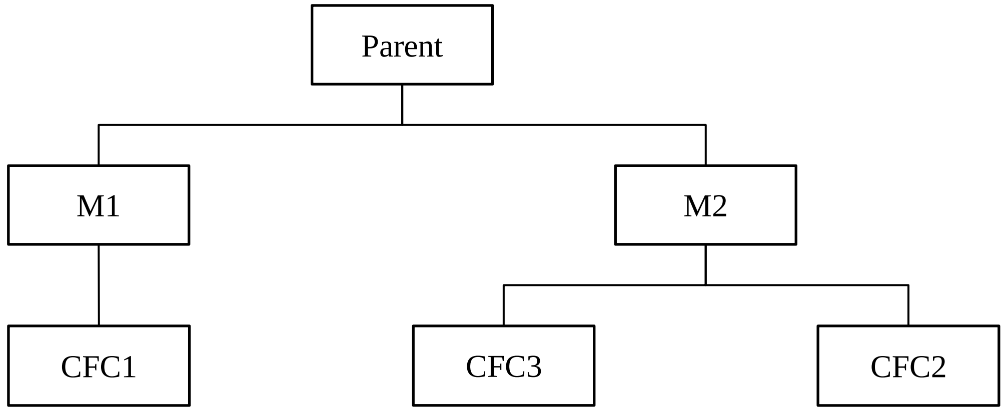
Tested income / (loss) = (100)
QBAI return = 0
Foreign tax rate = 0%
Foreign taxes = 0

Tested income / (loss) = 100
QBAI return = 0
Foreign tax rate = 0%
Foreign taxes = 0

| | **Nonaggregation** | | **Aggregation** |
|---|---|---|---|
| | **M1** | **M2** | **M** |
| Net CFC tested income | 0 | 100 | 100 |
| NDTIR | 0 | 0 | 0 |
| Section 951A inclusion | 0 | 100 | 100 |
| Aggregate of Related CFCs' tested income | 100 | 100 | 200 |
| Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income) | 0% | 100% | 50% |
| Foreign tax paid by Related CFCs with tested income | 15.11 | 0 | 15.11 |
| FTCs (80% * Inclusion percentage * Foreign tax) | 0 | 0 | 6.04 |
| Section 78 amount (Inclusion percentage * Foreign tax) | 0 | 0 | 7.55 |
| GILTI inclusion (Section 951A inclusion + Section 78 amount) | 0 | 100 | 107.55 |
| US tax before FTCs (GILTI inclusion * 50%[205] * 21%) | 0 | 10.50 | 11.29 |
| Incremental US tax, taking into account FTCs (US tax before FTCs - FTCs) | 0 | 10.50 | 5.25 |
| Aggregate tax (Foreign tax + Incremental US tax) | 15.11 | 10.50 | 20.36 |
| **Aggregate tax for consolidated group** | **25.61** | | **20.36** |

[205] Assumes full Section 250 deduction for GILTI is available.

*Example 8(c)*




CFC1:
Tested income / (loss) = 100
QBAI return = 0
Foreign tax rate = 13.125%
Foreign taxes = 15.11

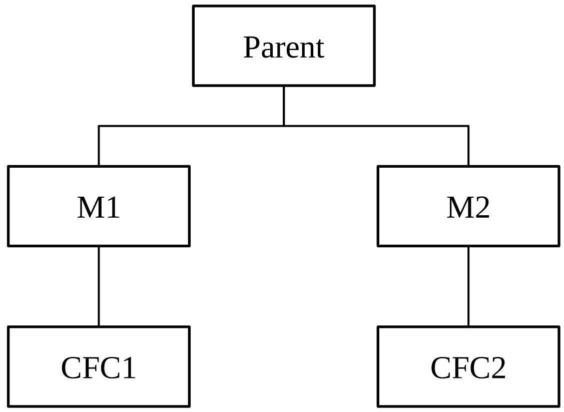
CFC3:
Tested income / (loss) = (100)
QBAI return = 0
Foreign tax rate = 0%
Foreign taxes = 0

CFC2:
Tested income / (loss) = 100
QBAI return = 0
Foreign tax rate = 0%
Foreign taxes = 0

| | **Nonaggregation** | | **Aggregation** |
|---|---|---|---|
| | **M1** | **M2** | **M** |
| Net CFC tested income | 100 | 0 | 100 |
| NDTIR | 0 | 0 | 0 |
| Section 951A inclusion | 100 | 0 | 100 |
| Aggregate of Related CFCs’ tested income | 100 | 100 | 200 |
| Inclusion percentage<br>(Section 951A incl. / Agg. Rel. CFCs' tested income) | 100% | 0% | 50% |
| Foreign tax paid by Related CFCs with tested income | 15.11 | 0 | 15.11 |
| FTCs (80% * Inclusion percentage * Foreign tax) | 12.09 | 0 | 6.04 |
| Section 78 amount (Inclusion percentage * Foreign tax) | 15.11 | 0 | 7.55 |
| GILTI inclusion<br>(Section 951A inclusion + Section 78 amount) | 115.11 | 0 | 107.55 |
| US tax before FTCs (GILTI inclusion * 50%[206] * 21%) | 12.09 | 0 | 11.29 |
| Incremental US tax, taking into account FTCs<br>(US tax before FTCs - FTCs) | 0 | 0 | 5.25 |
| Aggregate tax (Foreign tax + Incremental US tax) | 15.11 | 0 | 20.36 |
| **Aggregate tax for consolidated group** | **15.11** | | **20.36** |

[206] Assumes full Section 250 deduction for GILTI is available.

*Example 9(b)*



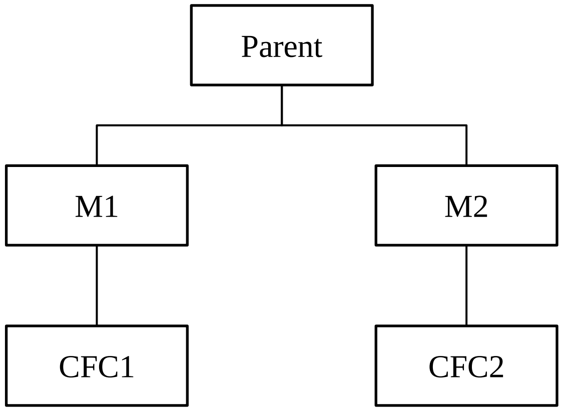

Tested income / (loss) = 100
QBAI return = 0
Foreign tax rate = 13.125%
Foreign taxes = 15.11

Tested income / (loss) = 100
QBAI return = 100
Foreign tax rate = 0%
Foreign taxes = 0

| | Nonaggregation | | Aggregation |
|---|---|---|---|
| | **M1** | **M2** | **M** |
| Net CFC tested income | 100 | 100 | 200 |
| NDTIR | 0 | 100 | 100 |
| Section 951A inclusion | 100 | 0 | 100 |
| Aggregate of Related CFCs' tested income | 100 | 100 | 200 |
| Inclusion percentage<br>(Section 951A incl. / Agg. Rel. CFCs' tested income) | 100% | 0% | 50% |
| Foreign tax paid by Related CFCs with tested income | 15.11 | 0 | 15.11 |
| FTCs (80% * Inclusion percentage * Foreign tax) | 12.09 | 0 | 6.04 |
| Section 78 amount (Inclusion percentage * Foreign tax) | 15.11 | 0 | 7.55 |
| GILTI inclusion<br>(Section 951A inclusion + Section 78 amount) | 115.11 | 0 | 107.55 |
| US tax before FTCs (GILTI inclusion * 50%[207] * 21%) | 12.09 | 0 | 11.29 |
| Incremental US tax, taking into account FTCs<br>(US tax before FTCs - FTCs) | 0 | 0 | 5.25 |
| Aggregate tax (Foreign tax + Incremental US tax) | 15.11 | 0 | 20.36 |
| **Aggregate tax for consolidated group** | **15.11** | | **20.36** |

[207] Assumes full Section 250 deduction for GILTI is available.

### *Example 9(c)*




Tested income / (loss) = 100
QBAI return = 0
Foreign tax rate = 0%
Foreign taxes = 0

Tested income / (loss) = 100
QBAI return = 100
Foreign tax rate = 13.125%
Foreign taxes = 15.11

| | **Nonaggregation** | | **Aggregation** |
|---|---|---|---|
| | **M1** | **M2** | **M** |
| Net CFC tested income | 100 | 100 | 200 |
| NDTIR | 0 | 100 | 100 |
| Section 951A inclusion | 100 | 0 | 100 |
| Aggregate of Related CFCs’ tested income | 100 | 100 | 200 |
| Inclusion percentage<br>(Section 951A incl. / Agg. Rel. CFCs' tested income) | 100% | 0% | 50% |
| Foreign tax paid by Related CFCs with tested income | 0 | 15.11 | 15.11 |
| FTCs (80% * Inclusion percentage * Foreign tax) | 0 | 0 | 6.04 |
| Section 78 amount (Inclusion percentage * Foreign tax) | 0 | 0 | 7.55 |
| GILTI inclusion<br>(Section 951A inclusion + Section 78 amount) | 100 | 0 | 107.55 |
| US tax before FTCs (GILTI inclusion * 50%[208] * 21%) | 10.50 | 0 | 11.29 |
| Incremental US tax, taking into account FTCs<br>(US tax before FTCs - FTCs) | 10.50 | 0 | 5.25 |
| Aggregate tax (Foreign tax + Incremental US tax) | 10.50 | 15.11 | 20.36 |
| **Aggregate tax for consolidated group** | **25.61** | | **20.36** |

[208] Assumes full Section 250 deduction for GILTI is available.

*Example 16(a)*

| | Taxable income | U.S. source basket | GILTI basket | Foreign source general basket | | |
|---|---|---|---|---|---|---|
| | | | | Exempt CFC income | Direct income | Basket total |
| Business income | 700 | 700 | 0 | 0 | 0 | 0 |
| Expenses | (700) | (500) | (100) | (100) | 0 | (100) |
| GILTI gross | 600 | 0 | 600 | 0 | 0 | 0 |
| GILTI deduction | (300) | 0 | (300) | 0 | 0 | 0 |
| **Total** | **300** | **200** | **200** | **(100)** | **0** | **(100)** |

*Calculate GILTI fraction without taking into account Section 904(b)(4), and by re-allocating $100 loss from foreign source general basket to GILTI basket*

$$\text{GILTI fraction} = \frac{\text{GILTI basket income} - \text{Foreign source general basket loss}}{\text{Worldwide income}}$$

$$\text{GILTI fraction} = \frac{100}{300} = 0.33$$

*Apply Section 904(b)(4) to disregard $100 of expenses allocable to exempt CFC income*

| | Taxable income | U.S. source basket | GILTI basket | Foreign source general basket | | |
|---|---|---|---|---|---|---|
| | | | | Exempt CFC income | Direct income | Basket total |
| Business income | 700 | 700 | 0 | 0 | 0 | 0 |
| Expenses | (600) | (500) | (100) | 0 | 0 | 0 |
| GILTI gross | 600 | 0 | 600 | 0 | 0 | 0 |
| GILTI deduction | (300) | 0 | (300) | 0 | 0 | 0 |
| **Total** | **400** | **200** | **200** | **0** | **0** | **0** |

$$\text{GILTI fraction} = \frac{\text{GILTI basket income}}{\text{Worldwide income}}$$

$$\text{GILTI fraction} = \frac{200}{400} = 0.50$$

***Example 16(b)***

| | Taxable income | U.S. source basket | GILTI basket | Foreign source general basket | | |
|---|---|---|---|---|---|---|
| | | | | **Exempt CFC income** | **Direct income** | **Basket total** |
| Business income | 150 | 100 | 0 | 0 | 50 | 50 |
| Expenses | (150) | (40) | (60) | (40) | (10) | (50) |
| GILTI gross | 600 | 0 | 600 | 0 | 0 | 0 |
| GILTI deduction | (300) | 0 | (300) | 0 | 0 | 0 |
| **Total** | **300** | **60** | **240** | **(40)** | **40** | **0** |

*Calculate GILTI and foreign source general basket fractions without taking into account Section 904(b)(4)*

$$\text{GILTI fraction} = \frac{\text{GILTI basket income}}{\text{Worldwide income}} = \frac{240}{300} = 0.80$$

$$\text{Foreign general basket fraction} = \frac{\text{Foreign general basket income}}{\text{Worldwide income}} = \frac{0}{300} = 0$$

*Apply Section 904(b)(4) to disregard $40 of expenses allocable to exempt CFC income*

| | Taxable income | U.S. source basket | GILTI basket | Foreign source general basket | | |
|---|---|---|---|---|---|---|
| | | | | **Exempt CFC income** | **Direct income** | **Basket total** |
| Business income | 150 | 100 | 0 | 0 | 50 | 50 |
| Expenses | (110) | (40) | (60) | 0 | (10) | (10) |
| GILTI gross | 600 | 0 | 600 | 0 | 0 | 0 |
| GILTI deduction | (300) | 0 | (300) | 0 | 0 | 0 |
| **Total** | **340** | **60** | **240** | **0** | **40** | **40** |

$$\text{GILTI fraction} = \frac{\text{GILTI basket income}}{\text{Worldwide income}} = \frac{240}{340} = 0.71$$

$$\text{Foreign general basket fraction} = \frac{\text{Foreign general basket income}}{\text{Worldwide income}} = \frac{40}{340} = 0.12$$

# A TOKEN GESTURE: TAX CONSIDERATIONS FOR CRYPTOCURRENCIES AND UTILITY TOKENS

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March 19, 2018

The Honorable David Kautter
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20024

Re: Tax Treatment of Cryptocurrency Hard Forks for Taxable Year 2017

Dear Acting Commissioner Kautter:

Enclosed please find comments regarding the federal income tax treatment of cryptocurrency hard forks that have taken place in 2017 ("Comments"). These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association.

The Section of Taxation will be pleased to discuss the Comments with you or your staff.

Sincerely,

Karen L. Hawkins
Chair, Section of Taxation

Enclosure

cc: Hon. William M. Paul, Acting Chief Counsel and Deputy Chief Counsel (Technical), Internal Revenue Service
Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury
Thomas West, Tax Legislative Counsel, Department of the Treasury
Rochelle Hodes, Associate Tax Legislative Counsel, Department of the Treasury
Drita Tonuzi, Deputy Chief Counsel (Operations), Internal Revenue Service
Scott Dinwiddie, Associate Chief Counsel (IT&A), Internal Revenue Service
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Karl Walli, Senior Counsel (Financial Products), Department of the Treasury

# AMERICAN BAR ASSOCIATION
# SECTION OF TAXATION
# COMMENTS ON THE TAX TREATMENT OF HARD FORKS

The following comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation (the "Section") and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Omri Marian, Vice Chair of the Section's Teaching Taxation Committee (the "Committee"), and Kerry Ryan, Chair of the Committee, had the principal responsibility for preparing these Comments. Substantive contributions were made by Adam Chodorow, James Creech, Elizabeth Crouse, Diane Ring, and Lisa Zarlenga. The Comments were reviewed by Lisa Zarlenga, Chair of the Section's Committee on Government Submissions.

Although some of the members of the Section who participated in preparing these Comments have clients who may be affected by the federal income tax principles addressed herein, no such member, or the firm or organization to which such member belongs, has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: March 19, 2018

## **Executive Summary**

In 2014, the Internal Revenue Service (the "Service") issued Notice 2014-21 (the "2014 Notice"),[1] addressing the federal income tax treatment of "virtual currencies." The Section offered comments to the 2014 Notice in a letter dated March 24, 2015.[2] Since then, several important developments in the cryptocurrency[3] economy have taken place that are not addressed in the 2014 Notice. These developments raise important federal income tax questions, and we appreciate the opportunity to respond to the Service's request for comments on these issues.

An important issue, and the focus of these Comments, is the proper federal income tax treatment of a cryptocurrency hard fork ("Hard Fork"). A Hard Fork is a "change to the software of the digital currency that creates two separate versions of the blockchain with a shared history."[4] After a Hard Fork takes place, the original owner of the cryptocurrency retains its interest in the original coin and also has the right to use the forked coin. Hard Forks raise unique tax issues. Specifically, does a holder of a cryptocurrency that experiences a Hard Fork realize income for federal income tax purposes? If so, how much and when? The significant volatility in the exchange prices of cryptocurrency make valuation difficult and inconsistent among taxpayers.

As discussed further in these Comments, current law provides no clear answers to these questions. There are reasonable analogies to both taxable and nontaxable events. In light of the legal ambiguity, the significant valuation issues, and need for immediate guidance regarding the 2017 Hard Forks, the Section recommends that the Service consider issuing guidance that offers a temporary rule, in the form of a safe-harbor, to taxpayers who were able to transact in a forked currency as a result of a Hard Fork during the 2017 tax year. We recommend that such guidance prescribe the following:

1. Taxpayers who owned a coin that was subject to a Hard Fork in 2017 would be treated as having realized the forked coin resulting from the Hard Fork in a taxable event.

2. The deemed value of the forked coin at the time of the realization event would be zero, which would also be the taxpayer's basis in the forked coin.

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[1] Notice 2014-21, 2014-16 I.R.B 938.

[2] https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/032415comments.authcheckdam.pdf.

[3] These Comments also refer to virtual currency as "digital currency," "cryptocurrency," or "coins."

[4] David Farmer, *What is a Bitcoin fork?*, THE COINBASE BLOG (Jul. 27, 2017), https://blog.coinbase.com/what-is-a-bitcoin-fork-cba07fe73ef1.

3. The holding period in the forked coin would start on the day of the Hard Fork.

4. Taxpayers choosing the safe harbor treatment as set forth in the guidance would be required to disclose this on their tax returns.[5]

5. The Service would not assert that any taxpayer who availed themselves of the safe harbor treatment as set forth in the guidance has understated federal tax liability because of the receipt of a forked coin in a 2017 Hard Fork.

6. The Service, with input from the Section and other stakeholders, will continue to develop its position regarding the tax treatment for future Hard Forks, and such position may be different from the one noted above and will apply prospectively.

This temporary rule has the benefit of encouraging consistency among taxpayers with respect to 2017 Hard Forks, avoiding difficult timing and valuation issues (including the ability of taxpayers to benefit from hindsight depending on how the values fluctuated during 2017), and providing information to the Service regarding holders of the original and forked cryptocurrencies. Although the treatment may result in capital gain as opposed to ordinary income treatment, it preserves the full value of the forked coin for taxation when the taxpayer sells it. In addition, it restarts the holding period, thus resulting in sales occurring within a year being taxed as short-term capital gains.

The Section will continue to develop its position on the tax treatment of future Hard Forks and is considering other issues for comment in the cryptocurrency area. The Section looks forward to working with the Service on these issues.

[5] The guidance could provide for a simplified disclosure procedure for taxpayers who may already have filed a 2017 return, but who otherwise have taken a position consistent with the guidance with respect to Hard Forks.

## I. Hard Forks in General

Cryptocurrencies are digital tokens, the ownership of which is recorded on a decentralized ledger. Cryptocurrencies are held in "wallets," which may be a type of hardware (*e.g.*, a device similar to a USB drive) or a type of software. Hardware wallets must be physically available to access certain security keys stored on the hardware that are required to control the disposition of the relevant cryptocurrency. Software wallets are just that: software stores the security keys that are required to control the disposition of the relevant cryptocurrency. Software wallets may be hosted in a variety of ways, including on the cloud, a desktop computer, or a mobile phone.

The security keys necessary to transfer cryptocurrency consist of a public key and a private key. Both are large strings of numbers that are mathematically linked to the wallet address. The private key is used to generate a "signature" for each blockchain transaction a user sends out. The private key is used to mathematically derive the public key, which is transformed with a hash function to produce the address that other people can see.

Cryptocurrencies generally may be traded for other cryptocurrencies or fiat currencies, for example the U.S. dollar, on exchanges that function much like stock exchanges. Cryptocurrency exchanges may also provide a software wallet in which users can store security keys for relevant cryptocurrencies. Trading on these platforms occurs in a manner analogous to trading in "street name" when an owner has an account with a large brokerage. That is, the exchange controls the owner's security keys and conducts batch trades for multiple users. This is a high-level description of how some intermediaries operate, though there are numerous variations.

Because the software that runs the ledger generally is open-source, and the network of computers that verify transactions generally operates via consensus, the software can be modified if enough participants on the network agree to do so. Hard Forks, sometimes also known as "Chain Splits" or "Coin Splits," are one example of such modifications. When a Hard Fork occurs, a new "branch" splits from the original ledger and is thereafter separately maintained. This means that the network of computers separates into subgroups, which separately verify transactions on the original ledger and the split or forked ledger. Those people whose ownership of a cryptocurrency was recorded on the original ledger maintain their ownership of the original cryptocurrency, but they are also entitled to claim ownership of the cryptocurrency maintained on the forked ledger. When an owner holds a cryptocurrency wallet directly (rather than through a custodial wallet), the owner does not actually receive anything new in a Hard Fork. Instead, the owner—once he or she has taken the necessary steps (as described below)—is able to use the same private key to transact on each of the ledgers. If the owner uses his or her private key to transact in the original cryptocurrency, the network participants verifying transactions on the original ledger will add it to that ledger, but the network participants verifying transactions on the forked ledger will not recognize it. This enables the owner to use his or her private key separately to transact in the forked coin and the original coin. The ownership history of both the original and forked cryptocurrency trace back to the same block on the blockchain, but going forward, the ledger of each cryptocurrency is independent (*i.e.*, they are not interchangeable).

It may be helpful to compare Hard Forks with "soft forks," which are more similar to a software upgrade. In a soft fork, the same blockchain is maintained (there is no split or branching), but some changes to the related software are made such that the blockchain functions somewhat differently after the soft fork. By analogy, a soft fork is more similar to the release of a new version of an existing variety of word processing software, for example, Microsoft Word. The new version typically recognizes documents created using the original version, but the original version may not recognize documents created using the new version unless the original software is updated.

There are many reasons for network participants to agree to Hard Forks. For example, one reason for Hard Forks is that users of the network agree that a fundamental upgrade to the ledger software is required. For example, on August 1, 2017, Bitcoin split into bitcoin (BTC) and bitcoin cash (BCH).[6] The purpose in creating BCH was to allow for a quicker generation of forked coins, as well as other improvements. Nonetheless, both BCH and BTC remain in existence, and both enjoy considerable trust of the cryptocurrency community. In contrast, some forks are a response to user mistrust in the original coin. For example, in 2016, the Ethereum blockchain was split into two in response to a hacking attack that affected the original ledger. In that case, the value of the original coin (Classic Ethereum) and the volume of trading in it plummeted due to the loss of user trust, while the forked coin (Ethereum), which is viewed more favorably by the market, essentially usurped the original coin. Even though original owners of Ethereum owned both the original and forked coins on the day of the split, the original coins became nearly worthless in comparison on that day (though both still trade and the original coin has since reached a greater price than it had prior to the fork).

In the case of a Hard Fork, an owner of the original coin must take active steps in order to transact in the forked coin. An owner that holds the original coin in a basic wallet (whether hardware or software), generally must download new software to a computer to use the forked coin. This requires some level of technological sophistication

[6] Other examples of Bitcoin chain splits include bitcoin gold in October 2017, bitcoin diamond in November 2017, and superbitcoin, bitcoin hot, and lightning bitcoin in December 2017.

and is inconvenient, but is not unduly burdensome for a reasonably experienced computer user. An owner that holds the original coin through certain other types of wallets is not required to download the software because the wallet service provider downloads the software, thus "supporting" the forked coin created in the Hard Fork. This is much easier for the average owner, but means that owners who use a custodial wallet service depend on the wallet service provider to permit them access to the forked coin.

For example, a few days before the BCH Hard Fork, Coinbase sent an e-mail to its customers stating that Coinbase has "no plans to support the Bitcoin Cash fork… Customers will not have access to, or be able to withdraw, bitcoin cash."[7] Only three days after the Hard Fork happened, Coinbase announced that it would support BCH, and would credit their customers' accounts accordingly.[8] Similarly, Xapo announced that customers had until December 14, 2017 to transfer or convert their BCH to BTC, or they would automatically convert it.[9] Many owners and wallet service providers take no action to claim the forked currency until the security risks have been sufficiently evaluated and mitigated. Nonetheless, it is generally possible for an owner to transfer the original coin from one wallet that will not support a Hard Fork and into another wallet that will support the Hard Fork prior to the occurrence of the Hard Fork. In that manner, the owner generally should be able to go through the processes necessary to claim the forked coin, at least if the owner is aware that a Hard Fork is going to occur.

## II. Potential Tax Treatments of Hard Forks

Hard Forks raise the question of whether owners of an original coin who become entitled to use a forked coin by reason of a Hard Fork, realize income. We believe reasonable arguments may be made both ways because Hard Forks may be analogized to existing taxable and nontaxable events.

### A. Hard Fork as a Realization Event

The Supreme Court in *Commissioner v. Glenshaw Glass*[10] liberally construed the term "gross income" as "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion," reflecting Congress' intent to tax

[7] David Farmer, *Update for customers with bitcoin stored on Coinbase*, THE COINBASE BLOG (Jul. 27, 2017), https://blog.coinbase.com/update-for-customers-with-bitcoin-stored-on-coinbase-99e2d4790a53.

[8] David Farmer, *Update of Bitcoin Cash*, THE COINBASE BLOG (Aug. 3, 2017), https://blog.coinbase.com/update-on-bitcoin-cash-8a67a7e8dbdf.

[9] Xapo Bitcoin Cash Update, https://support.xapo.com/xapo-bitcoin-cash-update.

[10] 348 U.S. 426, 431 (1955).

all gains except those specifically exempted. One could argue that the ability to use the forked coin in addition to the original coin represents such an accession to wealth.

In *Eisner v. Macomber,* the Supreme Court considered whether a pro-rata stock dividend paid to a common shareholder by a corporation with one class of stock constituted income. In holding that it did not, the Court distinguished taxable "gain derived from capital" from unrealized—and therefore nontaxable—"gain accruing to capital or a growth or increment of value in the investment."[11] The pro-rata stock dividend in *Macomber* fell into the latter category because it was simply an additional piece of paper evidencing the increased worth of the taxpayer's original investment in the company—the shareholder has received nothing out of the corporation's assets for his use and benefit, and the corporation has not experienced a change in its aggregate assets or its outstanding liabilities.[12] In contrast, the Court defined a taxable "gain derived from capital" as "something of exchangeable value proceeding from the property, severed from the capital . . . and received or drawn by the [taxpayer] for his separate use, benefit and disposal."[13]

In *Macomber,* the receipt of additional stock was a consequence of owning the original stock, and the same could be said for forked coins, such as BCH, received in a Hard Fork. However, unlike in *Macomber*, BCH has unique properties, and it is unrelated to BTC except by the shared historical ownership. Thus, unlike the taxpayer in *Macomber*, one could argue that an owner of BTC who received BCH at the time of the fork received a new and different asset of exchangeable value for the owner's separate use rather than something representing an increase in the underlying value of the previously held BTC.

The regulations under section 1001[14] define a realized gain or loss as, *inter alia*, one from "the exchange of property for other property differing materially in either kind or extent."[15] The Supreme Court in *Cottage Savings Association v. Commissioner* defined materially different properties as those where "their respective possessors enjoy legal entitlements that are different in kind or extent."[16] Although there was not an exchange of BTC for BCH at the time of the Hard Fork, such that *Cottage Savings* is not precisely on point, the definition is useful in determining whether a holder of BTC at the

[11] 252 U.S .189, 207 (1920). This case involved a number of Constitutional issues that are not relevant here. Rather, we cite the case for the proposition that realization is an important element of income.

[12] *Id*. at 210-11.

[13] *Id.* at 207.

[14] References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

[15] Reg. § 1.1001-1(a).

[16] 499 U.S. 554, 555 (1991).

Hard Fork received something materially different than the previously held BTC. One might argue that the upgrade reflected in the forked cryptocurrency represents a significant change in the protocol that mattered to users (otherwise the fork would not have been permanent), thus representing a material change. Although the forked cryptocurrencies share a pre-split transaction history, a Hard Fork represents a permanent split in the blockchain. Thereafter, transactions on the original blockchain are valid only in BTC, but invalid in BCH, and vice versa. In addition, BTC and BCH are traded separately, each with its own value.

Based on the above authorities, we believe a reasonable argument can be made that the receipt of a forked coin resulting from a Hard Fork constitutes a realization event.[17] However, even if one accepts such a view, there remains ambiguity as to *when* the realization occurs, and what is the *amount* realized.

*Timing of realization*

As mentioned above, the Supreme Court in *Commissioner v. Glenshaw Glass* defined taxable income as "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." [18] It is the last part of this definition—complete dominion—that raises an issue as to the timing of realization with regard to Hard Forks.

One possible argument is that realization happens at the time of the Hard Fork. At that point, an owner of the original coin becomes (at least in theory) unconditionally eligible to claim the forked coin, and he or she therefore must include the value of the forked coin at that time. However, when an owner holds an original coin in an account maintained by an intermediary such as Coinbase, the timing of realization becomes murky. In that case, a financial intermediary—whether the owner's agent or not—is preventing the owner from controlling the forked coin, which arguably may prevent the owner from experiencing a realization event.[19] On the other hand, cryptocurrencies are virtual currency and can be transferred to other intermediaries or the owner relatively easily and quickly. Consequently, it can be argued that the owner has voluntarily failed

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[17] Other possible analogies to taxable transactions include dividends of property (§§ 301, 316), found property or treasure trove (Reg. § 1.61-14(a); *Cesarini v. United States*, 296 F. Supp. 3 (N.D. Ohio 1969)), awards (*Hornung v. Commissioner*, 47 T.C. 428 (1967)), or free samples (*Haverly v. United States*, 513 F.2d 224 (7th Cir. 1975)).

[18] 348 U.S. at 431.

[19] *See, e.g.*, *Maryland Casualty v. U.S.*, 251 U.S. 342 (1920). Even if the owner does not hold an original coin through a third-party wallet, he or she may still take no action to claim the forked currency until the security risks have been sufficiently evaluated and mitigated.

to meet the conditions under which the forked coin can be claimed and is in constructive receipt of it.[20]

*Amount Realized*

Assuming realization, one must determine the amount realized, meaning, the value of the forked coin when realization occurs. Given the complexities in the cryptocurrency market, valuation is as much a problem of administrability and predictability as it is of consistency with existing U.S. federal income tax law.

After a Hard Fork occurs, there is a process of market price discovery. However, this process often takes place on multiple exchanges that do not "talk" to each other. As a consequence, the same type of cryptocurrency—even established cryptocurrencies such as BTC—may have different values on different exchanges at the same time. Thus, even though market values for a forked coin may emerge quickly (though, in some cases, a market may fail to materialize), the same coin may have different market values on different exchanges even within the same country at any point in time. Nonetheless, at the moment that a Hard Fork occurs—the first moment at which an owner of the original coin may obtain an interest in the forked coin—the forked coin arguably has no market value because it has not been previously traded and it is not clear whether a market will emerge for the coin.

We note that in some instances (such as in the case of BCH), an exchange may permit futures contracts in a forked coin to be traded before a Hard Fork occurs. However, to the best of our knowledge, no such websites constitute an "established market"—a concept to which many provisions in the Code refer as a method for determining market price—and therefore should not be used as a definitive source for determining the value of the underlying property (*i.e.*, the forked coin) for tax purposes.[21]

If one determines that realization occurs when an owner first has clear control over the forked coin resulting from a Hard Fork, then it is reasonable to argue that the fair market value of the forked coin must be determined at that time. It is reasonable to argue that in the case of third-party exchanges that also function as a wallet provider (*e.g.*, Coinbase), the amount realized would be the U.S. dollar value of the forked coin on that exchange at the time it is credited to an owner's account (*i.e.*, the first moment that the

[20] Reg. § 1.451-2. If the value of the forked currency is included in income immediately upon the fork, but the modifications to the blockchain are ultimately not adopted by participants on the network so that the fork is not permanent and the blockchain re-merges, the owner should arguably be able to take a loss equal to its adjusted basis in the forked currency. I.R.C. § 165(c)(2).

[21] *See, e.g.*, Reg. § 1.1.1273-2(f) (determining issue price for purposes of determining original issue discount).

intermediary elects to recognize the forked coin on behalf of the owner). As a result, the owner would report the fair market value of the coin at the time of crediting as ordinary income, since the forked coin was not received in a sale or exchange, and would take a basis in the forked coin equal to its fair market value at that time.

However, an owner who holds the forked coin through another wallet provider or technological method that recognizes the forked coin and credits it to an owner's account at the moment of the Hard Fork may include a very different amount in ordinary income due to the different timing of the realization event (*i.e.*, when the user obtained clear control over the forked coin). The owner may also be able to select the most favorable exchange rate by shopping the various exchanges. This is not necessarily a problem of fairness given that the owner has a choice regarding how he or she holds the original coin involved in the Hard Fork, but it is a problem of predictability and administrability (and an opportunity for taxpayers to attempt to game the U.S. federal income tax system).

**B. Hard Fork as a Non-Realization Event**

Given that a forked coin resulting from a Hard Fork shares transactional and ownership history with the original coin, one could also argue that the original coin has always included the future potential to create a forked coin. For example, one could argue that part of the potential of BTC has always been the creation of additional coins (such as BCH), and that such a possibility is capitalized into the market value of BTC. In other words, the forked coin is like the stock dividend in *Macomber* in that it simply represents part of the value of the original coin and therefor is more in the nature of a change in the form of ownership than a realization event. In this way, a Hard Fork is arguably similar to the birth of young from pregnant livestock, which generally has not been treated as a realization event.[22] Notably, the fact that BCH has modestly different properties from BTC should not be seen as conclusively establishing that a realization event has occurred; a calf has different properties from the cow that gives birth to the calf, and stock received in a nontaxable stock dividend need not be identical to the stock on which the dividend is paid.

If this position is accepted, the creation of BCH should not be treated as a realization event until the disposition of BCH by the owner (and taxed as a capital gain if the cryptocurrency is held as a capital asset). This position is supported by a reduction in

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[22] *See, e.g.*, *Metz v. United States*, 10 AFTR 2d 5443 (E.D. Ky. 1962); *Gamble v. Commissioner*, 68 T.C. 800 (1977); Rev. Rul. 86-24, 1986-1 C.B. 80. Other possible analogies to nontaxable transactions include the sale of minerals extracted (Reg. § 1.61-3(a)) or timber cut from land (*cf.* I.R.C. § 631(a)), the partition of property (Reg. § 1.61-6(a)), or the severance of a joint tenancy (Rev. Rul. 56-437, 1956-2 C.B. 507).

price of BTC that happened at the time of the Hard Fork with BCH.[23] One could argue that the reduction of BTC value was attributable to the split with BCH, the value of which was no longer integrated with the value of BTC. It is difficult, however, to empirically prove that the prices of BTC and BCH are so associated due to the volatility of both currencies.

Alternatively, one may view the forked currency as not materially different than the original currency under the standard of *Cottage Savings*. The owner continues to use the same private key that permitted the owner to spend BTC prior to the Hard Fork to access BCH after the Hard Fork, and each are verified by a subset of the same network of computers. In addition, the ownership history of both BTC and BCH trace back to the same block on the blockchain; any changes emerge only going forward.

Even if one accepts the position that a Hard Fork is not a realization event, an important question remains. Specifically, one has to decide how to divide the basis between the original coin and the forked coin. One possible approach would be to adopt rules similar to those used in stock distributions, in which the basis is split based on the fair market value of the original and distributed stock.[24] However, in such a case, it will be necessary to determine the value of the forked coin at the time of the Hard Fork. As discussed above, there are real practical difficulties with determining the value of a forked coin.

## III. PROPOSAL FOR 2017

The original intent of the Section was to fully develop the issues discussed herein. However, given that multiple Hard Forks took place in 2017, it is apparent that these issues are pressing and must be addressed in time to be of assistance for taxpayers during the current filing season. Therefore, the Section decided to leave the full development of these issues for later and instead proposes a temporary solution to apply only for the 2017 tax year.

Under the proposed temporary solution, we recommend that the Service issue guidance that offers a safe harbor to taxpayers who were able to transact in a forked coin as a result of a Hard Fork occurring during the 2017 tax year. Such safe harbor would prescribe the following:

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[23] Laura Shin, *Bitcoin Cash Skyrockets, Bitcoin Price Drops As Civil War Continues*, FORBES (Nov. 12, 2017), https://www.forbes.com/sites/laurashin/2017/11/12/bitcoin-cash-skyrockets-bitcoin-price-drops-as-civil-war-continues/#3968e99135b5.

[24] Reg. § 1.307-1.

1. Taxpayers who owned a coin that was subject to a Hard Fork in 2017 would be treated as having realized the forked coin resulting from the Hard Fork in a taxable event.

2. The deemed value of the forked coin at the time of the realization event would be zero, which would also be the taxpayer's basis in the forked coin.

3. The holding period in the forked coin would start on the day of the Hard Fork.

4. Taxpayers choosing the safe harbor treatment as set forth in the guidance would be required to disclose this on their tax returns.

5. The Service would not assert that any taxpayer who availed themselves of the safe harbor treatment as set forth in the guidance has understated federal tax liability because of the receipt of a forked coin in a 2017 Hard Fork.

6. The Service, with input from the Section and other stakeholders, will continue to develop its position regarding the tax treatment for future Hard Forks, and such position may be different from the one noted above and will apply prospectively.

While the Section has not concluded that this is the proper U.S. federal income tax treatment of Hard Forks, we believe that such temporary solution represents a reasonable interpretation of current law. In addition, we believe that the temporary solution imposes a reasonable administrative burden on the Service and compliance burden on taxpayers in this filing season, as it avoids difficult timing and valuation issues.[25] It also minimizes the ability of taxpayers to benefit from hindsight depending on how the values fluctuated during 2017. Finally, by requiring disclosure, the Service will obtain valuable information about cryptocurrency transactions and taxpayers participating in them.

We acknowledge that the temporary treatment may result in capital gain as opposed to ordinary income treatment (assuming the cryptocurrency is held as a capital asset), but by assigning a zero value, it preserves tax on the full value of the forked currency for taxation when the taxpayer sells it. In addition, this approach restarts the holding period, thus resulting in sales occurring within a year being taxed as short-term capital gains.

The Section will continue to refine its position and is happy to assist the Service in developing a permanent position regarding the tax treatment of Hard Forks. The

[25] We note that the Service has previously adopted safe harbors to avoid difficult valuation issues. *See, e.g.*, Rev. Proc. 93-27, 1993-2 C.B. 343, *clarified by* Rev. Proc. 2001-43, 2001-2 C.B. 191.

Section also plans to comment on other issues in the cryptocurrency area and looks forward to prioritizing and working with the Service on those issues.

# Taxation of Bitcoin, Its Progeny, and Derivatives: Coin Ex Machina

by Stevie D. Conlon, Anna Vayser, and Robert Schwaba

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In this report, Conlon, Vayser, and Schwaba provide a primer on income tax issues regarding cryptocurrencies and related financial derivatives, including cryptocurrency futures, in light of important developments in 2017. They explain that Form 1099-B reporting, straddles, tax arbitrage possibilities, taxable income resulting from forks of cryptocurrencies, and IRS audits are all new concerns.



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Financial markets and investments constantly change, and bitcoin, a cryptocurrency, has been the recent focus of much attention by the investing public, the markets, and non-luddites of all sorts.[1] This report provides a primer on the state of general U.S. income tax issues for investors regarding cryptocurrencies and related financial derivatives like cryptocurrency futures.

There were significant developments concerning cryptocurrencies in 2017. At the beginning of the year, a single bitcoin was valued at barely $1,000. By the end of 2017, however, that value exceeded $15,000. Market awareness and participation continued to grow in 2017, and the bitcoin blockchain forked twice (in August and November). In November came a published court decision on an IRS subpoena of bitcoin activities by participants,[2] and bitcoin futures were introduced in December.[3]

Much has been written about whether recent massive price fluctuations in bitcoin portend a tulip-mania-like market crash for cryptocurrencies.[4] We leave those discussions to others. Instead, our goal is to lay out the fundamental tax issues for virtual currencies and their related derivatives. An important caveat regarding any discussion of financial innovations like those covered here is that there is little specific tax law on many aspects of cryptocurrencies or their derivatives, and what law there is can change. Accordingly, in many cases we have tried to identify the relevant tax questions even if there is no clear answer. Moreover, given that cryptocurrencies are relatively new, general background information is appropriate.

# I. Background

## A. What Is a Bitcoin or a Cryptocurrency?

Bitcoin and other cryptocurrencies generally are types of decentralized digital currencies that are not typically managed by a central bank or administrator. Instead, they are specific applications of blockchain technology. Bitcoin was invented in 2009 by an unknown person or persons under the name Satoshi Nakamoto.[5] Fintech commentators have noted that major technological innovations like blockchain, bitcoin, and others related to finance emerged and were likely accelerated as a result of the financial market challenges and related global recession at that time.[6] It is noteworthy that the following block of text was embedded in the first, or "genesis," block of bitcoin: "The Times 03/Jan/2009 Chancellor on the brink of second bailout for banks."[7]

Like another paradigm-shifting technological initiative — artificial intelligence — it is important to understand that more generally, blockchain technology is being developed or used to radically transform many business processes. Its significance is difficult to understate, and it could represent as significant a change from a technology perspective as the evolution from steam-based infrastructure to electricity-based infrastructure. Many banks, brokers, fintech companies, and market intermediaries are using or have projects underway to use blockchain. For example, the Depository Trust and Clearing Corp. (DTCC) has begun a project to use distributed ledger (blockchain) technology as the base technology to re-platform its trade information warehouse, which automates the recordkeeping, lifecycle events, and payment management of more than $11 trillion of credit derivatives. The DTCC plans to complete testing and start in "shadow mode" alongside its active solution in the first quarter of 2018.[8]

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[1] Daniel Shane, "Bitcoin: What's Driving the Frenzy?" CNN Money (Dec. 8, 2017).

[2] *United States v. Coinbase Inc.*, No. 3:17-cv-01431 (N.D. Cal. 2017).

[3] Alexander Osipovich and Gabriel T. Rubin, "U.S. Bitcoin Futures Climb in First Day of Trade," *The Wall Street Journal*, Dec. 11, 2017.

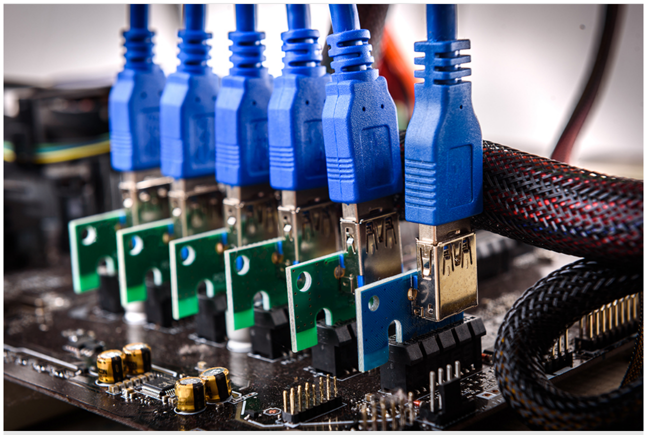
[4] Although many of the supposed excesses of the tulip craze are apparently more properly attributed to cautionary tales penned by Calvinists who had an axe to grind with what they saw as rampant, greed-driven consumerism than a systemic financial bubble fueled solely by ornamental horticulture (Lorraine Boissoneault, "There Never Was a Real Tulip Fever," Smithsonian.com, Sept. 18, 2017), the fact remains that bitcoin went from around $1,000 on the first day of 2017 to nearly $20,000 before the end of 2017. *See* Pete Rizzo, "Bitcoin Price Tops $1,000 in First Day of 2017 Trading," coindesk.com, Jan. 1, 2017; and Eric Mack, "As Bitcoin Flirts With $20,000, Let's Revisit Its Earlier Crashes," Forbes.com, Dec. 16, 2017.

[5] Nathaniel Popper, "What Is Bitcoin, and How Does It Work?" *The New York Times*, Oct. 1, 2017.

[6] *See generally* Brett King, *Breaking Banks: The Innovators, Rogues and Strategists Rebooting Banking*, Ch. 5 (2014).

[7] Timothy B. Lee, "Five Years of Bitcoin in One Post," *The Washington Post*, Jan. 3, 2014.

[8] Michael del Castillo, "DTCC Milestone: $11 Trillion in Derivatives Gets Closer to the Blockchain," Coindesk.com, Oct. 20, 2017.



*Bitcoin mine close-up (jure@Bigstock.com)*

All blockchain systems, including those underlying cryptocurrencies, rely on a distributed ledger and network nodes to verify the authenticity of a specific block, such as a unique unit of cryptocurrency. The distributed ledger attempts to prevent fraud and counterfeiting through self-verification, effectively doing away with the need for oversight of the cryptocurrency by a central bank or administrator.[9]

Cryptocurrencies are completely electronic. New coins are created through a process called "mining": Computers are used to create a new block, which includes an algorithmic cryptographic hash that links the new block to the prior block (hence creating the blockchain) and a proof-of-work that includes a number referred to as a nonce. The proof-of-work requires the solutions to mathematical problems,[10] and the system readjusts periodically to raise the difficulty of these computations to effectively throttle the number of new bitcoins that can be created.[11] Because of how the blocks are all linked together, a corrupt or modified block would likely be rejected. This sort of security system embedded within each block of the chain is what technologists believe makes it so difficult to counterfeit bitcoin and other cryptocurrencies.

Miners receive both newly minted bitcoins and transaction fees for their efforts. This is processed through a transaction described as a coinbase.[12] The value of bitcoins is fundamentally based on their predesigned scarcity: The total number of the coins that can ever be created based on the related algorithms is limited to 21 million. Although it was originally expected that all 21 million bitcoins would be mined by 2140, the rapid changes in valuation and the continued building of large-scale bitcoin mining facilities could accelerate the exhaustion of the supply of bitcoins.[13] Of course, other cryptocurrencies have been and will likely continue to be created with new, artificially architected raw supplies available for mining across our technological world.[14]

The algorithms needed to link the coins and generate proof-of-work are major elements in what makes cryptocurrency mining so difficult. Large banks of dedicated computers and servers are used in massive, loud, heat-generating old warehouses and factories that have been repurposed as mining facilities. Concerns have been raised about energy consumption and the environmental effects of these activities.[15]

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[9] Shyam Shankar, "Centralized Ledgers vs. Distributed Ledgers (Layman Understanding)," Medium.com, July 12, 2017.

[10] Adding leading zeroes to the solution of the mathematical problem increases the difficulty exponentially. For example, the hash of the genesis block had 10 leading zeroes. In early days, the number of leading zeroes fell as low as eight, but it has increased dramatically to around 18. Kiran Viadya, "Decoding the Enigma of Bitcoin Mining — Part I: Mechanism," All Things Ledger, Dec. 14, 2016.

[11] Difficulty is generally expressed as the estimated number of hashes required divided by $2^{32}$ (approximately 4.3 billion). Between March 1, 2014, and March 1, 2015, the average number of hashes miners had to try before creating a new block increased from 16.4 quintillion to 200.5 quintillion, which could also be expressed as a difficulty change from approximately 3.8 billion to approximately 46 billion. Since the start of 2016, the difficulty has continued to increase precipitously: Difficulty as of December 24, 2017 was approximately 1.8 trillion (or requiring approximately $7.74 \times 10^{21}$ attempted hashes).

[12] Jerome Morrow, "What Is a Coinbase Transaction?" Cex.io, Oct. 29, 2014.

[13] The year 2140 was an estimate. Given that each added block includes transaction fees for the successful miner and that successive blocks reward miners with fewer new bitcoins, by the time miners are close to 21 million bitcoins the transaction fees themselves may be a sufficient incentive to mine.

[14] Prableen Bajpai, "The 6 Most Important Cryptocurrencies Other Than Bitcoin," Investopedia, Dec. 7, 2017.

[15] Popper, "Into the Bitcoin Mines," *The New York Times*, Dec. 22, 2013.

## B. Tracking Ownership: Keys and Wallets

Each bitcoin has a unique electronic address. Transfer of a bitcoin requires both a public and private key. The public key is on the blockchain, while the private key is only in a miner's digital wallet. It is virtually impossible to reverse-engineer a private key. In an exchange, the public key identifies the electronic address and the private key verifies the transaction, like a digital signature. Losing a private key is equivalent to losing cash, because the network does not recognize any method of ownership besides private keys. This point is emphasized by the story of a man who claims to have lost the private keys for 7,500 bitcoins in 2013 because he had accidentally thrown away a hard drive containing them (worth approximately $75 million, assuming a bitcoin value of $10,000 per coin).[16]

A software wallet holds the information needed to identify bitcoins, and it can be online (permitting ready access) or offline. It essentially stores a person's credentials that identify bitcoin holdings (the private and public key pairs).[17] Bitcoins can be stolen if the private keys are stolen, so security of this information is critical. A theft of this kind notably occurred in 2011 with Mt. Gox, a Tokyo-based bitcoin exchange.[18] Accordingly, to manage security risks, this information may sometimes be kept in a paper wallet (physically printed and stored) or a hardware wallet (the storage of the information electronically but offline, not connected to the internet).

A single bitcoin has often had a value of hundreds or thousands of dollars, but there are standardized fractions of bitcoins that can be held, bought, or sold. The smallest fractional amount recorded by the blockchain is a "satoshi," which represents one hundred millionth of a single bitcoin.[19] Accordingly, individuals could acquire small fractions of bitcoins at different times, with each fraction registered separately as part of the blockchain, potentially even segregated into discrete wallets, each with its own public and private keys.

Bitcoin can also be owned indirectly. Some entities may have restrictions on investment types that could prohibit direct investments in alternative assets like cryptocurrencies. Indirect investments in custodial arrangements offered by some market participants might avoid those restrictions.

## C. Forks and Coin Creation

As a blockchain, each block of bitcoin transactions effectively links under prescribed rules to all others. When the rules for a blockchain are updated or changed, older blocks in the chain may no longer meet the newer requirements and may therefore no longer be linked to the blocks created after the update or change. This creates a fork (like a fork in the road), or the creation of two different potential paths: an existing path, which simply follows the old rules; and another potential path, on which new blocks are linked based on the updated or changed rules. Because bitcoin is not centrally managed, each of its participants has the ability to decide which path they want to take. The viability of each path depends on the mining power represented by the participant's choice. Presumably, a consensus will emerge based on values in the marketplace.

A hard fork can be an intentional result of newer rules that might be added to correct security risks or provide some other technological benefit.[20] A bitcoin hard fork took place in August 2017, arising because some participants wanted to change the one-megabyte standard size of a bitcoin block to eight megabytes to increase transaction processing speed. This hard fork created a split in the bitcoin blockchain, and for

[16] Aatif Sulleyman, "Man Who 'Threw Away' Bitcoin Haul Now Worth Over $80M Wants to Dig Up Landfill Site," *The Independent*, Dec. 4, 2017.

[17] "How to Choose the Best Bitcoin Wallet," www.bitcoin.com (Jan. 27, 2017).

[18] Robert McMillan, "The Inside Story of Mt. Gox, Bitcoin's $460 Million Disaster," *Wired*, Mar. 3, 2014.

[19] Popper, *supra* note 5.

[20] A soft fork differs in that the new blocks comply with all the old rules but are also subject to new rules. Soft forks rely on miners switching over to the new rules. This means that while nodes mining under the old rules will recognize the new blocks as valid, nodes mining under the new rules might not recognize blocks mined under the old rules after the fork. For example, if 75 percent of miners recognize the new rules, 25 percent of the new blocks generated might not follow the new rules. Nodes running the old rules will see them as valid, but new nodes will probably ignore them. Theoretically, this should result in speedy adoption once the majority of nodes follow the new rules, since miners do not want their nodes to be rejected.

pre-fork holders of bitcoin it essentially resulted in ownership of two separate sets of coins: bitcoin and bitcoin cash.[21] In practice, all holders of bitcoin as of the date of the hard fork (as referenced by a particular block in the bitcoin chain) received the right to an equal number of bitcoin cash units. After the hard fork, the relative ownership of bitcoin and bitcoin cash was expected to quickly diverge. Miners could prospectively mine either cryptocurrency, deciding on an ongoing basis whether bitcoin or bitcoin cash would result in better profitability to the miner. Similarly, investors could decide which cryptocurrency they would rather prospectively acquire: bitcoin or bitcoin cash.

In November 2017 another hard fork of bitcoin occurred, resulting in bitcoin gold. It was believed that the bitcoin mining algorithms tended to create a centralization of the mining environment. Bitcoin gold's algorithms were designed in a manner intended to provide better opportunities for smaller miners.[22] All holders of bitcoin as of the date of the November hard fork (as referenced by a particular block in the bitcoin chain) effectively received the right to an equal number of bitcoin gold units. Mining and investment of bitcoin and bitcoin gold was similarly expected to rapidly diverge. An investor holding a single bitcoin that was mined before either fork, before making any trades, theoretically holds a unit each of bitcoin, bitcoin cash, and bitcoin gold following the second fork.[23] After both forks, an investor who held a bitcoin before both forks can effectively sell the bitcoin three times: once under the bitcoin gold rules, once under the bitcoin cash rules, and once under the original bitcoin rules.[24]

### D. Other Cryptocurrencies and Tokens

There are several cryptocurrencies other than bitcoin. Bitcoin cash and bitcoin gold have already been mentioned, but others of note include Litecoin and Ripple. Future cryptocurrencies are inevitable; in general, they are intended to function as a standardized and liquid medium of exchange that does not rely on a central banking system. Electronic currencies are often intended to provide global access to a currency that may be more stable than local currencies. The blockchain architecture and distributed record system is intended to facilitate lower fees for exchange transactions than those that typically arise with existing centralized-bank-supported currency exchange systems.[25]

Related but distinguishable from cryptocurrencies are tokens or smart contracts like Ethereum, Filecoin, Storj, and Blockstack.[26] Rather than serve as a medium of exchange, tokens or smart contracts use blockchain and a distributed record system to track ownership of assets and facilitate execution of promises and other agreements electronically in a manner that eliminates the need for access to centralized and stored records or existing signature verification protocols.[27]

### E. Cryptocurrency Derivatives

"It is rare that you see something more volatile than bitcoin, but we found it: bitcoin

[21] Amy Castor, "Bitcoin Cash 101: What Users Need to Know Before the Fork," Coindesk.com, July 31, 2017.

[22] The two major changes were shifting to a more memory-intensive and less processor-intensive mining algorithm, and adjusting mining difficulty after each block rather than approximately every two weeks. Aaron van Wirdum, "Bitcoin Gold Launches on November 12," *Bitcoin Magazine*, Nov. 11, 2017.

[23] Depending on the method of bitcoin storage, some bitcoin holders may not immediately be able to access the forked virtual currency. For example, the cryptocurrency exchange Coinbase did not initially permit users to withdraw the bitcoin cash they received because of the fork. "Bitcoin Cash — Frequently Asked Questions," coinbase.com, Dec. 19, 2017. Note substantial price variances can occur between the date of the fork and access to the forked virtual currency.

[24] For example, bitcoin cash nodes recognize bitcoin balances from before the fork but don't recognize spending transactions on the bitcoin chain after the fork, and bitcoin nodes likewise recognize bitcoin cash balances but don't recognize bitcoin cash spending transactions. Post-fork, a holder can dispose of the bitcoin he held before the fork twice — once with a bitcoin spend transaction, and once with a bitcoin cash spend transaction. Jim Calvin, "Adequately Identifying Bitcoin Dispositions for Federal Income Tax Purposes," 58 *Tax Mgmt. Memo.* 363, 366 (2017).

[25] Satoshi Nakamoto, "Bitcoin: A Peer-to-Peer Electronic Cash System," bitcoin.org, at 1 (undated) ("The cost of mediation increases transaction costs."). Satoshi Nakamoto is a pseudonym; the real identity of the author or authors is unknown.

[26] David J. Shakow, "The Tax Treatment of Tokens: What Does It Betoken?" *Tax Notes*, Sept. 11, 2017, p. 1387.

[27] *Id.*

futures," said Zennon Kapron, a consultant quoted by Bloomberg, on December 10, 2017 — the day bitcoin futures began trading on the Chicago Board Options Exchange (CBOE).[28]

Not surprisingly, derivatives for bitcoin and other cryptocurrency have emerged. These permit indirect investment in cryptocurrencies, facilitate shorting and potential arbitrage opportunities, and may offer different levels of liquidity and other benefits of exchange-traded investing. On December 10 and December 17, 2017, respectively, bitcoin futures were introduced by both of the Chicago-based futures exchanges: the CBOE and the Chicago Mercantile Exchange (CME).[29] Other financial derivatives also permit investors to indirectly take positions in cryptocurrencies. For example, Grayscale manages an investment trust that holds bitcoin (over-the-counter markets ticker GBTC), and investors can purchase shares that represent a portion of the trust's holdings.[30] In May 2015 issuer XBT Provider began offering exchange-traded notes (ETNs) in Europe that are intended to mirror the returns of bitcoin (one is based on the Swedish kroner and another is based on euros).

## II. U.S. Taxation

### A. Notice 2014-21

In March 2014 the IRS released Notice 2014-21, 2014-16 IRB 938, which provides the agency's conclusions on some basic tax principles concerning cryptocurrencies. Although notices do not have the force and effect of statutes or regulations, when they give specific direction or guidance (as opposed to being only announcements), notices are considered tax authority.[31] Given the lack of other guidance on cryptocurrencies and the specific direction and guidance in the notice, it is informative of the IRS's views. Notice 2014-21 provides its guidance in the form of answers to several frequently asked questions. Although many commentators concur with the conclusions in the notice, some have raised concerns that tax compliance with its positions, particularly for small transactions, is burdensome.[32]

### B. Bitcoin: Currency or Property?

As is often discussed, U.S. income taxation of financial instruments is generally based on a schema premised on a particular financial instrument's tax classification. The applicable tax rules are generally determined by that tax classification. Subpart J (of Part III of subchapter N of the code) provides a set of tax rules that applies to transactions concerning currencies.[33] Notably, those rules do not include an explicit definition of currency. Thus, a threshold issue is whether cryptocurrencies are considered currencies or property for U.S. income tax purposes.

That issue was addressed by Notice 2014-21. The notice begins by defining a virtual currency as "a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value," and further defines a convertible virtual currency as a subset of virtual currencies "that has an equivalent value in real

[28] Yuji Nakamura, Camila Russo, and Rob Urban, "Bitcoin Futures Deliver Wild Ride as Debut Brings Rally, Halts," Bloomberg, Dec. 10, 2017.

[29] *See* CBOE XBT Bitcoin Futures, and CME Group Bitcoin Futures Key Information Document.

[30] The investment trust, formed in 2013, functions like a commodities investment trust. Each share represents approximately 0.09181239 bitcoin, as of January 3, 2018. Although a registration statement for the Bitcoin Investment Trust was filed with the SEC on May 4, 2017, it was withdrawn on October 25, 2017. Bitcoin Investment Trust, "Registration Statement" (Form S-1) (May 4, 2017).

[31] *See, e.g.*, reg. section 1.6662-3(b)(iii) (providing that for purposes of the penalty for underpayments attributable to negligence or disregard of rules or regulations, rules and regulations include code provisions, temporary or final Treasury regulations issued under the code, and revenue rulings or notices (other than notices of proposed rulemaking)). Reg. section 1.6662-3(b)(2). *See also* reg. section 1.6662-4(d)(3)(iii) (identifying notices as an authority concerning the substantial authority defense to the imposition of understatement penalties).

[32] William Hoffman, "After March IRS Notice, Bitcoin Users Await More Tax Guidance," *Tax Notes*, Sept. 8, 2014, p. 1128 (reporting that David Golden, director of the capital markets tax practice at EY, said "The IRS could provide a de minimis rule for taxpayers' administrative convenience for when bitcoin is used in a personal transaction as a medium of exchange."). *See also* Eric Kroh, "More Guidance Sought on Bitcoin and Other Virtual Currencies," *Tax Notes*, Apr. 7, 2014, p. 32.

[33] Sections 985 through 988. Note these provisions only apply to non-functional currencies. In general, this report does not discuss cross-border or other international tax issues, including those related to sourcing or withholding.

currency, or that acts as a substitute for real currency."[34] The notice provides that bitcoin is a convertible virtual currency, and it cross-references guidance issued by the Financial Crimes Enforcement Network for a comprehensive description of convertible virtual currencies.[35] The notice limits its scope of application to convertible virtual currencies and states that it does not provide guidance outside that scope. Accordingly, its guidance presumably does not apply to Ethereum or other token-based blockchain systems like smart contracts.[36]

Notice 2014-21 provides that virtual currency is treated as property for federal income tax purposes, not as currency that would be subject to rules applicable to currency transactions under subpart J.[37] The release of the notice and its conclusion regarding the treatment of virtual currencies like bitcoin was generally greeted with agreement and relief by tax practitioners and commentators.[38] However, some noted that property treatment would likely reduce the use of virtual currencies for payment because of the potential to recognize gain or loss on each disposition.[39] Some concerns have been raised regarding whether virtual currencies could still be considered currencies if facts become different than those posited in the notice, like the effect of participation by a central bank. For example, Venezuela is reportedly close to founding a cryptocurrency backed by its oil.[40] A report by the American Bar Association Section of Taxation on the notice raises the question whether a virtual currency is a currency subject to subpart J under similar circumstances.[41]

Despite the guidance of Notice 2014-21, important questions remain. The notice does not address the kind of property that virtual property should be regarded as for tax purposes.[42] For example, could it be considered a commodity or a security? The Commodity Futures Trading Commission has already ruled bitcoin a commodity for purposes of futures trading.[43] Could bitcoin therefore be considered a commodity for tax purposes?[44] Alternatively, could a virtual currency be classified as stock for federal income tax purposes?[45] A further complication is that the same terms can have different definitions under different tax provisions.[46] The lack of additional clarity is a major concern in trying to understand the potential tax consequences of virtual currencies in several contexts, as discussed later.

[34] Notice 2014-21 at 938.

[35] *Id*. FinCEN, "Guidance on the Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies," FIN-2013-G001 (Mar. 18, 2013).

[36] Presuming that there is a clear, understandable delineation between cryptocurrencies and other token-based systems. However, at least one commentator argues that the delineation is less than clear. *See* American Institute of CPAs, "Comments on Notice 2014-21: Virtual Currency Guidance" (June 10, 2016).

[37] Notice 2014-21, Q&A-1 and Q&A-2.

[38] Hoffman, *supra* note 32. William R. Davis, "Bitcoin Guidance Not Designed to Answer All Questions," *Tax Notes*, Mar. 30, 2015, p. 1603.

[39] Kroh, *supra* note 32 ("Victor Fleischer of the University of San Diego School of Law said the IRS guidance results in the correct tax treatment of virtual currencies but doesn't leave much room or accommodation to allow virtual coins to be functional currencies.").

[40] *See* "Venezuela Oil-Backed Cryptocurrency to Launch in Days, Government Says," CNBC (Dec. 29, 2017). Similarly, Israel is considering offering a national cryptocurrency. *See* Jon Buck, "Israel Government Considering National Cryptocurrency," Cointelegraph, Dec. 24, 2017.

[41] ABA tax section, "Comments on Notice 2014-21," at 3 (Mar. 24, 2015) (asking whether a virtual currency might be considered foreign currency subject to subpart J if adopted as legal tender by a foreign country. Note that this concern is far from purely speculative; Japan recognizes the bitcoin as legal tender). *See* Emiko Terazono, "Bitcoin Gets Official Blessing in Japan," *Financial Times*, Oct. 17, 2017.

[42] Hoffman, *supra* note 32 (quoting Golden as saying that the IRS "has not offered guidance on what type of property bitcoin is, which might determine how it can be taxed").

[43] *See In re Coinflip Inc., d/b/a Derivabit, and Francisco Riordan*, CFTC Dkt. No. 15-29, Comm. Fut. L. Rep. (CCH) para. 33,538 (CFTC Sept. 17, 2015) (consent order); and *In re TeraExchange LLC*, CFTC Dkt. No. 15-33 Comm. Fut. L. Rep. (CCH) para. 33,546 (CFTC Sept. 24, 2015) (consent order).

[44] At least one commentator believes the classification of bitcoin as a commodity for tax purposes is likely. *See* Calvin, *supra* note 24, at 367 n.45.

[45] A recent article raises this possibility, turning largely on the difficult interpretive question of whether holders of cryptocurrencies are jointly participating in business profits. Shakow, *supra* note 26. Analysis of this question would examine whether participants in a cryptocurrency system could be considered a cohesive group and whether the token or coin generated could be considered a share in an enterprise, like a share of stock, certificate of participation, or other unit of representation that could be a stock or security under tax or securities law. Could the group be an association taxable as a corporation? Under section 7701 and its regulations, as well as the earlier case law, it appears difficult to combine cryptocurrency creators, miners, and/or holders as a partnership, de facto corporation, or any type of enterprise of persons contributing capital or acting together. *See* reg. section 301.7701-2(b)(2) (defining the term "corporation" to include an association as determined under reg. section 301.7701-3); *Commissioner v. Tower*, 327 U.S. 280 (1946); and *Commissioner v. Culbertson*, 337 U.S. 733 (1949).

[46] For example, securities can include stock or can be limited to specific debt instruments, depending on the particular application in the code.

### C. Miners, Dealers, and More

The tax treatment of property can radically differ depending on a person's relationship to the property — that is, the purpose for which the taxpayer holds the property. For example, special tax rules and tax treatment typically apply to manufacturers and dealers. Those rules are usually very different from the tax rules and tax treatment that typically apply to persons that merely acquire and hold that created, manufactured, or sold property. As discussed above, there are miners of bitcoin and other cryptocurrencies. There are also dealers and issuers of related derivatives. Some merchants that do not mine may simply acquire or exchange cryptocurrencies in connection with their trades or businesses. Purchasers of cryptocurrencies and related derivatives may be dealers, traders, or investors from a tax perspective. And some holdings could be personal. The character and timing of income and the deductibility and timing of expenses related to cryptocurrencies may differ substantially depending on those relationships.[47] For example, one commentator noted that gains from cryptocurrencies held as personal property would generally be taxable, whereas losses would not.[48]

This report generally focuses on basic tax issues concerning investors and does not comprehensively address the potential tax consequences of miners' activities. It does, however, discuss the pronouncements of Notice 2014-21 regarding miners of cryptocurrencies.

### D. Taxation of Mining and Payment

Notice 2014-21 provides that convertible virtual currencies (cryptocurrencies) received as payment for goods and services must be included in gross income for tax purposes based on the fair market value of those cryptocurrencies as of the date received.[49] The notice specifies that a taxpayer who mines virtual currency must include the FMV of the virtual currency received in gross income as of the date of receipt.[50] If the mining activity is carried on as a trade or business and the miner is not conducting those activities as an employee, the earnings from the mining activity (net of allowable business expense deductions) constitute self-employment income and would be subject to self-employment tax.[51] The notice further clarifies that an independent contractor who mines virtual currency has self-employment income.[52] Similarly, if a miner conducts mining activities and receives virtual currency as an employee, the value of the cryptocurrencies received are considered wages subject to federal income tax withholding by employers, according to the notice.[53] It further provides that FICA and FUTA taxes also apply and must be reported in connection with the receipt of virtual currency.[54]

### E. Forms 1099 and Backup Withholding

In general, when a business pays $600 or more to an independent contractor for the performance of services, the payer must timely file a Form 1099-MISC with the IRS and provide a copy to the payee (a reportable payment).[55] Each payee must generally give the payer their tax ID and related information on Form W-9. If a tax ID is requested and the payee does not timely and properly provide it to the payer, the payer must withhold tax from the related payment (backup

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[47] Other relationships will continue to present themselves as blockchain technology's effects resonate through the financial sector. Some banks and credit card companies intend to use Ripple's blockchain-based method of clearing cross-border payments. *See* Martin Arnold, "Ripple Cryptocurrency Surges as Japanese Groups Agree to Use It," *Financial Times*, Dec. 29, 2017; and Ryan Brown, "American Express, Santander Team Up With Ripple for Cross-Border Payments Via Blockchain," CNBC (Nov. 16, 2017). Ripple also has an eponymous cryptocurrency. Note that income-sourcing concerns are beyond the scope of this report.

[48] David Stewart, "IRS Preps Bitcoin Investigators as Treatment Questions Remain," *Tax Notes*, Sept. 29, 2014, p. 1538 ("Steven M. Rosenthal of the Urban Institute said that given Treasury and the IRS's position, a person who uses bitcoin exclusively for consumption will be required to recognize gains, but would be denied deductions for any losses because the transaction was not entered into for profit as required by section 165(c)(2).").

[49] Notice 2014-21, at 938, Q&A-1.

[50] *Id*. at 939, Q&A-8.

[51] *Id*. at 939, Q&A-9.

[52] *Id*. at 939, Q&A-10.

[53] This is not limited to mining services performed by an employee; virtual currency paid by an employer as remuneration for any services generally constitutes wages. *Id*. at 939, Q&A-11.

[54] *Id*.

[55] *Id*. at 939, Q&A-13.

withholding).[56] Notice 2014-21 provides that payments made in connection with a trade or business in bitcoin or other virtual currencies are subject to backup withholding under those circumstances, just like other payments made in property.[57]

Credit card intermediaries are also subject to specific information reporting requirements under the tax law. They must generally report payments made to merchants on Form 1099-K if, for a calendar year, more than 200 transactions are settled for the merchant and gross payments made to the merchant exceed $20,000. The notice provides that payments made in bitcoin or other virtual currencies can be reportable on Form 1099-K.[58]

A miner may be considered as receiving virtual currencies in connection with the performance of services. However, investors and traders in virtual currencies may simply receive them in exchange for property or cash, and not in connection with services. Notably, Notice 2014-21 does not address the information reporting consequences of virtual currency transactions in exchange for property or cash that are not reportable on Form 1099-MISC or Form 1099-K.[59]

### F. Each Bitcoin Has a Unique Basis

Notice 2014-21 provides that the cost basis of a unit of cryptocurrency received as a payment for goods or services is equal to the FMV of that unit in U.S. dollars on the date received.[60] The ABA tax section, in comments on the notice, requested that the meaning of the term "received" be clarified.[61] The group also asked whether bitcoin is deemed received on the date earned (presumably the date the benefits and burdens of ownership of the cryptocurrency unit are considered transferred for tax purposes under tax common law concepts of property ownership), or whether it is received when record ownership is transferred.

### G. Uncertainty for Miners and Merchants

The ABA tax section has raised concerns about the reporting of fees for facilitating virtual currency transactions.[62] Both the ABA tax section and the American Institute of CPAs have recommended a de minimis rule for reporting virtual currency gains and losses (similar to the rule that applies to currency transactions under section 988(e)), even though legislation may be needed to authorize that treatment.[63] The ABA tax section has also requested guidance on the documentation that will be expected to establish cost, holding periods, and measures of value, particularly for exchanges that do not use the U.S. dollar for virtual currency valuations.[64] The AICPA has requested guidance on charitable contributions of virtual currency.[65]

The ABA tax section also asked for guidance on the tax treatment of mining costs and the timing and manner of related deductions, as well as guidance on the tax consequences of pooled mining activities.[66] For example, are the pools considered partnerships for tax purposes? Can a section 761 election be made? What would be the timing and character of pooled activity income? The tax treatment of pooled mining is of critical importance because many miners work collectively on a pooled basis due to the technology and power required to mine.

Even more fundamentally, the ABA tax section requested additional guidance on the tax consequences and nature of each of the steps constituting mining activities (as services or as mere investment). Could specific mining activities result in "prize income, earned income, or even in some instances capital assets"?[67]

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[56] *Id*. at 939, Q&A-14.

[57] *Id*.

[58] *Id*. at 939, Q&A-15.

[59] *Id*. at 939, Q&A-13 and Q&A-15. *But see* the discussion below of cost basis reporting regarding whether the definition of a commodity under reg. section 1.6045-1(a)(5) potentially triggers Form 1099-B reporting and related backup withholding obligations under sections 3406 and 6045.

[60] Notice 2014-21 at 941, Q&A-15.

[61] ABA tax section, *supra* note 41, at 4 ("When is virtual currency received?").

[62] *Id.* at 3 (If "third-party exchanges charged transaction fees for facilitating transactions, how would a merchant conducting business report such fees?").

[63] *Id.* at 4; and AICPA, *supra* note 36, at 4.

[64] ABA tax section, *supra* note 41, at 4. The AICPA has also raised concerns about how to measure the value of cryptocurrency, since different exchanges often report different values concurrently. AICPA, *supra* note 36, at 2.

[65] AICPA, *supra* note 36, at 4.

[66] ABA tax section, *supra* note 41, at 5.

[67] *Id.*

## H. Taxation of Receipt and Disposition

Notice 2014-21 provides taxpayers can recognize taxable gain if they exchange virtual currency for property or cash. The amount of gain is the amount by which the FMV of property or the amount of cash received exceeds the taxpayer's adjusted basis of the virtual currency exchanged.[68] If the basis of the virtual currency disposed of exceeds the FMV of property or the amount of cash received, the taxpayer has a loss.[69] The notice provides that the deductibility of the loss depends on other factors, and it cross-references IRS Publication 544, "Sales and Other Dispositions of Assets."[70] In general, losses from the exchange or disposition of assets held for personal purposes are not deductible.[71]

The ABA tax section comment letter[72] requests guidance on how the FMV of property received is determined when one virtual currency is exchanged for another, and the AICPA comment letter[73] raises concerns about differing quoted values by different market makers. Questions also remain about nonrecognition or deferral of gain or loss under several other provisions.[74] And as discussed above, commentators have requested a de minimis rule to permit taxpayers to better manage the burden of calculating gain or loss for small transactions.[75]

68 Notice 2014-21 at 938, Q&A-6.

69 *Id.*

70 *Id.*

71 Hoffman, *supra* note 32 (quoting Rosenthal as saying, "That means that personal bitcoin gains can be taxed, but personal losses cannot be recognized or deducted.").

72 ABA tax section, *supra* note 41, at 5.

73 AICPA, *supra* note 36, at 2.

74 For example, the ABA tax section specifically requested guidance regarding like-kind exchanges under section 1031. ABA tax section, *supra* note 41, at 5. We note that although section 13303(a) of the Tax Cuts and Jobs Act (P.L. 115-97) limits like-kind exchanges under section 1031 to exchanges of real property, questions may remain for transfers before its effective date. Further, sections 1091 and 1092 might apply to defer losses on the sale or exchange of financial instruments, and questions remain concerning whether installment sales provisions might apply to defer the timing of recognition of gain. AICPA, *supra* note 36, at 3.

75 ABA tax section, *supra* note 41, at 4; and AICPA, *supra* note 36, at 4.

## I. Character of Gain or Loss Recognized

Notice 2014-21 provides that the character of gain or loss on the disposition or exchange of virtual currency depends on the nature of the holdings in the hands of the taxpayer.[76] As discussed above, a miner, dealer, or issuer might hold bitcoins or other virtual currencies as inventory for sale in that person's trade or business. Alternatively, bitcoin or other virtual currencies could be held by a trader or investor. And some holdings could be personal. The tax consequences and character of gain or loss could be very different depending on the nature of a person's holdings. The notice cross-references Publication 544 for additional information.[77]

For investors, the notice indicates that gain or loss on the sale or exchange of virtual currencies will likely be capital gain or loss. Capital gains and losses are segmented depending on whether they are long term (for assets held for at least one year) or short term (held for less than a year) based on a disposed asset's holding period at the time of sale, exchange, or other taxable disposition. Long-term capital gains can be eligible for favorable tax treatment and lower tax rates than other types of income.[78] Capital losses are typically limited under the tax law so that only $3,000 per year can be recognized, and any losses exceeding $3,000 for individuals (and zero for corporations) are carried forward under special carryforward rules and limitations.[79] Generally, an asset's holding period begins on the day after it is acquired and ends on the date of sale or disposition.[80]

If significant losses in market value occur, holders of virtual currencies may argue that they are not investors but rather traders who can elect

76 Notice 2014-21 at 938, Q&A-7.

77 *Id.*

78 Section 1(h).

79 Section 1211.

80 Section 1223.

mark-to-market tax treatment of those holdings under section 475.[81] Eligibility for mark-to-market treatment depends on virtual cryptocurrencies constituting either a commodity or a security under section 475.[82] This would permit ordinary (rather than capital) losses without a $3,000-per-year limitation but would also result in recognition of mark-to-market ordinary income (rather than capital gains) on any appreciation in holdings occurring during each applicable tax year (rather than the recognition of gain or loss strictly at the later time of disposition).[83]

There is substantial litigation between the IRS and taxpayers regarding the availability and timing of eligibility for the mark-to-market election, so careful planning is critical if the election is contemplated.[84] Commentators and the ABA tax section have noted that merchants could be harmed if cryptocurrency gains and losses are treated as capital while their other business activities are not, resulting in a risk of capital losses that cannot offset ordinary income.[85]

### J. Adjusted Basis Upon Sale or Exchange

Notice 2014-21 provides that the amount of income or loss realized in connection with the sale, exchange, or disposition of virtual currencies is based on the difference between the FMV of the property (and, implicitly, the amount of cash) received on that transaction and the adjusted basis of the virtual currency exchanged.[86]

Two important issues are apparent. First, the adjusted basis at the time of the sale of the virtual currency must be determined. Second, if more than one tax lot of virtual currency was acquired by the taxpayer, it must be determined which specific lot was considered sold.

Section 1012 generally provides that a taxpayer's basis in property is its cost. Section 1016 sets forth rules regarding adjustments to cost. Commissions on the acquisition of property are an example of costs that brokers must add to basis when reporting.[87] Section 1016 includes other adjustments that can apply depending on the classification of property as stock. For example, stock splits, reverse splits, stock dividends, and corporate reorganizations can each have significant consequences on the cost basis of related stocks exchanged or received. In determining the basis at time of sale, one must always consider whether basis allocations or similar adjustments could apply to virtual currencies.

Similarly, the application of special rules that apply to stocks and securities (including contracts or options to acquire stocks or securities) can also have significant consequences on cost basis.[88] The wash sale rules, which can substantially affect basis and holding period calculations of tax lots, may not apply to direct holdings in virtual currencies and would not apply to section 1256 contracts such as CME and CBOE bitcoin futures. However, they could apply to other virtual

[81]Section 475(f) permits traders in securities or commodities to make the election. Section 475 does not apply to securities held for investment. *See* section 475(b)(1). That restriction also applies to commodities held for investment. *See* section 475(e)(1). *See* Allyson Versprille, "Should Bitcoin Investors Become 'Traders' for Tax Purposes?" *DTR*, Jan. 18, 2018. Attorneys cited in the article have noted that although the new tax law causes the loss of itemized deductions for investment-related expenses — including specialized computer equipment and website subscriptions — for traders under section 475, those expenses would be fully deductible. Other concerns include some important downsides to trader status: the loss of long-term capital gains, and self-employment tax on net gains. The article notes opposing views on whether cryptocurrency could be a security under section 475, but it does not address possible classification as a commodity.

[82]*See* section 475(e)(2) regarding the definition of a commodity and section 475(c)(1) regarding the definition of security for purposes of this election.

[83]Section 475(b)(3).

[84]*See, e.g., Poppe v. Commissioner*, T.C. Memo. 2015-205; and *Spicko v. Commissioner*, T.C. Memo. 2016-41 (taxpayers failed to make valid section 475 mark-to-market elections).

[85]Davis, "Bitcoin Is Property, Not Currency, IRS Says," *Tax Notes*, Mar. 31, 2014, p. 1399 ("David S. Miller of Cadwalader, Wickersham & Taft LLP provided a hypothetical situation in which a merchant accepts $100 worth of virtual currency for merchandise and then sells the currency for $90. In that scenario, the merchant would net only $90, but unless it had capital gains from other sources to offset the capital loss, the merchant would be taxed on $100.").

[86]Notice 2014-21 at 938, Q&A-6.

[87]Reg. section 1.6045-1(d)(6)(i). Similarly, brokers must subtract commissions or transfer taxes for sales of securities when reporting. Reg. section 1.6045-1(d)(5).

[88]Reg. section 1.6045-1(d)(6)(iii).

currency derivatives. The straddle rules could apply to virtual currencies and virtual currency derivatives.[89] These issues are discussed in more detail below.

In general, under section 1012, the basis of each item of property is separately tracked and must be used to compute gain or loss upon the disposal of property.[90] This method for determining the basis upon disposition is generally referred to as specific identification. Because ownership of cryptocurrencies is established through private keys, at first blush each specific purchase can be readily identified. However, tracking could be more challenging or artificial if an investor holds positions in cryptocurrencies through a third-party wallet or other intermediary. Under some circumstances, it might be difficult to demonstrate which specific cryptocurrency tax lot was sold.

To the extent basis allocations arise in connection with cryptocurrencies, or the straddle rules apply, related basis (and holding period) adjustments (or loss deferrals[91]) may apply or relate to only a portion of a tax lot, thereby creating two separate tax lots (one position that was subject to the adjustments, and one that was not). We often refer to these resulting tax lots as "sublots." For stocks and securities, it can be challenging as an operations matter to specifically track these sublots. Similar challenges could arise in identifying sublots in connection with cryptocurrencies or cryptocurrency derivatives.

The cost basis regulations also provide specific guidance on determining the basis when stock is sold.[92] Under those specific rules, the basis of stock sold is generally determined on a first-in, first-out method. Specific ID is available on the disposition of stock only if the taxpayer can adequately identify (in a manner specified in the regulations) which particular lots were sold.[93] An average cost method (averaging) is also available under the regulations for stock if various requirements are met.[94] Related rules also permit the use of those three methods for bonds and book-entry securities.[95]

The regulations' special rules for stocks, bonds, and book-entry securities make sense because individual certificates or book-entry records of the same stocks or securities are generally treated as fungible. Because these methods are used to manage the tracking of gains and losses from individual lots or blocks of stocks or securities acquired and held, they are generally referred to as lot relief methods. The use of FIFO, specific ID, or averaging lot relief methods provides efficiencies to both investors and intermediaries in managing the tracking of positions in stocks or securities and computing deemed gain or loss on dispositions. Specific guidance in the regulations also benefits the fisc by providing clear rules to reduce gamesmanship and inconsistent reporting.

Does it make sense that the three different lot relief methods also potentially apply to measure gains and losses on dispositions of virtual currencies? Should the availability of those methods be determined based strictly on whether virtual currencies are or should be considered stocks or securities rather than commodities (or

[89] As a technical matter, the straddle rules do not provide for basis adjustments related to deferred losses similar to the wash sale rules. Instead, the applicable temporary regulations provide that disallowed losses related to dispositions of positions comprised in a straddle are deferred and are not allowed unless the positions that resulted in the deferral are disposed of during the tax year (and the straddle rules do not trigger further disallowance). Reg. section 1.1092-1T(b). Separately tracking those loss deferrals for allowance later, in lieu of mechanically adjusting the basis of related positions, could create additional accounting and operations challenges. There may be little practical difference between basis adjustments to deferral-triggering tax lots under the wash sale rule and separately tracking and maintaining a pending deferral ledger.

[90] Reg. section 1.1012-1(a).

[91] Rather than explicit basis adjustments for straddles.

[92] Reg. section 1.1012-1(c).

[93] Reg. section 1.1012-1(c)(1)-(3). Under these regulations, adequate confirmation is made if at "the time of the sale or transfer, the taxpayer specifies to such broker or other agent having custody of the stock the particular stock to be sold or transferred, and . . . [w]ithin a reasonable time thereafter, confirmation of such specification is set forth in a written document from such broker or other agent." Concerns have been raised regarding the ability to satisfy these requirements in the context of cryptocurrencies. *See* Calvin, *supra* note 24, at 369.

[94] Reg. section 1.1012-1(e) (election to use average basis method).

[95] Reg. section 1.1012-1(c)(6) and (7).

something else) for purposes of the regulations? The ABA tax section comment letter requests guidance.[96] That guidance would be beneficial to investors, intermediaries, and the fisc for the same reasons that such rules have been useful in connection with stock, bonds, and book-entry securities.

Because of the growing investment in and expanded availability of cryptocurrency and related derivatives, it is important to determine whether virtual currency will simply be considered one more type of investment asset in a person's portfolio. There has been much discussion about investment in virtual currency,[97] and for many years there has been a focus on the differing tax treatment for different forms and types of investments. Should investments in virtual currency be treated substantially differently from investments in stocks or securities for tax purposes? For example, the Senate amendment to the Tax Cuts and Jobs Act (P.L. 115-97) included a provision that would have prevented taxpayers from using the specific ID method for sales of "specified securities" (stocks, debt, and some options and securities futures contracts).[98] Although that provision was not included in the enacted bill, it could have led to a notable divergence in the comparative tax treatment of dispositions of virtual currency (specific ID) and stocks and securities (mandatory FIFO or averaging under some circumstances).[99]

Given the notice's lack of specific guidance on the determination of basis, it might be prudent to assume that the specific ID method applies in measuring gains or losses on all dispositions. Under that assumption, it is critical for an investor to track and identify specific lots or positions in bitcoins or other cryptocurrencies to manage gains and losses recognized from their disposition. That makes the management of private key records and the association with acquisition cost and date data significant. Unfortunately, the assumption also does not address practical or tax-driven complications in determining which specific lots are sold.

## K. Cost Basis Reporting

The cost basis reporting law was enacted in 2008 to raise tax revenue as a partial offset to the anticipated cost of bailing out banks and other institutions in the wake of the global financial crisis.[100] It requires "brokers" (as the term is broadly defined under applicable law) to annually report the adjusted cost basis of covered securities sold for cash during the calendar year in connection with the reporting of the proceeds received. That information is reported to the IRS on Form 1099-B, and investors receive copies of the form.[101] The definition of covered securities is based in part on the related defined term "specified securities," which includes stock, debt, and options and securities futures contracts on stock or debt.[102]

The purpose of cost basis reporting was to increase the accuracy of tax reporting of gains and losses in connection with sales of stocks, bonds, and such options.[103] There were concerns that calculation complexities created risks of

[96] ABA tax section, *supra* note 41, at 4. At least two writers have taken the position that, analogous to stock, FIFO should apply when adequate identification has not been made. *See* Calvin, *supra* note 24, at 369; and Andrea S. Kramer, *Financial Products: Taxation, Regulation and Design*, at section 61A.02 ("Taxpayers with convertible virtual currency should be able to rely on the identification conventions used with respect to securities and commodities. They should be able to specify which positions they intend to close out" [citations omitted].). Kramer and Calvin cite *Perlin v. Commissioner*, 86 T.C. 388 (1986). Section 1012 and regulations on averaging for regulated investment company and dividend reinvestment plan stock, specific identification, or FIFO when specific identification is not available, apply to stocks and bonds. Reg. section 1.6045-1(d)(2)(ii), governing broker reporting of sales of specified securities, provides lot relief rules. Application of those rules by analogy to cryptocurrencies could necessitate complicated and time-consuming IRS rulemaking in coordination with SEC, CFTC, and other agency rulemaking.

[97] Lee A. Sheppard, "Is Bitcoin Going Out of Style?" *Tax Notes*, Sept. 11, 2017, p. 1329.

[98] Section 13533 of engrossed Senate amendment to H.R. 1 (Dec. 2, 2017).

[99] As discussed later in connection with cost basis reporting, this turns on whether bitcoin or other cryptocurrencies are "specified securities" as defined in section 6045.

[100] Section 403 of the Emergency Economic Stabilization Act of 2008, P.L. 110-343.

[101] Reg. section 1.6045-1(d).

[102] Section 6045(g)(3)(A) and (B). Reg. section 1.6045-1(a)(14) and (15).

[103] *See* 152 *Cong. Rec.* S2196 (Mar. 15, 2006) (remarks of Sen. Bayh on the Simplification Through Additional Reporting Tax Act, S. 601, 110th Cong. (2007), and the Simplification Through Additional Reporting Tax Act, H.R. 878, 110th Cong. (2007)).

inaccuracies in tax reporting by investors and that the lack of third-party reporting of that information (by brokers) made it easier for investors to avoid tax.[104]

Cost basis reporting was added to the long-standing information reporting rules for gross proceeds by brokers.[105] Those rules generally require brokers to report the amounts of sales transactions on Form 1099-B to the IRS (and give copies to the related taxpayers). They often apply to transactions involving sales of specific types of intangible personal property: stocks, securities, and similar types of financial investment interests.

Section 6045(a) grants the IRS regulatory power to implement the broad Form 1099-B reporting obligation imposed on brokers for gross proceeds. Reg. section 1.6045-1 provides key definitions that detail who is a broker and what triggers cost basis reporting.[106] Sales of securities, commodities, options, regulated futures contracts, securities futures contracts or forward contracts (including stock redemptions and retirements of debt instruments), and short sales for cash are generally reportable by brokers.[107] If virtual currencies are not considered to be among those types of assets, Form 1099-B reporting does not apply.

However, the question remains: Should virtual currency transactions that are not for services or reportable on Form 1099-K be subject to information reporting? Should cost basis reporting apply?

Under the Form 1099-B reporting regulations, the term "commodity" has a specific definition: "Any type of personal property or an interest therein (other than securities as defined in paragraph (a)(3)), the trading of regulated futures contracts in which has been approved by the Commodity Futures Trading Commission."[108]

The CFTC approved the trading of regulated futures contracts on bitcoin in connection with the introduction of bitcoin futures contracts by the CME and CBOE.[109] That action would appear to cause the related bitcoin to fall within the definition of a commodity for purposes of Form 1099-B reporting. Consequently, bitcoin sales for cash might be reportable by brokers on Form 1099-B, presumably on or after the date of the CFTC approval.[110] Brokers could also be liable for backup withholding for Form 1099-B reporting.[111] Of course, a critical related issue is whether particular intermediaries fall within the definition of a broker in the Form 1099-B reporting regulations.

Note that bitcoin or another cryptocurrency, if characterized as a commodity rather than as a stock, debt instrument, option, or securities futures contract, would not be a specified security and therefore would not be subject to cost basis reporting unless the IRS designates it as such.[112] Still, cryptocurrency derivatives sales for cash by brokers should in many cases be reported on Form 1099-B because of the broad definition of sale under the regulations.

### L. FBAR, FATCA, and Cash Reporting

Persons with a financial interest or signing authority over various types of foreign financial accounts that exceed specified thresholds must annually file a foreign bank and financial account report to Treasury.[113] In their comment letters, the ABA tax section and the AICPA request guidance

[104] Stevie Conlon, "Re: Proposed Regulations for Cost Basis Reporting for Debt and Options," Wolters Kluwer, at n.2 (Feb. 23, 2012) (citing Government Accountability Office, "Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed," GAO-06-603 (June 13, 2006)).

[105] Gross proceeds reporting was originally added to the code in 1954. Cost basis reporting under section 6045B was added to the code in section 403 of the Energy Improvement and Extension Act of 2008, P.L. 110-343 (Oct. 3, 2008).

[106] Reg. section 1.6045-1(a).

[107] Reg. section 1.6045-1(a)(9).

[108] Reg. section 1.6045-1(a)(5)(i).

[109] Commodity Futures Law Reporter, "CFTC Backgrounder on Self-Certified Contracts for Bitcoin Products," at 158, section 34. We leave it to others to debate whether this constitutes "approved."

[110] This is because the regulations generally require reporting by brokers of sales for cash. *See* the definition of sale at reg. section 1.6045-1(a)(9) and of broker at reg. section 1.6045-1(a)(1).

[111] *See generally* section 3406.

[112] *See* the definition of specified security in section 6045(g)(3)(B) and reg. section 1.6045-1(a)(14).

[113] 31 CFR section 1010.350. The FBAR is filed on FinCEN Form 114. Because of a change in law, FBAR reporting is now due annually on April 15. The IRS hosts instructions for the form.

on whether virtual currency accounts could be subject to that reporting.[114] Some commentators have recommended reporting those accounts on the foreign bank account report because there is no penalty for overreporting.[115]

The Foreign Account Tax Compliance Act[116] imposes substantial compliance burdens on financial intermediaries, including withholding tax obligations and liabilities.[117] FATCA also requires individual taxpayers to report financial assets held outside the United States that exceed a specified threshold on Form 8938, which is attached to the individual's tax return.[118] The ABA tax section and AICPA comment letters request guidance on whether virtual currency holdings are reportable for FATCA purposes. Guidance has also been requested on whether virtual currency intermediaries are subject to FATCA compliance and withholding obligations.[119]

Federal law also requires taxpayers to report cash payments exceeding $10,000 received in a trade or business on Form 8300.[120] Cash is defined to include U.S. currency, currency of any other country, cashier's checks, money orders, and similar instruments.[121] Consistent with the conclusion of Notice 2014-21 that virtual currencies are not currency, an IRS attorney has said that he did not believe Form 8300 reporting applied to virtual currency.[122]

[114] *See* AICPA, *supra* note 36, at 5; and ABA tax section, *supra* note 41, at 5.

[115] Andrew Velarde, "Open Questions About Bitcoin Examined by Official, Practitioners," *Tax Notes*, May 22, 2017, p. 1095.

[116] Sections 1471 through 1474 of the code, enacted by section 501 of the Hiring Incentives to Restore Employment Act of 2010 Hiring Incentives to Restore Employment Act of 2010, P.L. 111-147 (Mar. 18, 2010).

[117] Section 1471; reg. section 1.1471-2.

[118] Conlon and Marietta Probst, "New IRS FATCA Reporting Requirements for Holders of Foreign Stock" Wolters Kluwer (Feb. 15, 2013).

[119] ABA tax section, *supra* note 41, at 5; and AICPA, *supra* note 36, at 5.

[120] Section 6050I(a) and (g), and related regulations.

[121] Section 6060I(d); reg. section 1.6050I-1(c)(1).

[122] Davis, *supra* note 38 (reporting that Andrew Keyso Jr., IRS associate chief counsel (income tax and accounting) "said he believes that virtual currencies don't fit the definition of currency for purposes of the regime, and that receipt of virtual currencies in a trade or business therefore isn't subject to Form 8300 reporting").

### M. IRS Subpoena of Bitcoin-Related Transactions

The popularity of bitcoin and other cryptocurrencies continues to grow, but there has apparently been little taxpayer reporting of virtual currency transactions. An IRS attorney noted that only 800 taxpayers reported bitcoin transactions on Schedule D of their tax returns in 2015.[123] And although many may believe virtual currency transactions can be hidden from the IRS, an IRS Criminal Investigation division director cautioned that the activity "is not really anonymous, and we actually have suspicious activity reports being filed on these and we are able to trace them back to the inception of the bitcoin — every place it has ever touched."[124]

The recent decision in *Coinbase* further calls into question the public perception of anonymity in the virtual currency market, particularly for cryptocurrencies held with large digital currency exchanges.[125] The case involves a November 2016 John Doe summons served by the Justice Department on bitcoin exchange Coinbase, seeking its customer and transaction records. Coinbase did not comply, and the IRS filed a petition in district court to enforce the summons. After oral argument, the IRS narrowed the scope of the summons. On November 28, 2017, the court partially granted the petition to enforce the further narrowed summons on the basis that it "serves the IRS's legitimate purpose of investigating Coinbase account holders who may not have paid federal taxes on their virtual currency profits."

The narrowed summons requires Coinbase to provide information for accounts with at least $20,000 in any one transaction type — buy, sell, send, or receive — in any one year from 2013 to 2015. It would not apply to accounts that bought and held bitcoin only during that period or for which Coinbase filed Form 1099-K. The required information includes account name, address, tax ID, date of birth, records of account activity

[123] Velarde, *supra* note 115 (reporting that Donna Welsh, branch 4 senior technician reviewer, IRS Office of Associate Chief Counsel (Income Tax and Accounting) "said that only 800 taxpayers had reported bitcoin transactions to the IRS . . . before the Justice Department sought a John Doe summons").

[124] Stewart, *supra* note 48.

[125] *Coinbase*, No. 17-cv-01431.

(including transaction logs or other records), and all periodic account statements or invoices.[126]

Because the court further narrowed an already narrowed summons, Coinbase considered the decision a partial victory because it reduced the number of affected customers by 97 percent — to "only" about 14,000 customers.[127] However, it has also been noted that the enforcement decision means the IRS can issue summonses to other virtual currency exchanges.[128] It also means that miners, investors, and others who use or exchange virtual currencies should be mindful that the IRS can obtain information that could be used to enforce compliance of tax reporting and tax payments concerning virtual currency. One commentator has raised the concern that the Coinbase subpoena could lead to changes in law that would impose more reporting requirements on virtual currencies in the same way that noncompliance in the reporting of foreign investments led to FBAR and FATCA reporting.[129]

### N. Applicability of Tax Penalties

Notice 2014-21 warns that taxpayers may be subject to penalties for failing to comply with tax laws. What may be troubling for some is that it provides no safe harbor or penalty relief for transactions in virtual currencies that occurred or were reported before March 25, 2014 — the date the notice was released.[130] The notice infers that underpayments on taxes for virtual currency transactions could be subject to accuracy-related penalties under section 6662, and that failure to timely comply with the information reporting requirements for those transactions (like on Form 1099-MISC or Form 1099-K) could give rise to penalties under section 6721 or section 6722. The notice says relief from information reporting penalties could be available if taxpayers demonstrate reasonable cause,[131] but that is a statement of existing law.[132]

The notice's lack of assurance that reporting or underpayment penalties will not apply may be particularly concerning in light of the *Coinbase* decision.

### O. Taxation of Forks

In the fork events for bitcoin cash and bitcoin gold described earlier, bitcoin holders essentially received a right to or ownership of a new cryptocurrency as of a specified date. A fundamental tax question is whether that receipt resulted in taxable income to those recipients based on the value of the new cryptocurrency received. A related tax question is whether an event constituted a material modification of the holders' rights in the bitcoin held on the date of the event such that taxable gain or loss should be recognized based on the value of the bitcoin on that date relative to the holders' basis in the coins.[133] Character of any gain or loss recognized and the basis in the new cryptocurrency received are other considerations.

Although there has been no guidance on the taxation of the fork events,[134] some aspects of those

[126] Emily Foster, "Judge Vastly Narrows Summons on Coinbase Bitcoin Exchange Users," *Tax Notes*, Dec. 4, 2017, p. 1374.

[127] *Id*.

[128] *Id*. ("Josh O. Ungerman of Meadows, Collier, Reed, Cousins, Crouch & Ungerman LLP agreed that Coinbase triumphed in this case, but he said the enforcement of the John Doe summons 'is incredibly important to the IRS as it sets the stage for the agency to repeat the requests to other virtual currency exchanges.'").

[129] Dashiell C. Shapiro, "IRS Targets Bitcoin Users, but Is Coinbase the Next UBS?" *Tax Notes*, Apr. 3, 2017, p. 129.

[130] IR-2014-36.

[131] Notice 2014-21 at 938, Q&A-16.

[132] Section 6724(a).

[133] The timing and amount of taxable income arising from a fork is an unresolved question. There may not be an adequate method of valuing the forked cryptocurrency, and the holder may not have immediate access to it. In some cases, if the holders keep their bitcoin on an online exchange, they may never be able to withdraw the cryptocurrency. Tyson Cross, "Yes, the Bitcoin Hard Fork Really Is Taxable Income. Here's What You Need to Know," *Forbes*, Oct. 17, 2017.

[134] *See, e.g.*, Calvin, *supra* note 24, at 365 ("The Bitcoin chain-split has no obvious analogy for federal income tax purposes.").

events are relatively certain: Bitcoin was not exchanged for bitcoin cash, and bitcoin cash was received as a result of holding bitcoin.[135] In contrast, there is comparatively clear guidance under subchapter C regarding the taxation of corporate actions.[136]

Is the receipt of the rights to bitcoin cash or bitcoin gold a kind of income to the recipients? The answer appears to be yes. Federal income tax law broadly defines items constituting taxable income.[137] The recipients of rights to bitcoin cash or bitcoin gold obtain them because of their preexisting ownership in the bitcoin blockchain before the related forks.[138] They were not obtained as gifts or simply found.[139] The right to the new cryptocurrency has measurable value.[140]

What is the timing of the recognition of income for the receipt of rights to bitcoin cash or bitcoin gold? It depends on when dominion and control over the rights is deemed to occur. Could dominion and control be deemed to arise when adequate information is provided to holders to allow them to separately sell those rights? Or does it arise later, when holders take some other act?[141] Could the amount of taxable income vary between holders based on the valuations on the dates those respective holders exercise dominion and control? Are there any Form 1099-MISC implications given the conclusions of Notice 2014-21? Consistent approaches and guidance would likely benefit holders, intermediaries, and the fisc.

A related question that often arises in the transformation of financial instruments is whether an event triggers the recognition of gain or loss on the intangible property previously held. Does either fork (or both) analogously give rise to the recognition of any taxable gain or loss regarding the appreciation of bitcoin previously acquired? Gain or loss is generally recognized under the tax law on the sale or other disposition of property.[142] There is IRS guidance on when the modification of debt instruments gives rise to a taxable exchange,[143] but there is little guidance and great uncertainty about whether specific modifications of nondebt financial instruments trigger the recognition of gain or loss as an "other disposition of property."[144]

Another question is whether there should be an allocation of basis from the bitcoin previously purchased to the rights received.[145] Generally, allocations or adjustments of basis are based on specific tax law guidance. Unfortunately, there is no specific guidance on virtual currencies.

[135] *Id*. "While the conclusion may not be certain, the following can be said: There was no exchange of bitcoin for bitcoin cash; and, the receipt of bitcoin cash was a consequence of holding bitcoin" [internal citations omitted].

[136] Subchapter C provides explicit rules regarding the tax treatment of events like stock splits, stock dividends, mergers, and spinoffs. In general, specific rules and requirements provide nontaxable treatment in some cases, but only if various conditions are met. There are important differences between a cryptocurrency fork and a stock split. *See* Ash Bennington, "Why a Bitcoin Fork Is Not a 'Stock Split,'" Coindesk.com, Aug. 2, 2017.

[137] *See, e.g.*, *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955). *See also* Rev. Rul. 70-498, 1970-2 C.B. 6, which ruled that the value of books accepted by a book reviewer constituted taxable income to the reviewer.

[138] Under some authority, the knowing purchaser of a pregnant cow or racehorse should allocate basis to the unborn calf or foal, based on comparative fair market values at time of purchase. *See, e.g.*, Rev. Rul. 86-24, 1986-1 C.B. 80, and *Launce E. Gamble v. Commissioner*, 68 T.C. 800 (1977). The general applicability of these cases to argue that all holders of forked cryptocurrency are not taxed on forks seems a stretch given that holders of cryptocurrency generally aren't aware of potential future forks as of the time the cryptocurrency is acquired.

[139] *See* discussion by Calvin, "When (and if) Income Is Realized From Bitcoin Chain-Splits," *DTR*, Jan. 4, 2018.

[140] Because of the decentralized nature of cryptocurrencies, different sources (CoinMarketCap, Coinalyze) may provide different valuations, even for the same cryptocurrency at the same time.

[141] Exercise of dominion and control can be further muddied by the various ways holders of bitcoin actually hold their bitcoins. Some may hold through a service like Coinbase. Those services may delay or even prevent a holder's ability to access the new property received in the fork. "Bitcoin Cash — Frequently Asked Questions," coinbase.com, Dec. 19, 2017. Similarly, a holder who never upgrades the software controlling their own electronic wallet might never actually notice the new coins (although they probably should have known of them). Finally, some holders may unintentionally destroy the bitcoin cash they received by accidentally sending it to an address on the original bitcoin blockchain. Jordan Pearson, "People Are Losing Bitcoin Cash by Accidentally Sending It to Bitcoin Addresses," motherboard.vice.com, Sept. 12, 2017. The destination doesn't accept it, and the transfer can't be undone, so the bitcoin cash is simply lost (barring specific recoverable circumstances, which might require the assistance of miners). Kai Sedgwick, "Someone Just Helped Themselves to $600K of Bitcoin Cash From Segwit Addresses," news.bitcoin.com, Nov. 21, 2017.

[142] Section 1001(a).

[143] *See, e.g.*, reg. section 1.1001-3.

[144] *See, e.g.*, James M. Peaslee, "Modifications of Nondebt Financial Instruments as Deemed Exchanges," *Tax Notes*, Apr. 29, 2002, p. 727.

[145] Calvin, *supra* note 24.

If any income or loss is recognized in connection with the forks, the character of that income or loss must be considered. In other words, is it ordinary income or loss, or capital gain or loss? Capital gain or loss usually arises with sales of property or under specific tax laws mandating capital gain or loss treatment. Thus, in the absence of any such provisions, income arising from the receipt of the rights to bitcoin cash or bitcoin gold under the forks appears to constitute ordinary income for tax purposes. Each recipient presumably has a corresponding tax basis in the rights that would equal their value when subject to tax (adjusted for any applicable fees), and the holding period of those rights received as property would begin the date after the receipt.

Obviously, it would be prudent for affected taxpayers to carefully review Notice 2014-21 with their tax advisers. One possible conclusion is that the receipt of additional cryptocurrencies is taxable to the holders and that the basis of that property as of the date received should be tracked for purposes of computing gain or loss on later dispositions. It is also necessary to consider whether any income recognized is properly characterized as ordinary income or capital gain.

Other transactions involving cryptocurrencies could raise similar issues.

For exchanges of cryptocurrencies after 2017, the like-kind exchange rules are generally unavailable to defer the recognition of taxable gain. Similarly, the like-kind exchange rules are generally unavailable to defer the recognition of taxable gain on cryptocurrency derivatives. Because these changes were made by the Tax Cuts and Jobs Act, section 1031 might apply to prevent the recognition of gain or loss for exchanges made before 2018 if the exchanges meet applicable requirements.[146]

### P. Taxation of Bitcoin Derivatives

All financial derivatives must be carefully scrutinized under federal income tax law because the tax treatment of a financial derivative may differ significantly from the treatment of the related underlying property. We have already discussed various aspects of the tax treatment of cryptocurrencies when owned directly. This section raises some of the issues that investors should consider when assessing the tax treatment of indirect investments through financial derivatives of bitcoin and other cryptocurrencies. There are (possibly many) other issues concerning the tax treatment of financial derivatives and structured products that are not addressed here.

#### 1. Mark-to-market taxation of some financial instruments under section 1256.

Taxpayers are required to recognize taxable gain and loss on section 1256 contracts on a mark-to-market basis at the end of each tax year (usually the calendar year for individual taxpayers).[147] By statute, mark-to-market gain or loss recognized during a tax year — either from actual realization during that year connected with exchanges of contracts held during the tax year, or from current-tax-year mark-to-market gain or loss from contracts held at the end of the year — is treated as 60 percent long-term and 40 percent short-term capital gain or loss.[148]

Section 1256 contracts include regulated futures contracts, foreign currency contracts, nonequity options, dealer equity options, and

[146] Generally, section 1031 provides that neither gain nor loss is recognized on exchange of like-kind property either used in a trade or business or held for investment, but it does not apply to stock, bonds, notes, and some other financial instruments. Section 1031(a)(1) and (2). The section's purpose is to delay recognition of gain or loss while investment remains tied up in property that is of a similar kind, until converted into cash, marketable securities, or property of a different kind. H.R. Rep. No. 73-704, at 13 (1934). Coins exchanged as bullion were considered like-kind, whereas coins exchanged for their numismatic value were not. *Compare* Rev. Rul. 76-214, 1976-1 C.B. 218, *with* Rev. Rul. 79-143, 1974-1 C.B. 202. Those rulings provide guidance regarding tangible personal property. Thus, it is determined whether cryptocurrencies will be considered like-kind and whether nonrecognition of gain or loss under section 1031 is available for pre-2018 exchanges.

[147] Section 1256(a)(1).

[148] Section 1256(a)(3).

dealer securities futures contracts.[149] Section 1256 has several special rules and important exceptions, including the hedging transaction exception.[150] A regulated futures contract is defined in section 1256 as a contract "with respect to which the amount required to be deposited and the amount which may be withdrawn depends on a system of marking to market," and that is "traded on or subject to the rules of a qualified board or exchange."[151] All futures contracts traded on U.S. exchanges fall within the definition of a regulated futures contract.[152]

Futures contracts traded on U.S. exchanges, including the CBOE and CME bitcoin futures contracts, qualify as section 1256 contracts.[153] Therefore, investors who purchase bitcoin futures contracts and other cryptocurrency futures contracts traded on those exchanges will be taxed on a mark-to-market basis on gains and losses on contracts held at the end of the calendar year.[154] In other words, unlike direct investments in cryptocurrencies (in which gains and losses will generally be recognized only when the coins are disposed of or exchanged), those cryptocurrency-related futures contracts will be taxed differently, and gains and losses will also be recognized on any unsold positions held at the end of the calendar year.[155] Adjustments are tracked so that gains and losses recognized under section 1256 in prior tax years are accounted for and not double-counted when the related positions are disposed in later years.[156] Section 1256 applies selectively, so other cryptocurrency derivatives are not and may not be subject to it.

**2. Pooled investments in cryptocurrencies.**

Several funds invest in bitcoin or other cryptocurrencies on a pooled basis. The tax treatment of those investments could differ significantly. Some of the funds could be structured and taxed as partnerships for federal income tax purposes. Others could be taxed as regulated investment companies or grantor trusts. Those differences can affect the structure of the investment vehicle as well as the timing and character of income recognized by investors.

In general, partners are taxed on their allocable share of taxable income, capital gains and losses, etc., without regard to the timing of cash distributions on their investment. Holders of RIC shares are treated as holding stock for tax purposes and are generally taxed on actual and deemed distributions concerning their stock. Short-term gains recognized within a RIC that are distributed to shareholders are generally treated as ordinary dividend income (rather than short-term capital gain) upon distribution. Capital losses are typically trapped inside RICs and can be offset only by later capital gains.[157] Holders of interests in investment entities taxed as grantor trusts are treated as directly holding a proportionate share of assets, and they recognize gains, losses, income, and expenses at the same time and character as if the assets were held directly.[158] These different rules could affect the comparative tax treatment of indirect investments in cryptocurrencies.

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[149] Section 1256(b)(1). Note that section 1256(b)(2) specifically excludes some types of contracts from the definition of a section 1256 contract, including securities futures contracts or options (other than dealer securities futures contracts) and some swaps, caps, and floors. Section 1256(b)(2).

[150] Those rules and exceptions are beyond the scope of this report. The hedging exception will not apply to most investors because the hedging transaction must be entered into by the taxpayer in the normal course of the taxpayer's trade or business. Section 1256(e)(2); section 1221(b)(2)(A).

[151] Section 1256(g)(1).

[152] A qualified board or exchange means: "(A) a national securities exchange which is registered with the Securities and Exchange Commission; (B) a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission; or (C) any other exchange, board of trade, or other market which the Secretary determines has rules adequate to carry out the purposes of this section." Section 1256(g)(7). Foreign exchanges have been recognized as qualified in various revenue rulings. *See, e.g.*, Rev. Rul. 2007-26, 2007-1 C.B. 970 (ICE Futures Europe); Rev. Rul. 2009-24, 2009-36 IRB 306 (ICE Futures Canada); and Rev. Rul. 2013-5, 2013-9 IRB 525 (Eurex).

[153] *See, e.g.*, Proshares Trust II, "Pre-Effective Amendment No. 1 to Form S-1 Registration Statement (Form S-1A)," at 50 (Dec. 27, 2017) ("The Sponsor expects that each Fund will invest in Bitcoin Futures Contracts on either the CFE or CME or both through the life of each Fund and thus, the Sponsor expects substantially all of each Fund's futures contracts and foreign currency forward contracts to qualify as Section 1256 Contracts.").

[154] Section 1256(a)(1).

[155] *Id.*

[156] Section 1256(a)(2).

[157] Section 1212(a)(3).

[158] *See* reg. section 1.671-3(a); and Rev. Rul. 88-103, 1988-2 C.B. 304 (citing Rev. Rul. 85-13, 1985-1 C.B. 184).

### 3. Exchange-traded notes and structured debt.

ETNs are a comparatively new form of financial derivative. For tax purposes, they are generally structured as a cash deposit coupled with a forward contract. The forward contract is linked to a rate, an index, a stock, or a commodity. The cash deposit is essentially used to fund the holder's commitment under the ETN when the contract is exercised, terminated, or disposed of. Presumably, holders of ETNs are generally taxed at maturity or earlier termination or exercise of the contract, and income is characterized as capital gain or loss.[159]

Structured debt instruments can provide for interest or principal payouts linked to rates, indices, stocks, or commodities. If the interest payments are linked to rates, indices, or commodities, two different sets of rules may govern the tax treatment of those payments: the variable rate debt instrument (VRDI) rules or the contingent payment debt instrument (CPDI) rules. The tax treatment of payments and the consequences of secondary market purchases at various purchase prices are very different under these two sets of rules. In general, if applicable, the CPDI rules provide for the recognition of income in advance of payments based on projected payments. Although interest on VRDIs is ordinarily recognized when the rates are determined rather than accelerated, special rules can apply.[160]

Derivatives of bitcoin or other cryptocurrencies can be structured as ETNs or as structured debt subject to either the VRDI or CPDI rules. The tax consequences to holders can differ greatly depending on the tax treatment, so careful review before investment is important.

### 4. The wash sale and straddle rules of sections 1091 and 1092.

The wash sale and straddle rules defer a taxpayer's recognition of losses, not gains. The wash sale rules of section 1091 are much older, having been originally enacted in 1921.[161] The straddle rules are newer (though still more than 30 years old) and broader in their potential application.[162]

#### *a. Wash sales.*

The wash sale rules apply to defer the recognition of loss on the disposition of shares of stock or securities if the taxpayer acquires substantially identical stock or securities or has "entered into a contract or option so to acquire" within the 61-day period beginning 30 days before the date of the disposition at a loss and ending 30 days after that date.[163] The loss is merely deferred because the basis of the new stock or securities acquired is increased to account for the deferred loss, but later wash sales can occur, which would further delay when the losses are ultimately recognized.[164]

The critical issue here is whether particular bitcoin or other cryptocurrency derivatives are considered stock or securities for purposes of the wash sale rules.

In Rev. Rul. 74-218, 1974-1 C.B. 202, the IRS considered whether foreign currencies are securities for purposes of the wash sale rules. It concluded that "currency in its usual and ordinary acceptation means gold, silver, other metals or paper used as a circulating medium of exchange," and are distinguishable from securities for this purpose. Therefore, foreign currencies were not securities, and the wash sale rules should not apply.

Similarly, it must be considered whether cryptocurrency derivatives are securities for purposes of the wash sales rules. Could or should that definition of a security be interpreted broadly

[159] Typically an ETN registration statement contains information regarding possible tax treatments, and a supplemental registration for a specific product backed by the ETN contains an opinion specific to that product, usually characterizing it as a prepaid forward contract. Rev. Rul. 2008-1, 2008-1 C.B. 248, ruled that an instrument, issued and redeemed for U.S. dollars, that provided a return based on the euro was a euro-denominated debt instrument under section 988, the return being based on a nonfunctional currency. Notice 2008-2, 2008-1 C.B. 252, requested comments on the treatment of prepaid forward contracts or ETNs, *e.g.*, whether they are exchange traded, and whether the tax treatment should vary depending on the underlying asset (*e.g.*, stock versus commodity).

[160] Reg. section 1.1275-5(e).

[161] Revenue Act of 1921, section 214(a)(5); section 113(a)(1) of 1939 code.

[162] Economic Recovery Tax Act of 1981, P.L. 97-34, sections 501-509. For a general discussion concerning the straddle rules, see James N. Calvin et al., "Examining the Straddle Rules After 25 Years," *Tax Notes*, Dec. 21, 2009, p. 1301.

[163] Section 1091(a).

[164] *See* section 1091, reg. section 1.1091-2.

so that it would apply to cryptocurrency derivatives?[165]

Thus, the question is twofold. First, are cryptocurrencies not securities based on reasoning similar to that set forth in Rev. Rul. 74-218? Second, are specific cryptocurrency derivatives securities for purposes of the wash sale rules?

***b. Straddles.***

The straddle rules defer the recognition of losses and can transform the character of losses from short-term to long-term, and gains from long-term to short-term.[166] A straddle is defined for tax purposes as offsetting positions in personal property.[167] Offsetting positions are present when "there is a substantial diminution of the taxpayer's risk of loss from holding any position with respect to personal property by reason of his holding 1 or more other positions with respect to personal property (whether or not of the same kind)."[168] Personal property is generally defined as any personal property of a type that is actively traded.[169] Tax practitioners and commentators often focus on assessing whether particular types of property are considered actively traded for this purpose.[170]

The breadth of the definition of personal property and active cryptocurrency trading raises the likelihood that some or many transactions involving or relating to cryptocurrencies or related derivatives could be subject to the straddle rules. Of course, straddles require offsetting of both long and short positions. The introduction of cryptocurrency derivatives facilitates shorting of cryptocurrencies, which raises concerns that straddles could routinely arise.

The application and effect of the straddle rules on cryptocurrency and cryptocurrency derivative positions is beyond the scope of this discussion. However, it is a concern with many types of financial transactions, and there appears to be a risk that the straddle rules could adversely affect the tax consequences of cryptocurrency and cryptocurrency derivative transactions.

## III. Conclusion

The IRS has concluded that the receipt of bitcoins and similar cryptocurrencies is taxable. Miners and others who receive cryptocurrencies for services have ordinary income with both reporting and withholding tax consequences.

The IRS has also concluded that cryptocurrency is property and not currency for tax purposes. Unfortunately, it did not specify what type of property cryptocurrency is — commodity, stock, security, etc. The exchange of cryptocurrency as consideration for property or services generates gains or losses based on the difference between the value of the property received (which should generally equal the value of the transferor's cryptocurrency exchanged) and the adjusted basis in that cryptocurrency. This creates a burden on holders because the basis of each lot of cryptocurrency must be separately tracked so that it can be properly applied in computing gain or loss when disposed of. Basis in each lot will likely depend on the initial cost or value of the cryptocurrency at the time of receipt and would have to take into account any further applicable adjustments. The character of gain or loss on disposition will depend on the nature of the holding as inventory, for use in a trade or business, for trading, for investing, or for personal use. If personal, a holder would likely be unable to recognize any losses.

Notice 2014-21 specifies that some virtual currency transactions can give rise to reporting and potential withholding obligations in various contexts involving Forms W-2, 1099-MISC, and 1099-K. Moreover, cryptocurrency derivatives could give rise to Form 1099-B reporting obligations for cash sales by brokers. And the definition of commodity under the Form 1099-B

[165] In Rev. Rul. 74-218, in distinguishing currency from securities and other real or personal property, the IRS placed currency in a narrow category that excluded other intangible and tangible property. The IRS has excluded the direct application of Rev. Rul. 74-218 to cryptocurrency by stating that it is property, not currency, leaving open the possibility that cryptocurrency may be categorized as a security. Although cryptocurrency does not appear to clearly fit in the definition of security in section 1236(c), bitcoin exists in intangible form and could perhaps be compared to property like street name stocks, or debt in book-entry form. Reg. section 1.1012-1(c)(7). *See* Rev. Proc. 2011-35, 2011-25 IRB 890, discussing the difficulty of transferred basis determination in nontaxable stock acquisitions because of the shift to holding stock in street name.

[166] Calvin et al., *supra* note 162.

[167] Section 1092(c)(1).

[168] Section 1092(c)(2)(A).

[169] Section 1092(d)(1).

[170] *See, e.g.*, New York State Bar Association Tax Section, "Report on the Discussion Draft of the Modernization of Derivatives Tax Act of 2016" (Feb. 23, 2017).

reporting regulations raises new risks concerning Form 1099-B reporting of (and potential backup withholding in connection with) bitcoin or other cryptocurrency sales for cash by brokers.

The subpoena issued to Coinbase indicates that the IRS is likely actively investigating whether taxpayers are underreporting income associated with cryptocurrency activities. There is concern that more subpoenas could follow. Remember that Notice 2014-21 did not provide retroactive penalty relief for cryptocurrency activity that occurred before the release of the notice.

The 2017 bitcoin forks raise important new issues concerning the tax consequences for bitcoin holders who received rights in bitcoin cash and bitcoin gold. The broad definition of taxable income suggests that those recipients will recognize taxable income. However, there are murky questions of fact that could substantially affect assessments of a holder's dominion and control over rights in bitcoin cash and bitcoin gold. The outcome of those assessments could affect the timing, amount, and potential reporting of that income. This analysis could also affect the determination of basis in the rights received based on applicable valuations. However, once a holder sells the coins, dominion and control has clearly been exercised and the receipt of cash is potentially identifiable by the IRS.

For post-2017 exchanges of cryptocurrencies or cryptocurrency derivatives, the like-kind exchange rule is unavailable. Substantial losses in cryptocurrencies resulting from significant valuation fluctuations could cause taxpayers to argue that ordinary mark-to-market losses under a section 475 election should be available. However, taxpayers who make that argument would have to maintain that they are traders rather than mere investors, and elections would have to be timely and properly made — requirements that have historically led to substantial litigation with the IRS in other areas.

Cryptocurrency derivatives could be taxed differently from actual investments in cryptocurrencies. For example, new U.S. futures contracts on cryptocurrencies are marked to market under section 1256, and market gains and losses on positions held would be taxed at the end of each calendar year. The taxation of other types of cryptocurrency derivatives will depend on the details but also might differ from direct investment.

Cryptocurrency derivatives also help the shorting of investments in cryptocurrencies. This raises new concerns about potential application of the straddle rules, possible loss deferrals, and possible recharacterization of gains and losses as short-term and long-term. Loss deferrals and gain-loss recharacterization may also arise through the application of wash sale rules.

Regardless of what tomorrow holds, there are significant federal income tax issues regarding cryptocurrencies and their derivatives. Miners, merchants, holders, and investors need to be prepared. ■

McDermott
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# Cryptocurrencies & State Tax: Transactions with Virtual Currency

April 18, 2018

Alysse McLoughlin | Alan J. Schwartz | Mark W. Yopp | David Danesh


## Summary

To date, limited guidance on the taxation of cryptocurrencies has been released by tax authorities. Usage of cryptocurrencies in transactions creates significant ramifications concerning the determination of federal and state and local tax liabilities. While questions surround the tax treatment of the purchase and sale of cryptocurrencies for US dollars or other government-backed currencies, this article focuses on the state tax treatment of transactions where cryptocurrencies are used to pay for goods and services.


### IN DEPTH

Recently, there has been much discussion regarding cryptocurrencies, particularly given their significant fluctuations in value and the increased level of governmental scrutiny. Uncertainties notwithstanding, usage of cryptocurrencies in transactions creates significant ramifications concerning the determination of federal and state and local tax liabilities. While questions surround the tax treatment of the purchase and sale of cryptocurrencies for US dollars or other government-backed currencies, this article focuses on the state tax treatment of transactions where cryptocurrencies are used to pay for goods and services.

To date, limited guidance on the taxation of cryptocurrencies has been released by tax authorities. At the federal level, the IRS published a six-page Notice in March 2014 (Notice 2014-21). The Notice generally provides that cryptocurrencies that are designed to be used as a means of exchange are treated as property and not "currency" for US federal income tax purposes. The significant consequence of this treatment is that the use of cryptocurrency in purchasing an item is treated as a sale or exchange of the cryptocurrency, resulting in taxable gain or loss to the purchaser. This article does not discuss whether pre-Tax Cuts and Jobs Act, exchanges of cryptocurrency for another cryptocurrency could potentially be treated as tax-free like-kind exchanges under Code section 1031.

In addition to the IRS guidance that has been issued, several states have opined on the sales tax treatment of cryptocurrencies. For instance, in March 2014, New York State (NYS) declared that purchases of taxable goods and services using cryptocurrencies should be treated as barter transactions, with the cryptocurrencies considered intangible property (*New York Technical Service Bureau Memorandum* No. TSB-M-14(5)C, 12/05/2014).

Ordinarily, for NYS sales tax purposes a barter transaction between two parties is treated as two separate sale transactions. Each party is considered a seller and required to collect sales tax from the counterparty—who is considered a buyer—based on the value of the property or services received from the counterparty. However, a seller is not required to collect sales tax on the provision of intangible property to a counterparty (20 NYCRR 526.7(d)). Because NYS considers cryptocurrencies to be intangible property, there would be no sales tax collection requirement from the party exchanging cryptocurrencies in exchange for goods or services.

Consider this example. Suppose an individual provides a pen to an associate, in exchange for which the associate provides a notebook to the individual. NYS considers the initiating individual to have sold the pen to his associate and requires the individual to collect sales tax on the "sale" of the pen. NYS also considers the associate to have sold the notebook to the individual and requires him to collect sales tax on the "sale" of the notebook. (In a traditional buyer-seller relationship where goods or services are exchanged for cash, only the seller of goods or services is required to collect sales tax; the cash-paying buyer has no requirement to collect sales tax on the money provided to the seller).

In a deemed barter transaction, however, if the associate were to provide cryptocurrency to the seller in exchange for the seller's pen, only the seller and not the associate would be required to collect and remit sales tax on the transaction because the sale of the cryptocurrency would be considered the sale of an intangible asset that is not subject to sales tax.

Considering the issue from a sales tax compliance perspective, NYS requires a seller that makes sales in NYS and accepts cryptocurrencies in lieu of cash to:

- Register for sales tax purposes;
- Record the value of the cryptocurrency accepted at the time of each transaction, in US dollars;
- Record the amount of sales tax collected at the time of each transaction, in US dollars; and
- Report such sales and remit any sales tax due in US dollars when filing its periodic sales tax returns

While the federal income tax and state sales tax consequences described above appear to be relatively straightforward, there remain many tax-related concerns regarding transactions involving cryptocurrencies.

First, a business that decides to accept cryptocurrencies as payment for products will likely need to review its sales and use tax collection procedures and processes. In a typical cash-based transaction, sales and use tax is collected as cash and deposited into a bank account from which it is later withdrawn and remitted to the state or locality.

Where cryptocurrency is accepted in a transaction, the seller must consider the intermediate step of converting the cryptocurrency to cash (or making sure that the company has enough cash to cover its tax liabilities if there is no conversion or if conversion cannot happen quickly enough) to enable it to remit the sales tax. Sellers must be able to assess the value of the cryptocurrency at the time of the transaction for sales and income tax purposes. Sellers must also maintain records reflecting the dollar value of the amount of tax collected for purposes of determining the appropriate amount of tax remitted. It is important to note that conversion of a cryptocurrency into cash in order to pay sales taxes would be viewed as a sale of the cryptocurrency for income tax purposes, producing taxable gain or loss. The passage of time between a sale and the remittance of the tax due could cause significant financial implications to sellers if the value of that cryptocurrency fluctuates during that time period.

Second, businesses that accept cryptocurrencies as payment will need to determine how to refund purchase amounts to customers. Presumably, refunds would be expected to be based on the dollar value of the cryptocurrencies as of the time of the initial sale. But if refunds are expected to be given in cryptocurrency, is the refund treated as a new barter transaction resulting in additional tax consequences?

Third, companies generating receipts from holding or transacting in cryptocurrency will need to review how to characterize those receipts for state income tax purposes, as business or non-business receipts. Similar issues have been raised in other industries where assets have been held to hedge against fluctuations in materials used in the business (*See General Mills, Inc. et. al. v. Franchise Tax Board*, 1st District Appellate Court, Dkt. A 131477, August 31, 2012).

Finally, outside of the tax arena, businesses that accept and retain cryptocurrencies as payment should review any obligations that they may have as money transmitters, or as businesses engaged in the business of buying and selling cryptocurrencies, in addition to other legal or regulatory requirements. Visit McDermott's Fintech and Blockchain page to see how our Firm has assisted clients with cryptocurrency issues and with blockchain technology.

# 2018-2019 NEW YORK STATE BUDGET BILL: WHAT'S IN, WHAT'S OUT & WHAT IT ALL MEANS

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**State Tax Outline for the Summer Meeting of the Tax Section of the NYSBA**

# I. Federal Conformity -- Corporations

## A. Federal Changes:

### 1. Deemed Repatriation / "Toll Charge" under IRC § 965

Requires certain U.S. shareholders to include as Subpart F income a pro rata share of accumulated earnings and profits of foreign subsidiaries. This is a one-time event.

### 2. Global Intangible Low-Taxed Income (GILTI)

Annual inclusion of a U.S. shareholder's pro rata share of a controlled foreign corporation's "global low taxed income." I.R.C. § 951A. Includes a rate-effecting deduction under § 250.

### 3. Full Expensing of Purchases and Business Interest Expense Limitation

Companies can elect to fully expense, rather than depreciate, certain purchases placed into service after September 27, 2017 and before January 1, 2023. A corresponding limitation was enacted that limits the benefit of interest expenses (such as interest that finances purchases that are fully depreciated). Certain business interest deductions are limited to 30% adjusted gross income.

## B. New York's Response to the Federal Changes:

1. Proposals: See Response to the Federal Tax Cuts and Jobs Act, NYS Department of Taxation and Finance, https://www.tax.ny.gov/research/stats/stat_pit/preliminary-report-tcja-2017.htm.

2. On April 12, 2018, the Governor signed the 2019 Budget Legislation. The Budge Legislation address the Repatriation Issue (by treating any repatriation income was "other exempt income." However, GILTI was not addressed. The draft legislation purported to address it, however, the enacted legislation did not.

# II. Federal Mitigation – New York's Legislative Response to the TCJA

## A. Federal Changes:

1. Federal Changes: The TCJA eliminated many itemized deductions and reduced the personal itemized Schedule A deduction for State and Local Taxes to $10,000 for 2018 and subsequent years.

2. For 2017 and prior tax years, the deduction had been unlimited, and it had been in the Federal Tax Code since the Revenue Act of 1916, which was made possible by the February, 1913 ratification of the Sixteenth Amendment to the US Constitution.

3. Studies showed that more than 88% of the deduction benefited high income taxpayers who itemized their deductions and with income over $100,000. New York and California received more than 1/3 of the total benefit. Six states, California, New York, New Jersey, Illinois, Texas and Pennsylvania, claimed more than half of the total benefit. *See* Tax Foundation, The State and Local Tax Deduction: A Primer (March 15, 2017).

4. The TCJA was designed to lower rates, increase the standard deduction, reduce the number of taxpayers claiming the itemized deduction, and produce a net tax decrease for most taxpayers. But it also seemed to punish "Blue" states, resulting in a backlash and protective steps by New York, CT, California, New Jersey and some other states.

5. The IRS, in turn, has announced that it will closely watch steps by states to circumvent the SALT deduction limits of the new law.

**B. New York's Response to the Federal Changes:**

1. Proposals: See Response to the Federal Tax Cuts and Jobs Act, NYS Department of Taxation and Finance, https://www.tax.ny.gov/research/stats/stat_pit/preliminary-report-tcja-2017.htm.

2. On April 12, 2018 The Governor signed the 2019 Budget Legislation, which included ways to reduce the limitation on itemized and SALT deductions.

3. Retention of Certain Itemized Deductions. At the state level, alimony, moving expenses, mortgage interest and real estate taxes remain deductible as if the federal law did not change, and taxpayers can itemize even if they take the standard deduction on their federal return.

4. Payroll Tax and Charitable Contribution as Substitutes for the SALT Taxes. To avoid the harsh impact of the $10,000 limit on deductible state and local taxes, the Budget Legislation includes two alternatives:

(a) The first is via a payroll tax deduction in lieu of a state income tax. Under new Article 24 of the NY Tax Law, employers may make an annual election to pay a new state payroll tax applicable in the tax year following the year of the election. 2019 will be the first year when the new tax could apply, and it only applies to income over $40,000.

-- The rate of the tax is only 1.5% for 2019, 3% for 2020, and 5% after 2020. Employers would deduct the tax as a business expense. Presumably employers would pay this tax and reduce the income taxes payable by their employees, and would reimburse themselves by reducing a wage increase that might have been awarded. Employees would then pay federal income taxes on their reduced compensation, and employers would deduct as taxes amount they might have otherwise awarded as a wage increase.

-- Employers might have employees in two companies, one for those who would benefit from this tax (mainly highly-compensated employees who live and work in NYS) and one for those not eligible (with income below $40,000) or not viewing this as a benefit (such as a Vermont or California resident who might not get a credit for taxes paid by their employer).

-- Potential tax savings? When the tax is at the 5% level, federal and state tax saving should be about $18,000 per million in taxable income.

(b) Under the second alternative, real estate or income taxes can be paid to new charitable gift trusts set up by a state or a school district or municipality. The taxpayer makes contributions in one year and gets an 85% credit against their income or 95% against their real estate taxes in the next year. The qualified state charities include Health Research, Inc., the SUNY Impact Foundation, and the Research Foundation of the City University of New York.

-- For income taxes, the credit is 85%, meaning the remaining 15% of state income taxes is payable. The net benefit at the highest state tax rate of 8.82% seems to be about $14,000 per million of income.

(c) Other States: CT, NJ, NY and Oregon are among the states that have passed similar legislation.

5. The New York State Department of Taxation and Finance released for comment a draft bill to enact a new unincorporated business tax whose stated purpose is to provide relief to individual New York State taxpayers who would be subject to the $10,000 limitation on deductible state and local income taxes. *See* Mayer Brown, Using a Sledgehammer to Kill a Fly: New York State Considers Unincorporated Business Tax and Seeks Comments (May 18, 2018).

6. *See*, The Business Council, FY 2019 Budget Summary – Taxation.

7. *See*, Noonan's Notes Blog, Highlights from the 2019 Budget Bill (April 11, 2018).

**C. The IRS Response to New York's Response**:

1. Announcements by the Treasury or the IRS: On May 23, 2018 Treasury and the IRS issued a Notice that they intend to propose regulations to attack or curtail the charitable contribution technique, applying substance over form principles. Notice 2018-54, I.R.B. 2018-24, May 23, 20018. *See* Mayer Brown, IRS to Propose Regulations on Certain States' SALT Deduction Charitable Contribution Workaround (May 23, 2018).

2. Congress was aware that states might attempt these methods to soften the impact of the Federal changes, but did not legislatively address them. For years the IRS has characterized "donations" to private school vouchers, a state wildlife fund, etc. as charitable contributions, even when accompanied by a credit against state taxes. But now the stakes are higher. Some question whether the Treasury or IRS can successfully challenge these techniques, or whether Congress needs to weigh in on specific approaches.

3. *See* Institute on Taxation and Economic Policy, SALT/Charitable Workaround Credits Require a Broad Fix, Not a Narrow One (May 23, 2018):

"While these workaround credits have attracted significant attention in recent months, this type of abuse of the charitable giving deduction has been occurring for many years. Taxpayers have long claimed federal charitable deductions on so-called "charitable gifts" for which the taxpayer received a reimbursement from their state government via a tax credit."

"The closest parallel to these workaround credits in existing tax law is a policy typically favored by conservatives: tax credits that steer funding to private K-12 school vouchers. Tax accountants, private schools, and others in states with such credits have long marketed these programs as tools for exploiting the federal charitable deduction, and in the wake of the new federal tax law they are now using language that mirrors that used by proponents of the new workaround credits. While blue-state efforts to circumvent the SALT cap have attracted more attention, financial advisors in deep-red Alabama and elsewhere are touting the ability of their existing charitable tax credits to help their residents "avoid losing" their SALT deductions. And the sales pitch has proven persuasive. Alabama's entire allotment of private school tax credits was claimed more quickly this year than ever before."

## III. Qualified New York Manufacturer

### a. The benefit

For tax years beginning on or after January 1, 2015, New York provided a benefit for corporations "primarily engaged" in certain manufacturing or similar activities (*e.g.*, assembly, processing, etc) that also met a $1MM New York property threshold. N.Y. Tax Law § 210.1(a)(vi). A corporation or combined group of corporations is "primarily engaged" if greater than 50% of the gross receipts of the corporation or combined group of corporations for a taxable year was from the sale of goods produced by such activities. *Id.* The property value threshold is measured by reference to adjusted basis for federal income tax purposes. *Id.* If both the "primarily engaged" and property thresholds are met—or an alternative test related to employees and property is met—the corporation (or combined group of corporations) qualify as a "qualified New York manufacturer," which results in 0% business income base tax rate, a reduced capital base tax rate and capital base tax maximum, and a reduced fixed dollar minimum tax. N.Y. Tax Law §§ 210.1(a)(vi), (b)(1), (d)(1)(C). A corresponding real estate benefit also is available.

### b. Impact of Federal Reform

The TCJA did not directly impact the QNYM provision. However, because some corporations may chose to fully expense new assets, rather than depreciate them, a corporation's computation of its adjusted basis in qualifying property could be impacted. This would not impact the computation of adjusted basis for property already placed in service. But as new property is placed in service, it would have a basis of zero (if fully expenses) and therefore not count toward the $1MM threshold.

### c. **New York Response**—None yet.

If the Department wants to fulfill the Legislature's intent and make the benefit readily available to those who had sufficient property in the state using the federal measurement in effect when the New York Legislature enacted the provision (i.e., pre-TCJA), it could promulgate a regulation indicating that *for purposes of this provision only*, the reference to the I.R.C. was a reference to the I.R.C. "in effect on 1/1/2015." *See, e.g.*, Idaho Admin. Code r. 35.01.01.716.01 (interpreting Idaho incentive statute's reference to I.R.C. § 46(c) as meaning I.R.C. § 46(c) as it existed before it was later deleted by Congress).

## IV. Procedural

1. See NY LEGIS 59 (Part H) (extension of statute of limitations for amended returns)

2. The general period of limitations for assessment of tax is three years after the filing of a return. *See* Tax Law §§ 683(c), 1083(c), and City of New York Administrative Code § 11-1783(c). There are numerous exceptions, but previously, the filing of an amended return was not one of them.[1]

3. New legislation has amended each of these statutes to extend the statute of limitations for assessment by one year after the filing of an amended return. For example, New York Tax Law § 683(c) now provides:

> (12) Except as otherwise provided in paragraph three of this subsection, or as otherwise provided in this section where a longer period of time may apply, if a taxpayer files an amended return, an assessment of tax (if not deemed to have been made upon the filing of the amended return), including recovery of a previously paid refund, attributable to a change or correction on the amended return from a prior return may be made at any time within one year after such amended return is filed.

4. The stated purpose for this extension of the statute of limitations was to limit refund abuse:

> The Executive Budget will reduce refund abuse by extending the statute of limitations to three years after the filing date of the amended return, rather than three years after the original return filing date. Currently, taxpayers can file an amended return containing a refund request close to three years after the due date of their initial return, hampering the possibility of an audit and assessment by DTF. FY 2019 Executive Budget Briefing Book, at 18.

[1] Under the Internal Revenue Code, for amended returns filed within the 60-day period ending on the day on which the statute of limitations would otherwise expire, the IRS has an additional 60 days to assess additional tax. IRC § 6501(c)(7). New York Tax Law did not have a similar provision.

5. Note, however, the legislature only enacted a one year, and not a three-year (as proposed), extension of the statute of limitations after the filing of an amended return.

6. The new statute of limitations provisions state that the extended period will be "attributable to a change or correction on the amended return from a prior return." Accordingly, the filing of an amended return should only extend the statute of limitations with respect to the adjustments and new items on the amended return. However, this may not turn out to be the case, as the New York State Department of Taxation and Finance and the New York City Department of Finance often review and examine all aspects of the return when an amended return is filed. *See e.g. Bankers Trust Corp. v. New York City Dept. of Finance*, 750 N.Y.S.2d 29, 35-36 (1st Dep't 2002).

## V. Sales Tax

1. See NY LEGIS 59 (Part X) (Provide Responsible Person Sales Tax Relief for Minority LLC Owners)

2. Previously, Tax Law § 1131(1) imposed absolute liability on partners of partnerships (and members of LLC's) for unpaid sales taxes of the entity.

3. The Department of Taxation had an administrative policy, described in Technical Memorandum TSB-M-11(17) S (Sept. 19, 2011) (the "TSB"), to provide partial relief from absolute liability. The TSB stated that a limited partner with less than a 50% ownership interest who did not have a "duty to act" in assuring compliance with the sales tax laws, would be liable only for the amount of sales tax allocable to the percentage of ownership in the business, plus interest at the statutory rate (but not penalties). For example, under the TSB, a limited partner with a 20% ownership interest in the entity and no duty to act, would only be required to pay 20% of the entity's sales tax liability, plus interest.

4. The meaning of "duty to act" is described in case law as where the person "possessed all the indicia of control that would impose liability upon an officer, director or employee of a corporation." *Matter of Ianniello v. New York Tax Appeals Trib.*, 209 A.D.2d 740, 741 (1994). Some of the facts and circumstances are the person's status, the authority to hire and fire employees, and responsibility for the entity's management. *Luongo v. New York Tax Appeals Trib.*, 987 N.Y.S.2d 114, 116 (3 Dept. 2014)

5. The TSB was recently codified in Tax Law § 1133(a)(2). The reason for the codification was that "[t]he existing language of the state law that creates personal liability in passive investors is not just grossly unfair, it could deter investment in New York State businesses." *See* "Justification" of Assembly Bill 1983. New York Tax Law § 1133(a)(2) now states as follows:

(2) Notwithstanding any other provision of this article:

> (i) The commissioner shall grant the relief described in subparagraph (iii) of this paragraph to a **limited partner of a limited partnership** (but not a partner of a limited liability partnership) **or a member of a limited liability company if such limited partner or member demonstrates to the satisfaction of the commissioner that such limited partner's or member's ownership interest and the percentage of the distributive share**

**of the profits and losses of such limited partnership or limited liability company are each less than fifty percent, and such limited partner or member was not under a duty to act for such limited partnership or limited liability company in complying with any requirement of this article.** Provided, however, the commissioner **may deny** an application for relief to any such limited partner or member who the commissioner finds **has acted on behalf of such limited partnership or limited liability company in complying with any requirement of this article or has been convicted of a crime provided in this chapter or who has a past-due liability**, as such term is defined in section one hundred seventy-one-v of this chapter.

(ii) Such limited partner or member **must submit an application for relief**, on a form prescribed by the commissioner, and the information provided in such application must be true and complete in all material respects. Providing materially false or fraudulent information on such application shall disqualify such limited partner or member for the relief described in subparagraph (iii) of this paragraph, shall void any agreement with the commissioner with respect to such relief, and shall result in such limited partner or member bearing strict liability for the total amount of tax, interest and penalty owed by their respective limited partnership or limited liability company pursuant to this subdivision.

(iii) A limited partner of a limited partnership or member of a limited liability company, who meets the requirements set forth in this paragraph and whose application for relief is approved by the commissioner, **shall be liable for the percentage of the original sales and use tax liability of their respective limited partnership or limited liability company that reflects such limited partner's or member's ownership interest of distributive share of the profits and losses of such limited partnership or limited liability company, whichever is higher**. Such original liability shall include any interest accrued thereon up to and including the date of payment by such limited partner or member at the underpayment rate set by the commissioner pursuant to section eleven hundred forty-two of this part, and shall be reduced by the sum of any payments made by (A) the limited partnership or limited liability company; (B) any person required to collect tax not eligible for relief; and (C) any person required to collect tax who was eligible for relief but had not been approved for relief by the commissioner at the time such payment was made. Provided, however, such limited partner or member shall not be liable for any penalty owed by such limited partnership or limited

> liability company or any other partner or member of such limited partnership or limited liability company. Any payment made by a limited partner or member pursuant to the provisions of this paragraph shall not be credited against the liability of other limited partners or members of their respective limited partnership or limited liability company who are eligible for the same relief; provided, however that the sum of the amounts owed by all of the persons required to collect tax of a limited partnership or limited liability company shall not exceed the total liability of such limited partnership or limited liability company. New York Tax Law § 1133(a)(2) (emphasis added).

6. As can be seen from the above, the statute excludes from relief persons who have:

- acted on behalf of such limited partnership or limited liability company in complying with any requirement of this article
- been convicted of a tax crime; or
- a past due liability.

7. It is not entirely clear what "has acted on behalf of such limited partnership or limited liability company in complying with any requirement of this article" means, but we hope that this means that persons who try to intervene in the management of the business to get the company into compliance or make arrangements to pay *will not* be barred from relief, but that this exception is for persons who somehow tried to thwart collection and payment of a liability.

8. "Past due liability" is defined in Tax Law § 171-v (the provision that allows for enforcement of delinquent tax liability through suspension of driver's licenses), as "any tax liability or liabilities which have become fixed and final such that the taxpayer no longer has any right to administrative or judicial review."

9. It is not clear from the statute whether the requirement for driver's license suspension that the amount of the liability must be "equal to or in excess of $10,000" or whether a smaller amount will disqualify the person from relief. It is also not clear whether a taxpayer who is in compliance with an installment payment agreement would be barred from relief. Either way, taxpayers should try to clear up any delinquencies before applying for relief under § 1133(a)(2).

## VI. Personal Income Tax Legislation – The Sobotka Repeal and 457A Guidance

### A. Sobotka Legislation:

1. For personal income tax purposes, New York defines a resident as an individual who is either a domiciliary or a statutory resident. Tax Law §605(b). Generally, for tax years before 2019, a statutory resident is a person who is **not domiciled** in the State (or in New York City for City income tax purposes) but who maintains a permanent place of abode in NY for substantially all of the calendar year and who spends in the aggregate more than 183 full or part days in NY in that calendar year. Tax Law §605(b)(2).

2. In *David and Karen Sobotka* (ALJ Order DTA NO. 826286 August 20, 2015), the taxpayers were in NY for more than 183 full or part days but were domiciled in NY for a portion of the year. The NYS DTF argued that they were statutory residents for the full calendar year, but the taxpayers, citing the "not domiciled" language of the statute, argued that the statutory residency test could only be applied to the portion of the year when they were not domiciled in NY.

3. As support for this argument, the taxpayers examined the history of the "statutory resident" definition. The provision was added originally in 1922 (Article 16, §350(7), and at that time it covered a person who had an abode and spent in the aggregate more than 183 days of the taxable year within the state, **"whether or not domiciled in the state during any portion of said period...".**

4. By contrast, the law applicable to the Sobotka tax years contained an additional requirement. When the law was amended in 1987, it added the domicile limitation, and said that a person **not domiciled** in NY could be taxed as a statutory resident. Laws of 1987 (Ch. 267, § 10, effective July 20, 1987). The amendment did not include the "whether or not domiciled …" language of the prior law.

5. The Judge concluded that "This distinction strongly supports the conclusion that for purposes of determining statutory resident status during a portion of a given year, one may not count days that fall within the domicile-based resident portion of that same year." The taxpayers won, and were taxed as residents for the period they were domiciled in NY, but not taxed as statutory residents for the entire year because, in the nondomiciliary period, they were in NY less than 183 days.

6. Legislative solution: the 2018-19 Budget Bill proposed a reversal of Sobotka, **retroactive for all open years**. See 2018-2019 New York State Executive Budget Part O. Essentially, the Bill wanted to reinsert the language that was deleted in the 1987 amendment, so that a person could be taxed as a statutory resident **"whether or not domiciled in the state during any portion of said period…."**

7. The NYSBA Tax Section Report 1391 dated March 9, 2018 at pages 22-26 read, in part, as follows:

(a) Substantive Argument:

"The Court of Appeals has twice held (in Gaied v. N.Y. Tax Appeals Tribunal and Tamagni v. Tax Appeals Tribunal of the State of New York) that the legislative history of the statutory residency provision was to tax as residents those individuals who "for all intents and purposes" were residents of New York State, but claimed domicile elsewhere. While we take no position on whether the Legislature should amend the Tax Law's statutory residency provisions to reject the analysis of the administrative law judge in Sobotka, we note that the proposed amendment would have the effect of taxing individuals as full-year residents of New York when they are "for all intents and purposes" only part-year residents."

(b) Effective Date Argument:

Originally, the Budget Bill proposed a retroactive change. "The changes proposed in Part O of the Budget Bill take effect immediately and apply to all tax years for which a statute of limitations for seeking a refund or assessing additional tax is still open."

Our Tax Section Report took issue with retroactivity. We argued that this was a change, not just a clarification.

"Absent compelling circumstances, changes to longstanding statutes should not be made retroactively applicable. Here, the only rationale for retroactive application would seem to be generating additional tax revenue, which is not, alone, a compelling justification. We appreciate the goal of revenue protection. But, retroactively effective legislation, in addition to being susceptible to Constitutional challenges, is almost never good policy. Inasmuch as the current law fully comports with the legislative history of the current law, and the specific provision in question was tested by an August 2015 Division of Tax Appeals case that the Department chose not to appeal, retroactive application would not be good policy in this instance."

8. Legislative Change: The statutory change was enacted, but is only effective for tax years beginning after the 2018 date of enactment. So the change is effective in 2019 for calendar year taxpayers.

**B. 457 A Guidance:**

1. Code Section 457A was enacted in 2008 and required inclusion of certain deferred income no later than December 31, 2017. Generally, it applied to deferrals such as incentive management fees for services rendered to offshore hedge funds.

2. New York was surprisingly silent on the taxation of this income. If a resident received it in 2017, they would be taxed. But what if the recipient was a nonresident at the time of receipt? Would the deferral be treated as New York source income if it was deferred from a year when the person (or partnership or LLC) worked in New York?

3. TSB-M-18(2)C, (3)I was issued on April 6, 2018 and is applicable to resident and nonresident individuals, proprietorships, partnerships, LLC's, estates and trusts and Article 9-A taxpayers (corporations). Generally, for nonresidents, the income is taxed to the extent the business was carried on in New York. The TSB-M reads, in part, as follows:

"The amount of such nonqualified deferred compensation that must be included in a nonresident's New York source income is determined as follows: • If the business, trade, profession, or occupation was carried on wholly in New York State in the tax year the services were performed, the entire amount of nonqualified deferred compensation must be included in New York source income. • If the business, trade, profession, or occupation was carried on wholly outside New York State in the tax year the services were performed, none of the nonqualified deferred compensation is included in New York source income. • If the business, trade, profession, or occupation was carried on partly in and partly outside New York State during the tax year the services were performed, the amount of nonqualified deferred compensation to be included in New York source income is determined using the rules described below for: ◦ an employee, if the nonresident performed the services as an employee; or ◦ a business, if the nonresident was carrying on a business in New York State. For purposes of this memorandum, a business includes sole proprietorships and partnerships (including LLCs and LLPs that are treated as partnerships for federal income tax purposes). For the allocation rules for income earned as a nonresident shareholder of a New York S corporation, see Taxation under Article 9-A below."

**Summer Meeting of the Tax Section of the NYSBA - Support**
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3. NY LEGIS 59 (Part LL, MM, EEE) (Charitable Contributions & Payroll Tax)

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5. The Business Council, FY 2019 Budget Summary – Taxation

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9. Institute on Taxation and Economic Policy, SALT/Charitable Workaround Credits Require a Broad Fix, Not a Narrow One (May 23, 2018).

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TAX FOUNDATION

FISCAL FACT
No. 545
Mar. 2017

# The State and Local Tax Deduction: A Primer


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## Key Findings

- Taxpayers who itemize deductions on their federal income tax are permitted to deduct certain taxes paid to state and local governments from their gross income for federal income tax liability purposes.
- State and local tax deductibility would be repealed under the House Republican Blueprint, and capped—along with other itemized deductions—under the campaign plan put forward by President Donald Trump.
- The state and local tax deduction disproportionately benefits high-income taxpayers, with more than 88 percent of the benefit flowing to those with incomes in excess of $100,000.
- The deduction favors high-income, high-tax states like California and New York, which together receive nearly one-third of the deduction's total value nationwide. Six states—California, New York, New Jersey, Illinois, Texas, and Pennsylvania—claim more than half of the value of the deduction.
- The state and local tax deduction in New York and California represents 9.1 and 7.9 percent of adjusted gross income respectively, compared to a median of 4.5 percent.
- The deduction reduces the cost of state and local government expenditures, particularly in high-income areas, with lower-income states and regions subsidizing higher-income, higher-tax jurisdictions.




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# Introduction

For Ronald Reagan, it was "the most sacred of cows."[1] To Donald Regan, his Secretary of the Treasury, it was a "dragon" to be slayed.[2] Whatever its taxonomy, the state and local tax deduction has proved resilient, warding off foes for decades. It has withstood the accusation that it is regressive, rewarding high-income taxpayers. It has persevered despite being labeled a subsidy of wealthy, high-tax states funded by the rest of the country. It has endured economists' suspicion that it distorts state and local government expenditures. Thanks to the tenacious support it enjoys in some quarters, it has survived parries from the left and from the right. Again imperiled by the House Republican tax reform plan, which would eliminate all itemized deductions save those for mortgage interest and charitable contributions, its long-heralded demise might actually be in sight.

# Applicability of the Deduction

Under current law, taxpayers who itemize are permitted to deduct certain nonbusiness tax payments to state and local governments from their taxable income. An individual may choose to deduct either state individual income taxes or general sales taxes, but not both, and may also deduct any real or personal property taxes.[3] Most filers elect to deduct their state and local income taxes rather than sales taxes, because income tax payments tend to be larger, but those who reside in states which forego an income tax, or who have uncommonly high consumption expenditures in a given year, may opt to deduct sales taxes instead. The sales tax deduction may be taken either by documenting actual expenses or through the use of an optional sales tax table based on personal income.[4]

In tax year 2014, more than 95 percent of all itemizers, and 28 percent of all federal income tax filers, took a deduction for state and local taxes. Roughly 21.8 percent of filers deducted income taxes, while 6.5 percent elected to deduct sales taxes instead. Most itemizers are homeowners, so 25.1 percent of filers (representing 84.7 percent of itemizers) also took the deduction for real property taxes.[5] Taken together, deductions for state and local taxes represent the sixth largest individual income tax expenditure, estimated to be worth more than $100 billion per year by fiscal year 2018[6] even though most filers do not itemize.[7]

1 Sarah F. Liebschutz & Irene Lurie, "The Deductibility of State and Local Taxes," *Publius* 16, no. 3 (Summer 1986): 51.

2 Jeffrey Birnbaum & Alan Murray, *Showdown at Gucci Gulch: Lawmakers, Lobbyists, and the Unlikely Triumph of Tax Reform* (New York: Random House, Inc., 1987), 48.

3 Internal Revenue Service, "Topic 503 – Deductible Taxes," https://www.irs.gov/taxtopics/tc503.html.

4 Yuri Shandusky, "State and Local Tax Deductions," *Tax Notes* (July 1, 2013): 87.

5 Internal Revenue Service, *Statistics of Income*, Historical Table 2, 2014, https://www.irs.gov/uac/soi-tax-stats-historic-table-2.

6 U.S. Department of the Treasury, "Tax Expenditures [FY 2018]," Department of Tax Analysis, Sept. 28, 2016, https://www.treasury.gov/resource-center/tax-policy/Documents/Tax-Expenditures-FY2018.pdf, 34. For purposes of rankings, we combine defined contribution and defined benefit employer pension plans into one larger expenditure, as we do with the components of state and local tax deductibility. With all expenditures considered separately, deductibility of state and local taxes other than those on owner-occupied homes currently ranks seventh, while deductibility for taxes paid on owner-occupied homes ranks twelfth.

7 Internal Revenue Service, *Statistics of Income*.

The value of the deduction is lessened for some payers by the Pease limitation, which reduces itemized deductions by 3 percent of the amount that a taxpayer's adjusted gross income exceeds an indexed threshold,[8] and by the alternative minimum tax. The House Republican tax plan, like several before it, would repeal the deductibility of state and local taxes outright (along with most other itemized deductions) in favor of significantly lower rates.[9]

## History of State and Local Tax Deductibility

The deductibility of state and local taxes is older than the current federal income tax itself. The provision has its origin in the nation's first effort at income taxation (eventually found unconstitutional) under the Civil War-financing Revenue Act of 1862, and was carried over into the Revenue Act of 1913, the post-Sixteenth Amendment legislation creating the modern individual income tax. The rationale for the original provision only comes down to us in fragments, though a fear that high levels of federal taxation might "absorb all [the states'] taxable resources," a concern first addressed in the *Federalist Papers*, appears to have held sway.[10] Lawmakers sought a bulwark against the possibility that "all the resources of taxation might by degrees become the subjects of federal monopoly, to the entire exclusion and destruction of state governments,"[11] and found it in a federal deduction for state and local taxes.

This caution would appear prescient as top marginal rates soared from 7 percent in 1913 to 77 percent by 1918 as American doughboys took to European fields, and in 1944, when the top rate skyrocketed to 94 percent at the height of the Second World War. Even in the postwar era, the top marginal rate would remain at 91 or 92 percent every year from 1951 until 1964, when it declined with the implementation of the Kennedy tax cuts.[12] During this era, the state and local tax deduction prevented combined federal, state, and local income tax rates from exceeding 100 percent.[13]

In time, however, the prudence of the provision would be called into question. Neglecting some modest tinkering—the exclusion of license fees and excise taxes on alcohol and cigarettes in 1964, and later the exclusion of motor fuel excise taxes—the state and local tax deduction went largely unchallenged until the U.S. Department of the Treasury, under the direction of Secretary William E. Simon, issued *Blueprints for Basic Tax Reform* in the waning days of the Ford administration. The report, issued in January 1977, recommended the retention of state and local income tax deductibility while jettisoning the deduction for sales and property taxes.[14]

8 Kyle Pomerleau, "The Pease Limitation on Itemized Deductions Is Really a Surtax," Tax Foundation Tax Policy Blog, Oct. 16, 2014, http://taxfoundation.org/blog/pease-limitation-itemized-deductions-really-surtax.

9 *See generally*, Kyle Pomerleau, "Details and Analysis of the 2016 House Republican Tax Reform Plan," Tax Foundation Fiscal Fact No. 516, July 5, 2016, http://taxfoundation.org/article/details-and-analysis-2016-house-republican-tax-reform-plan.

10 Liebschutz & Lurie, 52.

11 Alexander Hamilton, *Federalist* No. 31, in *The Federalist Papers*, ed. Clinton Rossiter (New York: New American Library, 1961), 189-192.

12 *See generally*, Tax Foundation, "U.S. Federal Individual Income Tax Rates History, 1862-2013 (Nominal and Inflation-Adjusted Brackets)," Oct. 17, 2013, http://taxfoundation.org/article/us-federal-individual-income-tax-rates-history-1913-2013-nominal-and-inflation-adjusted-brackets.

13 Liebschutz & Lurie, 54.

14 Department of the Treasury, *Blueprints for Basic Tax Reform*, Jan. 17, 1977, https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Blueprints-1977.pdf, 93.

In 1983, Senator Bill Bradley and Congressman Dick Gephardt teamed up on a Democratic tax reform proposal that sought to proscribe the deduction, limiting it to income and real property taxes. A competing Republican plan introduced by Congressman Jack Kemp and Senator Bob Kasten would have retained it exclusively for real property taxes. Then, in 1984, at the behest of President Ronald Reagan and with Secretary Donald Regan at the helm, the Treasury unveiled a comprehensive tax reform proposal (retrospectively known as Treasury I) which incorporated the complete elimination of state and local tax deductibility.[15] After decades of quiet existence, the deduction was suddenly vulnerable, and the stage was set for it to assume a central role in the debate surrounding the Tax Reform Act of 1986.

"We were slaying a lot of dragons," Secretary Regan would later say, reminiscing about the heady days when, working in secret, a small cadre of Treasury staffers slashed through the tax code to develop a comprehensive tax reform proposal that could be championed by President Reagan.[16] Dragons, however, are not easily slain, and this one had powerful defenders.

A high-income and high-tax state, New York—and particularly New York's wealthy elite—benefited mightily from the deduction, which one congressman from the state termed "a matter of survival." Governor Mario Cuomo, Senator Alfonse D'Amato, and a powerful coalition studded with luminaries the likes of David Rockefeller (chairman of Chase Manhattan Bank), James Robinson III (chairman of American Express), and Laurence Tisch (chairman of Loews Corporation), joined by public sector unions and the Conference of Mayors, went to war. In time, proponents of state and local tax deductibility would forge alliances with other interests threatened by tax reform, and their advocacy very nearly derailed the entire tax reform agenda.[17]

In the end, the Tax Reform Act of 1986 did nothing more than withdraw the general sales tax deduction, which was later restored in part.[18] In 2005, an advisory panel convened by President George W. Bush declared that eliminating the deduction would offer a "cleaner and broader tax base" and a more equitable tax code, though nothing came of it.[19] But if the dragon had not been felled in the 1986 tax reform effort, neither had its foes. Today, the deductibility of state and local taxes again finds itself on the chopping block, recommended for elimination along with most other itemized deductions by the House Republican tax reform "Blueprint" championed by Speaker Paul Ryan and House Ways and Means Committee Chairman Kevin Brady. So too, the old arguments reemerge.

Four decades after the Treasury Department first floated the curtailment of deductibility, it is again necessary to consider the intended purposes of the state and local tax deduction and the arguments advanced for and against its continuation.

15 Louis Kaplow, "Fiscal Federalism and the Deductibility of State and Local Taxes in a Federal Income Tax," *82 Va. L. Rev.* 413 (1996): 416.

16 Birnbaum & Murray, 48.

17 *Id.*, 109-113.

18 Congressional Budget Office, "The Deductibility of State and Local Taxes," Feb. 2008, https://www.cbo.gov/sites/default/files/110th-congress-2007-2008/reports/02-20-state_local_tax.pdf, 4.

19 Gilbert Metcalf, "Assessing the Federal Deduction for State and Local Tax Payments," *National Tax Journal* 64, vol. 2 (June 2011): 565.

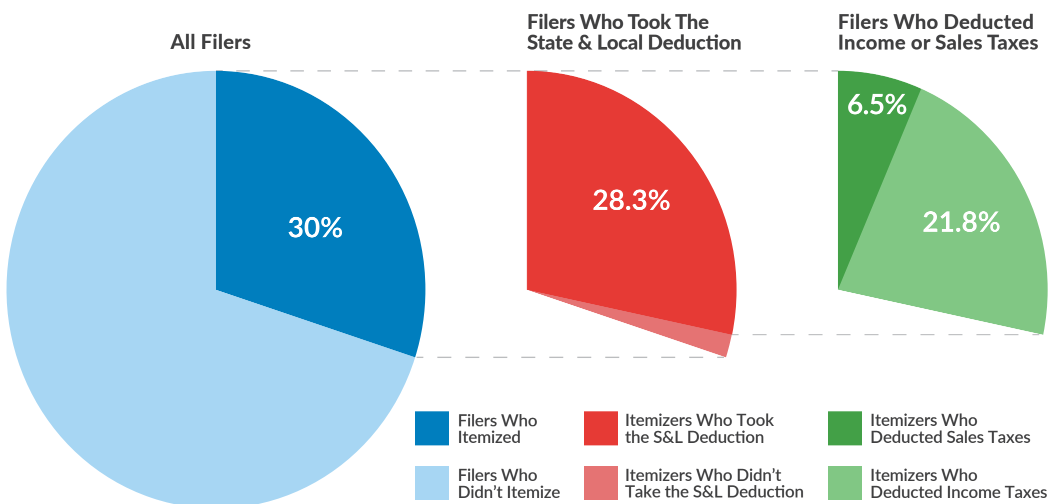
Opponents of the state and local tax deduction point out that it is regressive in that it is largely claimed by wealthier taxpayers, that it subsidizes higher taxes and potentially wasteful state and local spending, that it involves a transfer from lower-income to higher-income states, that it may encourage self-segregation by income groups, and that it favors public over private provision of certain services. Proponents counter that the deduction better aligns taxable income with ability to pay. They also argue that subsidization of local government expenditures offsets a tendency toward providing less than the optimal amount of government services, as determined by local taxpayers, due to what are known as spillover effects. Some local expenditures chiefly or exclusively benefit local residents, while others benefit residents and nonresidents alike. If residents are less willing to pay for government services that benefit nonresidents as well, they may settle on a lower level of service provision than they would prefer absent the spillover. Each of these arguments will be considered in turn.

## Benefits for High-Income Taxpayers

The lion's share of state and local tax deductions are claimed by upper-income earners. Only 30 percent of all federal income tax filers itemized rather than claiming the standard deduction in tax year 2014. Of these, over three-quarters reported adjusted gross income (AGI) above $50,000, even though taxpayers with AGIs above $50,000 represent a mere 38 percent of all filers.[20] According to the Joint Committee on Taxation, more than 88 percent of the benefit of state and local tax deductions accrued to those with incomes in excess of $100,000 in 2014, while only 1 percent flowed to taxpayers with incomes below $50,000.[21] In 1984, a Treasury report went so far as to disparage the state and local tax deduction's "distributionally perverse pattern of subsidies."[22]

**FIGURE 1.**

### What Percentage of Taxpayers Take the State & Local Deduction?




20 Internal Revenue Service, *Statistics of Income*.

21 The Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2015-2019," Dec. 7, 2015, https://www.jct.gov/publications.html?func=startdown&id=4857, 45-46.

22 Liebschutz & Lurie, 55.

A similar distribution is evident when comparing the value of the state and local tax deduction as a percentage of AGI for taxpayers in different income strata. Taxpayers with AGIs between $25,000 and $50,000 claim, in aggregate, state and local tax deductions worth 2.1 percent of AGI, whereas taxpayers with incomes above $500,000 claim deductions worth nearly 7.1 percent of AGI.[23] The elimination of deductibility would reduce the cash income of the top decile of income earners by 1.3 percent, but the reduction would be less than 0.1 percent for each of the bottom five deciles.[24]

**TABLE 1.**

**Value of the State and Local Tax Deduction as a Percentage of AGI**

| Adjusted Gross Income | S+L Deduction Value as % of AGI | Percentage of Filers Itemizing |
|---|---|---|
| $0 - $24,999 | 2.06% | 5.53% |
| $25,000 - $49,999 | 2.10% | 19.77% |
| $50,000 - $99,999 | 3.95% | 45.63% |
| $100,000 - $499,999 | 6.55% | 80.55% |
| $500,000 + | 7.07% | 92.16% |

Source: IRS Statistics of Income (2014)

Proponents sometimes posit that the elimination of deductibility would particularly disadvantage wealthy people who live in low-income communities, which could incentivize high-income earners to self-segregate in wealthier neighborhoods.[25] Studies, however, suggest that this effect would be quite modest, if it exists at all,[26] and that in many cases, the effect may run in the opposite direction. High-income earners who congregate in a single community, for instance, may support locally-funded amenities like golf courses and tennis courts, or more stately government buildings and costly public infrastructure—expenditures less likely to earn the support of high earners in mixed-income communities—while exporting some of the resulting tax burden to others.[27]

## Subsidization of High-Income, High-Tax States

Just as the state and local tax deduction disproportionately favors wealthier taxpayers, it also benefits states which combine high incomes and high-tax environments. Reliance on the deduction varies widely: the average value of the state and local deduction as a percentage of AGI in the ten states with the highest reliance on the deductions is 6.09 percent, whereas it is only 3.81 percent in the bottom ten states. In New York, the deduction is worth 9.1 percent of AGI; the median across all states is just under 4.5 percent. More staggering, though, is the fact that just six states—California, New York, New Jersey, Illinois, Texas, and Pennsylvania—claim more than half of the value of all state and local tax deductions nationwide, with California alone responsible for 19.6 percent of the national tax expenditure cost.[28]

23 Internal Revenue Service, *Statistics of Income*.

24 Metcalf, 575.

25 Edward M. Gramlich, "The Deductibility of State and Local Taxes," *National Tax Journal* 38, no. 4 (Dec. 1985): 448.

26 *Id.*, 463.

27 Bruce Bartlett, "The Case for Eliminating Deductibility of State and Local Taxes," *Tax Notes* (Sept. 2, 1985): 1122

28 Internal Revenue Service, *Statistics of Income*.

**TABLE 2.**

## State and Local Tax Deduction Shares and Value by State

| State | AGI Per Filer | % of Itemizers | Deduction as % of AGI | State Share |
|---|---|---|---|---|
| Alabama | $52,741 | 26.0% | 2.8% | 0.6% |
| Alaska | $67,212 | 22.2% | 1.5% | 0.1% |
| Arizona | $56,903 | 28.3% | 3.5% | 1.1% |
| Arkansas | $53,186 | 22.7% | 3.7% | 0.5% |
| California | $73,938 | 33.9% | 7.9% | 19.6% |
| Colorado | $70,342 | 32.6% | 4.0% | 1.4% |
| Connecticut | $93,806 | 41.2% | 8.3% | 2.6% |
| Delaware | $61,998 | 32.0% | 4.5% | 0.2% |
| Florida | $60,676 | 22.9% | 2.6% | 2.8% |
| Georgia | $57,899 | 32.7% | 4.9% | 2.4% |
| Hawaii | $58,209 | 29.2% | 4.5% | 0.3% |
| Idaho | $52,703 | 27.9% | 4.4% | 0.3% |
| Illinois | $69,186 | 32.4% | 6.0% | 5.0% |
| Indiana | $54,125 | 23.1% | 3.5% | 1.1% |
| Iowa | $59,559 | 29.2% | 4.7% | 0.8% |
| Kansas | $62,299 | 25.7% | 3.8% | 0.6% |
| Kentucky | $51,977 | 26.0% | 4.7% | 0.9% |
| Louisiana | $57,560 | 22.8% | 2.6% | 0.6% |
| Maine | $53,519 | 27.6% | 5.6% | 0.4% |
| Maryland | $72,746 | 45.2% | 7.7% | 3.2% |
| Massachusetts | $85,408 | 36.8% | 6.3% | 3.5% |
| Michigan | $56,937 | 26.5% | 4.3% | 2.2% |
| Minnesota | $68,649 | 35.0% | 6.2% | 2.2% |
| Mississippi | $46,639 | 22.9% | 3.0% | 0.3% |
| Missouri | $56,634 | 26.1% | 4.3% | 1.3% |
| Montana | $55,240 | 28.2% | 4.5% | 0.2% |
| Nebraska | $61,711 | 27.8% | 4.8% | 0.5% |
| Nevada | $58,745 | 24.6% | 2.4% | 0.4% |
| New Hampshire | $69,498 | 31.5% | 4.3% | 0.4% |
| New Jersey | $81,344 | 41.1% | 8.7% | 5.9% |
| New Mexico | $50,743 | 22.7% | 3.1% | 0.3% |
| New York | $79,268 | 34.2% | 9.1% | 13.3% |
| North Carolina | $56,385 | 29.1% | 4.7% | 2.2% |
| North Dakota | $73,499 | 17.7% | 1.6% | 0.1% |
| Ohio | $56,322 | 26.5% | 4.7% | 2.9% |
| Oklahoma | $59,450 | 24.0% | 3.2% | 0.6% |
| Oregon | $59,845 | 36.0% | 7.0% | 1.5% |
| Pennsylvania | $63,037 | 28.8% | 4.9% | 3.7% |
| Rhode Island | $62,296 | 32.9% | 6.4% | 0.4% |
| South Carolina | $52,434 | 27.0% | 4.2% | 0.9% |
| South Dakota | $60,690 | 17.3% | 1.6% | 0.1% |
| Tennessee | $54,997 | 20.0% | 1.9% | 0.6% |
| Texas | $67,253 | 23.0% | 2.5% | 3.9% |
| Utah | $60,792 | 35.4% | 4.5% | 0.7% |
| Vermont | $57,573 | 27.5% | 5.6% | 0.2% |
| Virginia | $72,151 | 37.2% | 5.5% | 3.0% |
| Washington | $73,010 | 30.4% | 2.9% | 1.4% |
| West Virginia | $50,401 | 17.1% | 3.0% | 0.2% |
| Wisconsin | $59,596 | 31.6% | 6.0% | 1.9% |
| Wyoming | $77,370 | 21.9% | 1.6% | 0.1% |
| District of Columbia | $88,430 | 39.4% | 6.8% | 0.4% |

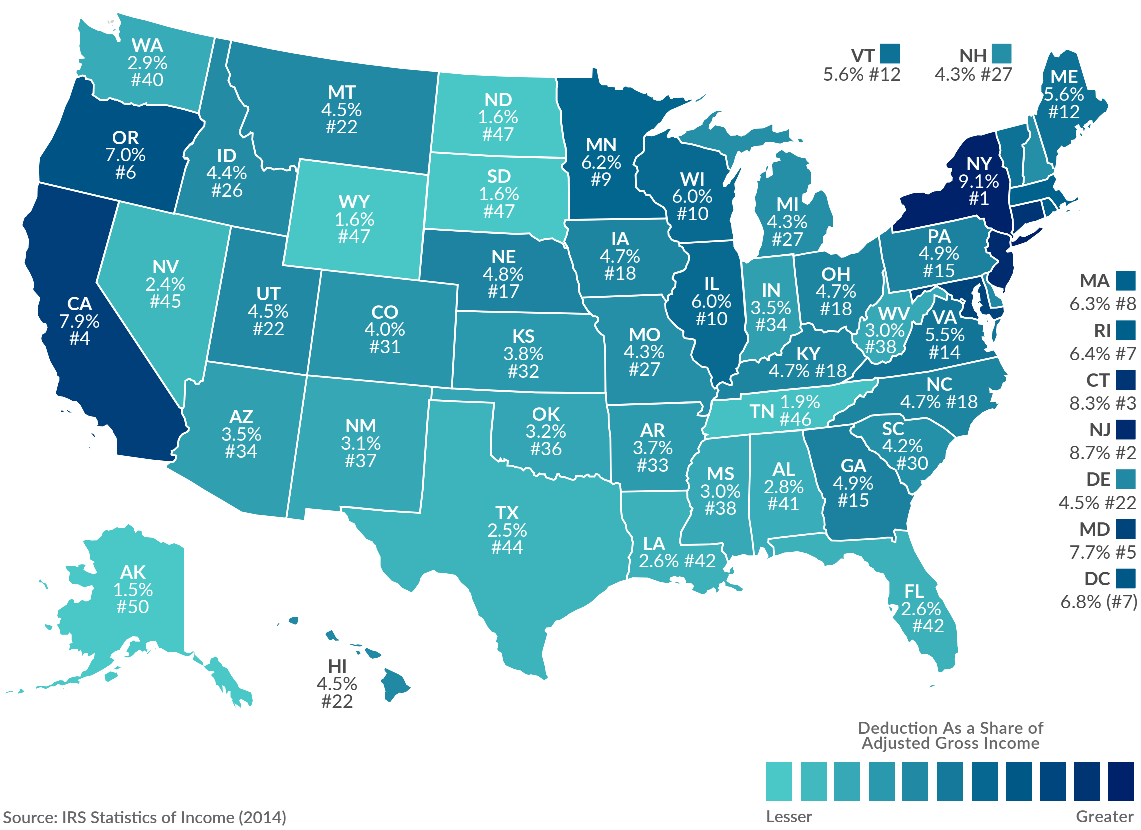
Source: IRS Statistics of Income (2014)

To some degree, this is a function of population. Any tax provision, no matter how neutral its application, will flow more to states with higher populations. The state and local tax deduction, however, expressly favors higher-income earners and state and local governments which impose above-average tax burdens. The deduction's effect is for lower- and middle-income taxpayers to subsidize more generous spending in wealthier states like California, New York, and New Jersey, reducing the felt cost of higher taxes in those states. As the Urban-Brookings Tax Policy Center has observed, state and local governments "are able to raise revenues from deductible state and local taxes that exceed the net cost to taxpayers of paying those taxes, in effect allowing those jurisdictions to export a portion of their tax burden to the rest of the nation."[29]

To the extent that the more generous spending is financed through progressive taxation at the state level—which might be imposed at higher rates and on more progressive schedules than would have been viable in the absence of the deduction—some of the regressive effect of the deduction at the federal level may be offset at the state level.[30] This is, however, an inefficient and convoluted approach to promoting state tax progressivity, and whatever greater progressivity may exist in a high-income, high-tax state is countered by a federal transfer away from residents of lower-income, lower-tax states.

**FIGURE 2.**

## State & Local Tax Deduction As a Share of Adjusted Gross Income by State




Source: IRS Statistics of Income (2014)

29 Frank Sammartino & Kim Rueben, "Revisiting the State and Local Tax Deduction," Tax Policy Center, March 31, 2016, http://www.taxpolicycenter.org/sites/default/files/alfresco/publication-pdfs/2000693-Revisiting-the-State-and-Local-Tax-Deduction.pdf, 1.

30 Shandunsky, 87.

Advocates of progressive taxation typically prefer progressivity at the federal level to progressivity at the state level, as "higher-income taxpayers can avoid progressive state and local taxes either by shifting income or physically moving to a lower-tax state."[31] The state and local tax deduction flips this preference on its head, sacrificing progressivity at the federal level in hopes of inducing more progressive state tax structures.

## Effect on State and Local Government Finances

Deductibility of state and local taxes increases state and local government expenditures by reducing the cost of that spending, but estimates differ on the magnitude of the effect. During the 1986 tax reform debate, the Congressional Research Service estimated that the deduction increased state and local spending by as much as 20.5 percent, while the now-defunct U.S. Advisory Commission on Intergovernmental Affairs concluded that the increase was on the order of 7 percent[32] and the National League of Cities arrived at an estimate of only 2 percent.[33] Other studies have found little evidence of any significant effect on state and local government expenditure levels.[34] Furthermore, any reductions in local expenditures "would appear to be concentrated in high income communities where most itemizers now live," according to one such study.[35]

By decreasing the cost of state and local government spending, the federal government provides a subsidy for such expenditures. Because not all forms of state and local revenue are deductible, moreover, the deduction's availability can promote greater reliance on deductible income and property taxes to the disadvantage of other possible sources of revenue, including user fees, which might otherwise be favored.[36] Using federal tax revenue to subsidize state and local governments—and particularly higher-income taxpayers—has critics on both the left and right, with the chief argument advanced in favor of the *status quo* predicated on the postulate that local government spending, in particular, is suboptimal.

All levels of government must strike a balance between demand for government-provided services and the desire to keep taxes and spending in check, and the democratically chosen balance will vary from place to place. The residents of some localities are willing to accept higher levels of taxation in exchange for greater government service provision; others prefer a smaller government which necessitates lower rates of taxation. Taxpayers may be supportive of increased levels of spending if part of the cost is borne by others; conversely, they may reduce expenditures if they believe that some of the benefit of that spending will be conferred on others. Federal subsidies thus place a thumb on the scale, distorting local decision-making.[37]

31 Sammartino & Rueben, 7-8.

32 Bartlett, 1123.

33 Liebschutz & Lurie, 64.

34 Metcalf, 568.

35 Gramlich, 462-463.

36 *Id.*, 568. See, e.g., Feldstein and Metcalf (1987), Holtz-Eakin & Rosen (1986), Metcalf (1993), and Gade & Adkins (1990).

37 Congressional Budget Office, "The Deductibility of State and Local Taxes," 7.

Some municipal services are inherently excludable; only residents, for instance, stand to benefit from municipal trash collection. Other amenities, however, like city parks, public parking, bike trails, community centers, and municipal athletic facilities, are utilized both by residents (who pay local taxes) and nonresidents (who do not) alike. This "spillover" theoretically reduces the amount that local residents are willing to pay in taxes for certain services to a level below what they would favor if the benefits accrued only to them.[38] A federal subsidy, regressive though it may be, might then be rationalized as a way to restore expenditure decisions to equilibrium rather than artificially inflating demand.

Several objections to this model quickly emerge. As the economist Helen Ladd argues, "Positive spillovers from public sector spending are more likely in low-income or heterogeneous cities than in higher-income communities where itemizing is more common,"[39] which is one reason why, under the current regime of tax deductibility, high-income individuals may find it even more advantageous to live together in the same communities. Moreover, the deduction is a blunt instrument, applying no matter what the possible spillover effect of an expenditure is, and without regard to the mix of services that exist in a community.[40] Many public expenditures have little or no spillover, yet they receive the same subsidy as those easily enjoyed by nonresidents. Specifically, it is highly unlikely that much spillover exists from high-income to low-income communities, yet it is high-income areas and taxpayers who benefit disproportionately from the deduction.

The argument particularly suffers if local government revenues hew closely to the benefit test, where tax (and fee) liability closely tracks benefits received—and this, it emerges, is frequently the case. Charles McLure, one of the architects of Treasury I, put it this way:

> If … the financing of state and local public services reflected more accurately the benefit of such services, the case for reducing tax competition via federal subsidies would be weak and perhaps vanish. Indeed, in a world of user charges and benefit taxes the existence of such subsidies would worsen the allocation of resources, rather than improving it, by reducing the cost of such services to state and local beneficiaries/taxpayers and causing over-production of the subsidized activity.[41]

Whereas the federal government engages in a broad array of cash transfers, social insurance, and social welfare spending, such expenditures are responsible for a modest portion of state, and particularly local, budgets. Social services comprise 11.3 percent of local budgets, and general expenditures—which would include many of the amenities which might benefit nonresidents—only account for 5.6 percent of local government budgets nationwide.[42] This suggests that, unlike federal taxes, state and especially local taxes function hew closer to the benefit principle, and that federal subsidization of these levels of government will tend to favor taxpaying residents, not free-riding nonresidents.[43]

38 Helen Ladd, as cited in Bartlett, 1123.

39 *Id*.

40 Charles McLure, "Tax Competition: Is What's Good for the Private Goose Also Good for the Public Gander?" *National Tax Journal* 39, no. 3 (Sept. 1986): 344.

41 *Id.*, 342.

42 U.S. Census Bureau, "State and Local Government Finances," 2014, https://www.census.gov/govs/local/.

43 Bartlett, 1124

A more generalized case of suboptimal state and local budgeting is that of "fiscal imbalance," where state and local expenditures are assumed to be suboptimal across the board, thus justifying federal subsidies designed to encourage higher levels of spending across all inferior governmental units.[44] To the extent that this concern is valid, however, the state and local deduction is a blunt instrument poorly suited to the task, as it flows most generously to those states and localities with the highest innate revenue capacity. Better calibration is possible with almost any other form of aid to states and localities.

**TABLE 3.**

**State and Local Expenditures by Spending Category**

| Expenditure | State & Local | State | Local |
|---|---|---|---|
| Education Services | 28.1% | 18.3% | 37.0% |
| Social Services | 24.7% | 39.3% | 11.3% |
| Insurance Trust Expenditure | 10.0% | 17.9% | 2.7% |
| Public Safety | 7.2% | 4.6% | 9.6% |
| Utilities | 6.7% | 1.7% | 11.3% |
| Transportation | 5.9% | 6.5% | 5.4% |
| Environment & Housing | 5.8% | 2.2% | 9.1% |
| General Expenditures | 4.4% | 3.1% | 5.6% |
| Government Administration | 3.9% | 3.4% | 4.4% |
| Interest on Debt | 3.3% | 2.9% | 3.6% |

Source: U.S. Census Bureau, "State and Local Government Finances" (2014)

A Congressional Budget Office (CBO) analysis summarized the effect of the deduction by noting that it "may spur state and local governments to provide services that are neither federal in nature nor targeted toward areas of national concern" and thus "interfere with the sorting mechanism that otherwise helps keep local public services at levels appropriate to their value to local taxpayers."[45] One of the virtues of federalism is the ability for state and local governments to experiment with different models of taxation and service provisions, with the recognition that what is appropriate or desirable for one population may be disfavored by another. Whatever balance communities might otherwise adopt, however, may be skewed by deductibility. As the CBO notes, "Because of the subsidy, too many of those services may be supplied, and state and local governments may be bigger as a result."[46]

44 Liebschutz & Lurie, 55.

45 Congressional Budget Office, "The Deductibility of State and Local Taxes," 7.

46 *Id*.

Additionally, the existence of the deduction can incentivize government provision of municipal services that might be provided more efficiently by the private sector, not because of some advantage or preference for government provision of the service, but because the cost, for instance, of municipal trash collection receives the benefit of the state and local tax deduction, whereas the economically equivalent private provision of waste management services would receive no such tax advantage.[47] From the start, local taxes remitted in exchange for local benefits (like license taxes) were not deductible.[48] In part because the deduction gives an advantage to general taxes over fees, any principle of excluding "consumption" argues against the deduction more broadly.

## The Double Taxation Argument

The coexistence of federal and state income taxes absent deductibility is sometimes characterized as a tax upon a tax, as federal taxes are paid on the share of income foregone to state (and potentially local) governments. Most taxes imposed by different levels of government are susceptible to some variation of this argument, but the crux of the case for deductibility is the taxpayer's ability to pay. As noted previously, at times when the top marginal federal individual income tax rate exceeded 90 percent, it would have been possible for some income to be taxed at combined rates in excess of 100 percent in the absence of deductibility.

It is, of course, fairly implausible to conclude that rates would have stood as high in the absence of the deduction, or that earning a marginal dollar above some threshold would actually expose the taxpayer to more than a dollar's worth of taxes. Even if such fears were warranted, however, they have little relevance under today's rate schedule, or any rates which might emerge from a tax reform package which includes the repeal of the state and local tax deduction.

This argument for the deduction also depends on the extent that higher levels of state and local taxation represent, at least in part, a choice about the consumption of government services. If state and local tax rates are largely invariant to service provision or fund services not utilized by many taxpayers, then these state and local taxes may be seen as reducing capacity to pay federal taxes. If, however, these taxes correlate strongly with services provided—and such a correlation is far stronger at the state and local level than it is at the federal level—then arguments about double taxation are less salient,[49] particularly when variations in local government taxation can be explained in part by consumption that might otherwise have been supplied by the private sector.

47 Jeremy Horpedahl and Harrison Searles, "The Deduction of State and Local Taxes from Federal Income Taxes," Mercatus Center at George Mason University, 3.

48 Sammartino & Rueben, 7.

49 Congressional Budget Office, "Option 6: Eliminate the Deduction for State and Local Taxes," Options for Reducing the Deficit: 2014 to 2023, Nov. 13, 2013, https://www.cbo.gov/budget-options/2013/44799.

In a federal system, moreover, individuals receive services from federal, state, and municipal governments. Each layer of government can be viewed as providing its own package of services, which one would expect to be "priced" separately. When two taxes levied by a single government, or similar types of governments (for instance, multiple states), fall disproportionately upon the same income or economic activity, this represents a clear case of double taxation. When different levels of governments levy taxes for discrete sets of services, the rationale for a deduction for taxes paid is far weaker.

A closely related argument holds that a large proportion of local government expenditures—schools, roads, police and fire protection, and the like—can be understood as investments in human and physical capital, and thus would be deductible as capital expenditures under an ideal tax code. Of course, not all local government spending can be reasonably construed as capital investment. States government budgets, moreover, tend to include far more welfare spending and transfers that clearly do not constitute capital expenditures.

The strength of this argument for local, if not for state, governments, turns at least in part on whether it is appropriate to consider a mandatory tax payment a capital expenditure even if the return to capital is accrued by other people or entities. When individuals and businesses purchase capital goods, they are—or at least they can designate—the intended beneficiary of any return on investment. When governments levy taxes, the payors have little control over either the investment or its beneficiaries.

## Federal Revenue Implications

According to the Tax Foundation's Taxes and Growth Model, eliminating the state and local tax deduction would raise an additional $1.8 trillion in federal revenues over a ten-year window on a static basis, and $1.7 trillion on a dynamic basis which takes changes in economic activity into account.[50] The adverse economic impact is estimated at a modest 0.4 percent reduction in gross domestic product (GDP),[51] which would be more than counterbalanced by any offsetting rate reductions. The small impact on economic growth makes it an enticing offset for more growth-oriented revenue-reducing reforms elsewhere in the system.

Distributionally, the lower four quintiles of households would see their after-tax income decrease by 0 to 0.7 percent on a static basis under the deduction's repeal. Households in the highest quintile would experience a tax increase of 2.2 percent on their income.[52] Dynamic effects, which take into account changes in behavior associated with taxes, are slightly larger.

50 Tax Foundation, *Options for Reforming America's Tax Code*, http://taxfoundation.org/sites/taxfoundation.org/files/docs/TF_Options_for_Reforming_Americas_Tax_Code.pdf, 49.

51 *Id.*

52 *Id.*

**TABLE 4.**

**After-Tax Income Change by Quintile**

| Income Quintile | Static % Change in After-Tax Income | Dynamic % Change in After-Tax Income |
|---|---|---|
| 0% to 20% | 0.0% | -0.3% |
| 20% to 40% | -0.1% | -0.4% |
| 40% to 60% | -0.3% | -0.6% |
| 60% to 80% | -0.7% | -1.0% |
| 80% to 100% | -2.2% | -2.5% |

Source: Tax Foundation, *Options for Reforming America's Tax Code*.

## Conclusion

Increasingly a costly anachronism which favors high-income earners in wealthy states, the state and local tax deduction has long outlived its usefulness. As such, it is an attractive "pay-for" to provide a revenue offset to rate reductions or other reforms. The House Republican tax plan would repeal the provision outright, while the campaign proposals of President Donald Trump promote caps on itemized deductions, which would limit the value of the deduction.

Whether as part of a plan emerging from one of these proposals, or as part of a tax reform plan still on the horizon, the end of the deduction for state and local taxes paid offers a rare convergence of the goals of both the left and the right, offering the opportunity to roll back a regressive element of the tax code to offset the cost of pro-growth reform. Forty years after the first rumblings of discontent in the Treasury's *Blueprints for Basic Tax Reform*, the repeal of the state and local tax deduction may be an idea whose time has come.

# Response to the federal Tax Cuts and Jobs Act

The passage of the federal Tax Cuts and Jobs Act (TCJA) will have a significant impact on the economy and tax system of New York State. New York State has taken several actions in response to the passage of the federal bill, which are outlined below.

## Preliminary report on the Tax Cuts and Jobs Act of 2017

In January, the Tax Department released a preliminary report to the Governor to outline options for New York State tax reform in response to the TCJA.  The report is divided into four sections.

- Part I outlines a proposal to increase charitable giving in New York State;
- Part II discusses various options for reducing the New York State's reliance on the personal income tax and adopting an employer compensation expense tax, including the possibility of a voluntary employer opt-in system;
- Part III outlines options for consideration of an unincorporated business tax; and
- Part IV discusses the impacts of the TCJA on New York State's tax system and potential responses.

## Actions taken in the FY 2019 Enacted Budget

The Division of the Budget released a summary of certain actions contained in the Enacted Budget (Chapter 59 of 2018). The FY 2019 Budget:

- creates a new state-operated Charitable Gifts Trust Fund to accept donations for the purposes of improving health care and public education in New York State;
- authorizes local governments to establish charitable gift reserve funds and to offer real property tax credits to incentivize contributions; and
- allows employers to opt-in to a new Employer Compensation Expense Program (ECEP).

## Discussion draft of an unincorporated business tax (UBT)

Following up on the options outlined in Part III of the preliminary report, the Tax Department has released a discussion draft of legislation imposing an unincorporated business tax (UBT), including a summary document highlighting key provisions of the draft.

This discussion draft puts forward a statewide UBT for public consideration and comment. The draft would apply a new business tax on partnerships doing business in New York State, while creating a corresponding tax credit for individual and corporate partners of those partnerships.

The purpose of this discussion draft is to allow interested parties the opportunity to provide feedback on both the general concept of a statewide UBT and the specific details involved in the design and implementation of such a tax. To that end, the discussion draft is annotated to note areas for potential comment.

The Tax Department welcomes your input on the draft, and respectfully asks for responses by July 16, 2018. Please send comments to federal.tax.response.comments@tax.ny.gov.

## UBT discussion resources

- Discussion draft
- Summary document

*Updated: May 16, 2018*

# STATE OF NEW YORK

S. 7509--C A. 9509--C

# SENATE - ASSEMBLY

January 18, 2018

IN SENATE -- A BUDGET BILL, submitted by the Governor pursuant to article seven of the Constitution -- read twice and ordered printed, and when printed to be committed to the Committee on Finance -- committee discharged, bill amended, ordered reprinted as amended and recommitted to said committee -- committee discharged, bill amended, ordered reprinted as amended and recommitted to said committee -- committee discharged, bill amended, ordered reprinted as amended and recommitted to said committee

IN ASSEMBLY -- A BUDGET BILL, submitted by the Governor pursuant to article seven of the Constitution -- read once and referred to the Committee on Ways and Means -- committee discharged, bill amended, ordered reprinted as amended and recommitted to said committee -- again reported from said committee with amendments, ordered reprinted as amended and recommitted to said committee -- again reported from said committee with amendments, ordered reprinted as amended and recommitted to said committee

AN ACT intentionally omitted (Part A); to amend the real property tax law, in relation to making the STAR income verification program mandatory; to amend the tax law, in relation to the calculation of income for basic STAR purposes; to repeal subparagraphs (v) and (vi) of paragraph (b) of subdivision 4, paragraphs (b) and (c) of subdivision 5 and paragraph (c) of subdivision 6 of section 425 of the real property tax law relating to the school tax relief (STAR) exemption; and to repeal section 171-o of the tax law relating to income verification for a city with a population of one million or more (Part B); intentionally omitted (Part C); intentionally omitted (Part D); to amend the general municipal law, the education law, the state finance law, the real property tax law and the tax law, in relation to making technical corrections to various statutes impacting property taxes; and to repeal subsection (bbb) of section 606 of the tax law, section 3-d of the general municipal law and section 2023-b of the education law, relating thereto (Part E); intentionally omitted (Part F); to amend the real property tax law, in relation to assessment ceilings; and to amend chapter 475 of the laws of 2013, amending the real property tax law relating to assessment ceilings for local public utility mass real property, in relation to the effectiveness thereof (Part G); to amend

EXPLANATION--Matter in ***italics*** (underscored) is new; matter in brackets [-] is old law to be omitted.

LBD12674-08-8

§ 4-d. Subparagraph (B) of paragraph 2 of subdivision (b) of section 1503 of the tax law, as added by chapter 649 of the laws of 1974, is amended to read as follows:

(B) any part of any income from dividends or interest on any kind of stock, securities or indebtedness, except as provided in subparagraphs (A) [~~and~~]**,** (B) **and (S)** of paragraph one hereof;

§ 4-e. Subparagraph (H) of paragraph 2 of subdivision (b) of section 1503 of the tax law, as amended by section 13 of part FF1 of chapter 57 of the laws of 2008, is amended to read as follows:

(H) in the discretion of the commissioner, any amount of interest directly or indirectly and any other amount directly attributable as a carrying charge or otherwise to subsidiary capital or to income, gains or losses from subsidiary capital**, or to the income described in subparagraph (S) of paragraph one of this subdivision**;

§ 4-f. Paragraph 2 of subdivision (b) of section 1503 of the tax law is amended by adding new subparagraphs (W) and (X) to read as follows:

**(W) The amount of any federal deduction allowed pursuant to subsection (c) of section 965 of the internal revenue code.**

**(X) The amount of any federal deduction allowed pursuant to section 250(a)(1)(A) of the internal revenue code.**

§ 5. This act shall take effect immediately and shall apply to taxable years beginning on or after January 1, 2017.

PART LL

Section 1. The state finance law is amended by adding a new section 92-gg to read as follows:

**§ 92-gg. Charitable gifts trust fund. 1. There is hereby established in the joint custody of the commissioner of taxation and finance and the state comptroller a special fund pursuant to section eleven of this chapter to be known as the "charitable gifts trust fund".**

**2. Moneys in the charitable gifts trust fund shall be kept separate from and shall not be commingled with any other moneys in the custody of the comptroller or the commissioner of taxation and finance. Provided, however that any moneys of the fund not required for immediate use may, at the discretion of the comptroller, in consultation with the director of the budget, be invested by the comptroller in obligations of the United States or the state. The proceeds of any such investment shall be retained by the fund as assets to be used for purposes of the fund.**

**3. Except as set forth in subdivisions two and four of this section, no moneys from the charitable gifts trust fund shall be transferred to any other fund, nor shall moneys from the fund be used to make payments for any purpose other than the purposes set forth in subdivisions two and four of this section.**

**4. The charitable gifts trust fund shall have two separate and distinct accounts, as set forth in paragraphs a and b of this subdivision. Moneys in each of the accounts shall be kept separate from and shall not be commingled with any other moneys of any other account within the fund.**

**a. The "health charitable account" shall consist of monetary grants, gifts or bequests received by the state, and all other moneys credited or transferred thereto from any other fund or source. Moneys of such account shall only be expended for the support of services relating to primary, preventive, and inpatient health care, dental and vision care, hunger prevention and nutritional assistance, and other services for New York state residents with the overall goal of ensuring that New York**

**state residents have access to quality health care and other related services.**

**b. The "elementary and secondary education charitable account" shall consist of monetary grants, gifts or bequests received by the state for the support of elementary and secondary education of children enrolled in public school districts in the state and all other moneys credited or transferred thereto from any other fund or source. Moneys of such account shall only be expended for the provision of elementary and secondary education of children in the state.**

§ 2. Credits for certain charitable contributions to Health Research, Inc. 1. Charitable monetary contributions to Health Research, Inc. (hereinafter "the corporation") that conform to the provisions of this subdivision shall be considered qualified contributions for purposes of the tax credit available pursuant to subsection (iii) of section 606 of the tax law.

(a) Applications for contribution authorization certificates. Contributors seeking to make a qualified contribution to the corporation shall apply to the corporation for a contribution authorization certificate for such contribution. Such application shall be in the form and manner prescribed by the corporation. The corporation may allow contributors to make multiple applications on the same form, provided that each contribution listed on such application shall be treated as a separate application and that the corporation shall issue separate contribution authorization certificates for each such application.

(b) Contribution authorization and receipt certificates. (i) Issuance of certificates. The president of the corporation shall issue contribution authorization certificates in two phases. In phase one, which begins on the first day of January and ends on the thirtieth day of September, the president of the corporation shall accept applications for contribution authorization certificates, but shall not issue any such certificates. Commencing after the first day of October, the president of the corporation shall issue contribution authorization certificates for applications received during phase one, provided that if the aggregate total of the contributions for which applications have been received during phase one exceeds the amount of the contribution cap in paragraph (e) of this subdivision, the authorized contribution amount listed on each contribution authorization certificate shall equal the pro-rata share of the contribution cap. If the contribution cap is not exceeded, phase two commences on October first and ends on November fifteenth, during which period the president of the corporation shall issue contribution authorization certificates on a first-come first-served basis based upon the date the corporation received the contributor's application for such certificate; provided, however, that if on any day the corporation receives applications requesting contribution authorization certificates for contributions that in the aggregate exceed the amount of the remaining available contribution cap on such day, the authorized contribution amount listed in each contribution authorization certificate shall be the contributor's pro-rata share of the remaining available contribution cap. For purposes of determining a contributor's pro-rata share of remaining available contribution cap, the head of the corporation shall multiply the amount of remaining available contribution cap by a fraction, the numerator of which equals the total contribution amount listed on the contributor's application and the denominator of which equals the aggregate amount of contributions listed on the applications for contribution authorization certificates received on such day. Contribution authorization certificates for applications received during phase one shall be mailed no later than the fifteenth day of October. Contribution authorization certificates for applications received during phase two shall be mailed within twenty days of receipt of such applications. Provided, however, that no contribution authorization certificates for applications received during phase two shall be issued until all of the contribution authorization certificates for applications received during phase one have been issued.

(ii) Contribution authorization certificate contents. Each contribution authorization certificate shall state: (A) the date such certificate was issued; (B) the date by which the authorized contributions listed in the certificate must be made, which shall be no later than November thirtieth of the year for which the contribution authorization certificate was issued; (C) the contributor's name and address; (D) the amount of authorized contributions; (E) the contribution authorization certificate's certificate number; and (F) any other information that the president of the corporation or the commissioner of taxation and finance deems necessary.

(c) Certificate of receipt. If a contributor makes an authorized contribution to the corporation no later than the date by which such authorized contribution is required to be made, the corporation shall, within 30 days of receipt of the authorized contribution, issue to the contributor a written certificate of receipt. Each certificate of receipt shall state: (i) the name and address of the corporation; (ii) the contributor's name and address; (iii) the date for each contribution; (iv) the amount of each contribution and the corresponding contribution authorization certificate number; (v) the total amount of contributions; and (vi) any other information that the commissioner of taxation and finance deems necessary.

(d) Notification to the department of the issuance of a certificate of receipt. Upon the issuance of a certificate of receipt, the corporation shall, within thirty days of issuing the certificate of receipt, provide the department of taxation and finance with notification of the issuance of such certificate in the form and manner prescribed by the department of taxation and finance.

(e) Contribution cap. The maximum permitted contributions under this section available annually for calendar year two thousand eighteen and all following years shall be ten million dollars.

2. Use of authorized contributions. The corporation shall develop policies and procedures to ensure that all contributions for which certificates of receipt have been issued are expended only for one or more of the following charitable health purposes: to support and supplement laboratory facilities and programs, including, but not limited to, laboratory testing and scientific research; to support and supplement bioinformatics programs, including, but not limited to, developing public health data analytical strategies; and to support and supplement other public health activities.

§ 3. Credits for certain charitable contributions to University Foundations. 1. Charitable monetary contributions to the State University of New York Impact Foundation (hereinafter "the SUNY foundation") or the Research Foundation of the City University of New York (hereinafter "the CUNY foundation") that conform to the provisions of this subdivision shall be considered qualified contributions for purposes of the tax credit available pursuant to subsection (iii) of section 606 of the tax law.

(a) Applications for contribution authorization certificates. Contributors seeking to make a qualified contribution to the SUNY foundation or the CUNY foundation shall apply to such foundation for a contribution authorization certificate for such contribution. Such application shall be in the form and manner prescribed by the corporation. Each foundation may allow contributors to make multiple applications on the same form, provided that each contribution listed on such application shall be treated as a separate application and that the foundation shall issue separate contribution authorization certificates for each such application.

(b) Contribution authorization and receipt certificates. (i) Issuance of certificates. The head of each foundation shall issue contribution authorization certificates in two phases. In phase one, which begins on the first day of January and ends on the thirtieth day of September, the head of each foundation shall accept applications for contribution authorization certificates, but shall not issue any such certificates. Commencing after the first day of October, the head of each foundation shall issue contribution authorization certificates for applications received during phase one, provided that if the aggregate total of the contributions for which applications have been received during phase one exceeds the amount of the contribution cap in paragraph (e) of this subdivision, the authorized contribution amount listed on each contribution authorization certificate shall equal the pro-rata share of the contribution cap. If the contribution cap is not exceeded, phase two commences on October first and ends on November fifteenth, during which period the head of each foundation shall issue contribution authorization certificates on a first-come first-served basis based upon the date the foundation received the contributor's application for such certificate; provided, however, that if on any day the SUNY foundation or the CUNY foundation receives applications requesting contribution authorization certificates for contributions that in the aggregate exceed the amount of the remaining available contribution cap on such day, the authorized contribution amount listed in each contribution authorization certificate shall be the contributor's pro-rata share of the remaining available contribution cap. For purposes of determining a contributor's pro-rata share of remaining available contribution cap, the head of each foundation shall multiply the amount of remaining available contribution cap by a fraction, the numerator of which equals the total contribution amount listed on the contributor's application and the denominator of which equals the aggregate amount of contributions listed on the applications for contribution authorization certificates received on such day. Contribution authorization certificates for applications received during phase one shall be mailed no later than the fifteenth day of October. Contribution authorization certificates for applications received during phase two shall be mailed within twenty days of receipt of such applications. Provided, however, that no contribution authorization certificates for applications received during phase two shall be issued until all of the contribution authorization certificates for applications received during phase one have been issued.

(ii) Contribution authorization certificate contents. Each contribution authorization certificate shall state: (A) the date such certificate was issued; (B) the date by which the authorized contributions listed in the certificate must be made, which shall be no later than November thirtieth of the year for which the contribution authorization certificate was issued; (C) the contributor's name and address; (D) the amount of authorized contributions; (E) the contribution authorization certificate's certificate number; and (F) any other information that the head of the respective foundation or the commissioner of taxation and finance deems necessary.

(c) Certificate of receipt. If a contributor makes an authorized contribution to the SUNY foundation or the CUNY foundation no later than the date by which such authorized contribution is required to be made, such foundation shall, within thirty days of receipt of the authorized contribution, issue to the contributor a written certificate of receipt. Each certificate of receipt shall state: (i) the name and address of the foundation; (ii) the contributor's name and address; (iii) the date for each contribution; (iv) the amount of each contribution and the corresponding contribution authorization certificate number; (v) the total amount of contributions; and (vi) any other information that the commissioner of taxation and finance deems necessary.

(d) Notification to the department of the issuance of a certificate of receipt. Upon the issuance of a certificate of receipt, the respective foundation shall, within thirty days of issuing the certificate of receipt, provide the department of taxation and finance with notification of the issuance of such certificate in the form and manner prescribed by the department of taxation and finance.

(e) Contribution cap. The maximum permitted contributions under this section available annually for calendar year two thousand eighteen and all following years shall be ten million dollars for the SUNY foundation and ten million dollars for the CUNY foundation.

2. Use of authorized contributions. The SUNY foundation and the CUNY foundation shall develop policies and procedures to ensure that all contributions for which certificates of receipt have been issued are expended only to support programs benefiting students enrolled at the state university of New York and the city university of New York, respectively. Provided however, contributions may not be used for scholarships or tuition assistance.

§ 4. Section 606 of the tax law is amended by adding a new subsection (iii) to read as follows:

**(iii) Credit for contributions to certain funds. For taxable years beginning on or after January first, two thousand nineteen, an individual taxpayer shall be allowed a credit against the tax imposed under this article for an amount equal to eighty-five percent of the sum of: (1) the amount contributed by the taxpayer during the immediately preceding taxable year to any or all of the following accounts within the charitable gifts trust fund set forth in section ninety-two-gg of the state finance law: the health charitable account established by paragraph a of subdivision four of section ninety-two-gg of the state finance law, or the elementary and secondary education charitable account established by paragraph b of subdivision four of section ninety-two-gg of the state finance law; (2) the amount of qualified contributions made by the taxpayer to Health Research, Inc. in accordance with section two of the chapter of the laws of two thousand eighteen that added this subsection; and (3) the amount of qualified contributions made by the taxpayer to the State University of New York Impact Foundation and/or the Research Foundation of the City University of New York in accordance with section three of the chapter of the laws of two thousand eighteen that added this subsection.**

§ 5. Section 1604 of the education law is amended by adding a new subdivision 44 to read as follows:

**44. To establish a charitable fund, by resolution of the trustees, to receive unrestricted charitable monetary donations made to such fund for use by the district for public educational purposes. The monies of such charitable fund shall be deposited and secured in the manner provided by section ten of the general municipal law. The monies of such charitable fund may be invested in the manner provided by section eleven of the general municipal law. Any interest earned or capital gain realized on the money so invested shall accrue to and become part of such fund. At such time and in such amounts as determined by the trustees, the monies of such charitable fund shall be transferred to the school district's general fund for expenditure consistent with the charitable purposes of the fund, provided that the amount of taxes to be levied by the school district for any school year shall be determined without regard to any such transfer. The school district shall maintain an accounting of all such deposits, interest or capital gain, transfers, and expenditures.**

§ 6. Section 1709 of the education law is amended by adding a new subdivision 12-b to read as follows:

**12-b. To establish a charitable fund, by resolution of the board, to receive unrestricted charitable monetary donations made to such fund for use by the district for public educational purposes. The monies of such charitable fund shall be deposited and secured in the manner provided by section ten of the general municipal law. The monies of such charitable fund may be invested in the manner provided by section eleven of the general municipal law. Any interest earned or capital gain realized on the money so invested shall accrue to and become part of such fund. At such time and in such amounts as determined by the board, the monies of such charitable fund shall be transferred to the school district's general fund for expenditure consistent with the charitable purposes of the fund, provided that the amount of taxes to be levied by the school district for any school year shall be determined without regard to any such transfer. The school district shall maintain an accounting of all such deposits, interest or capital gain, transfers, and expenditures.**

§ 7. Section 2590-h of the education law is amended by adding a new subdivision 54 to read as follows:

**54. To establish a charitable fund to receive unrestricted charitable monetary donations made to such fund for use by the city school district for public educational purposes. The monies of such charitable fund shall be deposited and secured in the manner provided by section ten of the general municipal law. The monies of such charitable fund may be invested in the manner provided by section eleven of the general municipal law. Any interest earned or capital gain realized on the money so invested shall accrue to and become part of such fund. At such time and in such amounts as determined by the chancellor, the monies of such charitable fund shall be transferred to the city school district's general fund for expenditure consistent with the charitable purposes of the fund, provided that the amount of taxes to be levied by the city for any school year shall be determined without regard to any such transfer. The city school district shall maintain an accounting of all such deposits, interest or capital gain, transfers, and expenditures.**

§ 8. The general municipal law is amended by adding two new sections 6-t and 6-u to read as follows:

**§ 6-t. Charitable gifts reserve fund. 1. The governing board of any county or New York city may establish a reserve fund to be known as a charitable gifts reserve fund.**

**2. Such fund may receive unrestricted charitable monetary contributions and the moneys in such fund shall be deposited and secured in the**

manner provided by section ten of this article. The governing board, or the chief fiscal officer of such county, or New York city, if the governing board shall delegate such duty to him or her, may invest the moneys in such fund in the manner provided by section eleven of this article. Any interest earned or capital gain realized on the money so deposited or invested shall accrue to and become part of such fund. The separate identity of such fund shall be maintained whether its assets consist of cash or investments or both.

3. At the end of the fiscal year, the governing board of the county or New York city, within sixty days of the close of the fiscal year, shall transfer the funds to the general fund or other fund of the municipal corporation, so that the funds may be used for charitable purposes.

4. The governing board shall establish a procedure for contributions to the charitable gifts reserve fund, which shall include the provision of a written acknowledgment of the gift to the contributor.

§ 6-u. Charitable gifts reserve fund. 1. The governing board of any city with a population less than one million, town or village may establish a reserve fund to be known as a charitable gifts reserve fund.

2. Such fund may receive unrestricted charitable monetary contributions and the moneys in such fund shall be deposited and secured in the manner provided by section ten of this article. The governing board, or the chief fiscal officer of such town, village or city, if the governing board shall delegate such duty to him or her, may invest the moneys in such fund in the manner provided by section eleven of this article. Any interest earned or capital gain realized on the money so deposited or invested shall accrue to and become part of such fund. The separate identity of such fund shall be maintained whether its assets consist of cash or investments or both.

3. At the end of the fiscal year, the governing board of the town, village or city, within sixty days of the close of the fiscal year, may transfer the funds to the general fund or other fund of the municipal corporation, so that the funds may be used for charitable purposes.

4. The governing board shall establish a procedure for contributions to the charitable gifts reserve fund, which shall include the provision of a written acknowledgment of the gift to the contributor.

§ 9. The real property tax law is amended by adding a new section 980-a to read as follows:

§ 980-a. Tax credits for contributions to certain funds. 1. (a) A municipal corporation that has established a fund pursuant to subdivision forty-four of section sixteen hundred four of the education law, subdivision twelve-b of section seventeen hundred nine of the education law, subdivision fifty-four of section twenty-five hundred ninety-h of the education law, or section six-t or six-u of the general municipal law, may adopt a local law, or in the case of a school district, a resolution, authorizing a tax credit to be provided pursuant to this section for contributions to such fund. For purposes of this section, a municipal corporation that has established such a fund and authorized such a credit shall be referred to as a "participating" municipal corporation.

(b) On and after a date specified in the local law or resolution adopted by a participating municipal corporation pursuant to paragraph (a) of this subdivision, the owner or owners of real property shall be allowed a credit against the real property taxes of a participating municipal corporation that have been imposed upon such property. The amount of such credit shall equal ninety-five percent, or such lesser allowable percentage credit as may have been established pursuant to paragraph (c) of this subdivision, of the amount contributed by one or more of the owners of such property during the "associated credit year" as defined in this section, to any or all of the funds established by such municipal corporation, subject to the limit established pursuant to paragraph (c) of this subdivision, if any.

(c) The participating municipal corporation may establish a limit upon the amount or percentage of such credit to be allowed in any given fiscal year, in which case the amount of such credit shall not exceed any limit so established. Any such limit shall be adopted by local law, or in the case of a school district, by resolution, which local law or resolution may either be the same as or separate from the local law or resolution that initially authorized the credit. Once such a limit has been adopted, it may be amended or repealed thereafter by local law, or in the case of a school district, by resolution, provided that any such amendment or repeal shall only apply to taxes of the participating municipal corporation for fiscal years commencing after the adoption of such local law or resolution. A copy of any local law or resolution establishing, amending or repealing such a limit shall be provided to the collecting officer who collects the taxes of the participating municipal corporation.

2. For purposes of this section, the "associated credit year" shall be the twelve-month period during which the owner of the property has made a contribution described in subdivision one of this section that ends on the last day prescribed by law on which the taxes of the participating municipal corporation may be paid without interest or penalties, subject to the following:

(a) Where such taxes are payable in installments, such twelve-month period shall end on the last day prescribed by law on which the first installment of such taxes may be paid without interest or penalties.

(b) Where a participating municipal corporation is a city school district that is subject to article fifty-two of the education law, such twelve-month period shall end on the last day prescribed by law on which city taxes may be paid without interest or penalties, or if applicable, on the last day prescribed by law on which the first installment of such taxes may be paid without interest or penalties.

(c) Each such twelve-month period shall be determined without regard to the possibility that the period prescribed by law for paying such taxes without interest or penalties may be extended due to a delay in the first publication of the collecting officer's notice as provided by sections thirteen hundred twenty-two or thirteen hundred twenty-four of this chapter or a comparable law, or due to an executive order issued in connection with a state disaster emergency as provided by subdivision two of section nine hundred twenty-five-a of this chapter.

3. The credit authorized by this section shall be administered as follows:

(a) The administrator of the fund or its designated agent shall, upon receiving a contribution to the fund specified in subdivision one of this section during a credit year, furnish the property owner with an acknowledgement in duplicate. Such acknowledgement shall be provided on a form prescribed by the commissioner and shall specify the amount of the contribution, the name and address of the donor, the date the contribution was received, the authorized signature of the administrator or agent, and such other information as the commissioner shall require.

(b) After receiving such an acknowledgement, the property owner may present it to the appropriate collecting officer on or before the last day prescribed by law on which taxes may be paid without interest or penalty, together with a credit claim on a form prescribed by the commissioner. Such credit claim form shall contain the name of the property owner or owners, the date and amount of the contributions made to the account during the associated credit year, the address of the property to which the credit claim relates, and such other information as the commissioner shall require. Notwithstanding any provision of law to the contrary, the collecting officer shall thereupon be authorized and directed to grant the property owner a tax credit equal to ninety-five percent, or such lesser allowable percentage credit as may have been established pursuant to paragraph (c) of subdivision one of this section, of the amount of the contributions made during the associated credit year as specified on the acknowledgement, and to reduce the tax liability on the parcel accordingly, provided that such credit may not exceed any percentage credit or other limit established by the participating municipal corporation pursuant to paragraph (c) of subdivision one of this section, if such a limit has been established, and may not exceed the property taxes due or paid that are attributable to the participating municipal corporation. Where taxes are payable in installments, if the credit exceeds the amount of the first installment, the excess shall be applied to future installments until exhausted. The participating municipal corporation may adopt a local law, or in the case of a school district, a resolution, providing that where a property owner submits a credit claim form to the collecting officer prior to the collecting officer's receipt of the tax warrant, or such other date as may be specified in such local law or resolution, the associated property tax bill shall reflect a reduction in the tax liability equal to the credit authorized by this section; provided however that if the collecting officer is not employed by the participating municipal corporation, such local law or resolution shall not take effect unless and until the governing body of the municipal corporation that employs the collecting officer has adopted a resolution agreeing thereto. The department of financial services, in consultation with the department, shall promulgate regulations related to the adjustment of mortgage escrow accounts to reflect the credits provided pursuant to this section.

(c) If the property owner fails to present the acknowledgment and credit claim form to the collecting officer on or before the last day prescribed by law on which taxes may be paid without interest or penalty, he or she may present the same to the chief fiscal officer or chief financial officer of the participating municipal corporation, or to a member of his or her staff. Such officer shall thereupon be authorized and directed to grant the property owner a refund of property taxes in the amount of the credit, which amount shall be equal to ninety-five percent, or such lesser allowable percentage credit as may have been established pursuant to paragraph (c) of subdivision one of this section, of the total contributions made during the associated credit year, provided that such refund shall not exceed the property taxes that have been paid on the property or any percentage credit or other limit established pursuant to paragraph (c) of subdivision one of this section, if any, and may not exceed the property taxes due or paid that are attributable to the participating municipal corporation. Provided further, that no interest shall be payable on such refund if paid within forty-five days of the receipt of the acknowledgment and credit claim form. The owner of the property may file such refund claim with the authorized officer at any time during the three year period beginning immediately after the last day such taxes were payable without interest or penalty.

**4. The amount of the itemized deduction that may be claimed by a taxpayer under section six hundred fifteen of the tax law with respect to the taxes paid on such property may not exceed the amount of the taxes of a participating municipal corporation that have been imposed upon such property minus the amount of the credit provided pursuant to this section.**

§ 10. This act shall take effect immediately; provided, however, that the amendments to section 2590-h of the education law made by section seven of this act shall not affect the expiration and reversion of such section and shall expire and be deemed repealed therewith; and provided further that if section 2590-h of the education law expires or is repealed and is reverted prior to the effective date of this act, section seven of this act shall not take effect.

PART MM

Section 1. The tax law is amended by adding a new article 24 to read as follows:

**ARTICLE 24**

**EMPLOYER COMPENSATION EXPENSE PROGRAM**

**Section 850. Definitions.**
**851. Employer election.**
**852. Imposition and rate of tax.**
**853. Pass through of tax.**
**854. Payment of tax.**
**855. Employee credit.**
**856. Deposit and disposition of revenue.**
**857. Procedural provisions.**

**§ 850. Definitions. For purposes of this article:**

**(a) Employer. Employer means an employer that is required by section six hundred seventy-one of this chapter to deduct and withhold tax from wages.**

**(b) Electing employer. Electing employer is an employer that has made the election provided for in section eight hundred fifty-one of this article.**

**(c) Payroll expense. Payroll expense means wages and compensation as defined in sections 3121 and 3231 of the internal revenue code (without regard to section 3121(a)(1) and section 3231(e)(2)(A)(i)), paid to all covered employees.**

**(d) Covered employee. Covered employee means an employee of an electing employer who is required to have amounts withheld under section six hundred seventy-one of this chapter and receives annual wages and compensation from his or her employer of more than forty thousand dollars annually.**

**§ 851. Employer election. (a) Any employer who employs covered employees in the state shall be allowed to make an annual election to be taxed under this article.**

**(b) In order to be effective, the annual election must be made by (1) if the employer is not a corporation, by any member, owner, or other individual with authority to bind the entity or sign returns required pursuant to section six hundred fifty-three of this chapter; or (2) if the employer is a for-profit or not-for-profit corporation, by any officer or manager of the employer who is authorized under the law of the state where the corporation is incorporated or under the employer's organizational documents to make the election and who represents to having such authorization under penalty of perjury; or (3) if the**

employer is a trust, by the unanimous consent of all trustees; or (4) if the employer is a governmental entity, by the chief executive officer of such governmental entity.

(c) The annual election must be made by December first of each calendar year and will take effect for the immediately succeeding calendar year. If an election is made after December first of a calendar year, it will first take effect in the second succeeding calendar year.

§ 852. Imposition and rate of tax. A tax is hereby imposed on the payroll expense paid by electing employers to covered employees. For two thousand nineteen, the tax shall be equal to one and one-half percent of the payroll expense paid by electing employers to covered employees during the calendar quarter. For two thousand twenty, the tax shall be equal to three percent of the payroll expense paid by electing employers to covered employees during the calendar quarter. For two thousand twenty-one and thereafter, the tax shall be equal to five percent of the payroll expense paid by electing employers to covered employees during the calendar quarter. An electing employer shall only be subject to the tax imposed under this article on the payroll expense paid to any covered employee during the calendar year in excess of forty thousand dollars.

§ 853. Pass through of tax. An employer cannot deduct from the wages or compensation of an employee any amount that represents all or any portion of the tax imposed on the employer under this article.

§ 854. Payment of tax. Employers with payroll expense. The tax imposed on the payroll expense of electing employers under section eight hundred fifty-two of this article must be paid at the same time the electing employer is required to remit payments under section six hundred seventy-four of this chapter; provided however, that electing employers subject to the provisions in section nine of this chapter must pay the tax on the payroll expense at the same time as the withholding tax remitted under the electronic payment reporting system and the electronic funds transfer system authorized by section nine of this chapter.

§ 855. Employee credit. A covered employee shall be allowed a credit against the tax imposed under article twenty-two of this chapter, computed pursuant to the provisions of subsection (ccc) of section six hundred six of this chapter.

§ 856. Deposit and disposition of revenue. All taxes, interest, penalties, and fees collected or received by the commissioner under this article shall be deposited and disposed of pursuant to the provisions of section one hundred seventy-one-a of this chapter.

§ 857. Procedural provisions. (a) General. All provisions of article twenty-two of this chapter will apply to the provisions of this article in the same manner and with the same force and effect as if the language of article twenty-two of this chapter had been incorporated in full into this article and had been specifically adjusted for and expressly referred to the tax imposed by this article, except to the extent that any provision is either inconsistent with a provision of this article or is not relevant to this article. Notwithstanding the preceding sentence, no credit against tax in article twenty-two of this chapter can be used to offset the tax due under this article.

(b) Notwithstanding the provisions of section six hundred ninety-seven of this chapter, if the commissioner determines that a person is liable for any tax, penalty or interest under this article pursuant to subsection (b) of section eight hundred fifty-four of this article, upon request in writing of such person, the commissioner shall disclose in writing to such person (1) the name of any other person the commissioner has determined to be liable for such tax, penalty or interest under this article for the electing employer, and (2) whether the commissioner has attempted to collect such tax, penalty or interest from such other person or electing employer, the general nature of such collection activities, and the amount collected.

(c) Notwithstanding any other law to the contrary, the commissioner may require that all filings of forms or returns under this article must be filed electronically and all payments of tax must be paid electronically. The commissioner may prescribe the methods for quarterly filings by electing employers, including but not limited to, the inclusion of specific employee-level detail.

§ 2. Section 606 of the tax law is amended by adding a new subsection (ccc) to read as follows:

(ccc) Article twenty-four employee credit. A covered employee of an electing employer shall be entitled to a credit against the tax imposed by this article as provided in this subsection. For purposes of this subsection the terms "covered employee" and "electing employer" shall have the same meanings as under section eight hundred fifty of this chapter. (1) For two thousand nineteen, the credit shall be equal to the product of (i) the covered employee's wages and compensation in excess of forty thousand dollars received during the tax year from the electing employer that are subject to tax under this article and (ii) one and one-half percent and (iii) the result of one minus a fraction, the numerator of which shall be the tax imposed on the covered employee as determined pursuant to section six hundred one of this article before the application of any credits for the applicable tax year and the denominator of which shall be the covered employee's taxable income as determined pursuant to this article for the applicable tax year. (2) For two thousand twenty, the credit shall be equal to the product of (i) the covered employee's wages and compensation in excess of forty thousand dollars received during the tax year from the electing employer that are subject to tax under this article and (ii) three percent and (iii) the result of one minus a fraction, the numerator of which shall be the tax imposed on the covered employee as determined pursuant to section six hundred one of this article before the application of any credits for the applicable tax year and the denominator of which shall be the covered employee's taxable income as determined pursuant to this article for the applicable tax year. (3) For two thousand twenty-one and thereafter, the credit shall be equal to the product of (i) the covered employee's wages and compensation in excess of forty thousand dollars received during the tax year from the electing employer that are subject to tax under this article and (ii) five percent and (iii) the result of one minus a fraction, the numerator of which shall be the tax imposed on the covered employee as determined pursuant to section six hundred one of this article before the application of any credits for the applicable tax year and the denominator of which shall be the covered employee's taxable income as determined pursuant to this article for the applicable tax year. If the amount of the credit allowable under this subsection for any taxable year shall exceed the taxpayer's tax for such year, the excess allowed for a taxable year may be carried over to the following year or years and may be deducted from the taxpayer's tax for such year or years.

§ 3. Subdivision 1 of section 171-a of the tax law, as amended by section 15 of part AAA of chapter 59 of the laws of 2017, is amended to read as follows:

1. All taxes, interest, penalties and fees collected or received by the commissioner or the commissioner's duly authorized agent under articles nine (except section one hundred eighty-two-a thereof and except as otherwise provided in section two hundred five thereof), nine-A, twelve-A (except as otherwise provided in section two hundred eighty-four-d thereof), thirteen, thirteen-A (except as otherwise provided in section three hundred twelve thereof), eighteen, nineteen, twenty (except as otherwise provided in section four hundred eighty-two thereof), twenty-B, twenty-one, twenty-two, **twenty-four,** twenty-six, twenty-eight (except as otherwise provided in section eleven hundred two or eleven hundred three thereof), twenty-eight-A, twenty-nine-B, thirty-one (except as otherwise provided in section fourteen hundred twenty-one thereof), thirty-three and thirty-three-A of this chapter shall be deposited daily in one account with such responsible banks, banking houses or trust companies as may be designated by the comptroller, to the credit of the comptroller. Such an account may be established in one or more of such depositories. Such deposits shall be kept separate and apart from all other money in the possession of the comptroller. The comptroller shall require adequate security from all such depositories. Of the total revenue collected or received under such articles of this chapter, the comptroller shall retain in the comptroller's hands such amount as the commissioner may determine to be necessary for refunds or reimbursements under such articles of this chapter out of which amount the comptroller shall pay any refunds or reimbursements to which taxpayers shall be entitled under the provisions of such articles of this chapter. The commissioner and the comptroller shall maintain a system of accounts showing the amount of revenue collected or received from each of the taxes imposed by such articles. The comptroller, after reserving the amount to pay such refunds or reimbursements, shall, on or before the tenth day of each month, pay into the state treasury to the credit of the general fund all revenue deposited under this section during the preceding calendar month and remaining to the comptroller's credit on the last day of such preceding month, (i) except that the comptroller shall pay to the state department of social services that amount of overpayments of tax imposed by article twenty-two of this chapter and the interest on such amount which is certified to the comptroller by the commissioner as the amount to be credited against past-due support pursuant to subdivision six of section one hundred seventy-one-c of this article, (ii) and except that the comptroller shall pay to the New York state higher education services corporation and the state university of New York or the city university of New York respectively that amount of overpayments of tax imposed by article twenty-two of this chapter and the interest on such amount which is certified to the comptroller by the commissioner as the amount to be credited against the amount of defaults in repayment of guaranteed student loans and state university loans or city university loans pursuant to subdivision five of section one hundred seventy-one-d and subdivision six of section one hundred seventy-one-e of this article, (iii) and except further that, notwithstanding any law, the comptroller shall credit to the revenue arrearage account, pursuant to section ninety-one-a of the state finance law, that amount of overpayment of tax imposed by article nine, nine-A, twenty-two, thirty, thirty-A, thirty-B or thirty-three of this chapter, and any interest thereon, which is certified to the comptroller by the commissioner as the amount to be credited against a past-due legally enforceable debt owed to a state agency pursuant to paragraph (a) of subdivision six of section one hundred seventy-one-f of this article, provided, however, he

shall credit to the special offset fiduciary account, pursuant to section ninety-one-c of the state finance law, any such amount creditable as a liability as set forth in paragraph (b) of subdivision six of section one hundred seventy-one-f of this article, (iv) and except further that the comptroller shall pay to the city of New York that amount of overpayment of tax imposed by article nine, nine-A, twenty-two, thirty, thirty-A, thirty-B or thirty-three of this chapter and any interest thereon that is certified to the comptroller by the commissioner as the amount to be credited against city of New York tax warrant judgment debt pursuant to section one hundred seventy-one-l of this article, (v) and except further that the comptroller shall pay to a non-obligated spouse that amount of overpayment of tax imposed by article twenty-two of this chapter and the interest on such amount which has been credited pursuant to section one hundred seventy-one-c, one hundred seventy-one-d, one hundred seventy-one-e, one hundred seventy-one-f or one hundred seventy-one-l of this article and which is certified to the comptroller by the commissioner as the amount due such non-obligated spouse pursuant to paragraph six of subsection (b) of section six hundred fifty-one of this chapter; and (vi) the comptroller shall deduct a like amount which the comptroller shall pay into the treasury to the credit of the general fund from amounts subsequently payable to the department of social services, the state university of New York, the city university of New York, or the higher education services corporation, or the revenue arrearage account or special offset fiduciary account pursuant to section ninety-one-a or ninety-one-c of the state finance law, as the case may be, whichever had been credited the amount originally withheld from such overpayment, and (vii) with respect to amounts originally withheld from such overpayment pursuant to section one hundred seventy-one-l of this article and paid to the city of New York, the comptroller shall collect a like amount from the city of New York.

§ 4. Subdivision 1 of section 171-a of the tax law, as amended by section 16 of part AAA of chapter 59 of the laws of 2017, is amended to read as follows:

1. All taxes, interest, penalties and fees collected or received by the commissioner or the commissioner's duly authorized agent under articles nine (except section one hundred eighty-two-a thereof and except as otherwise provided in section two hundred five thereof), nine-A, twelve-A (except as otherwise provided in section two hundred eighty-four-d thereof), thirteen, thirteen-A (except as otherwise provided in section three hundred twelve thereof), eighteen, nineteen, twenty (except as otherwise provided in section four hundred eighty-two thereof), twenty-one, twenty-two, **twenty-four,** twenty-six, twenty-eight (except as otherwise provided in section eleven hundred two or eleven hundred three thereof), twenty-eight-A, twenty-nine-B, thirty-one (except as otherwise provided in section fourteen hundred twenty-one thereof), thirty-three and thirty-three-A of this chapter shall be deposited daily in one account with such responsible banks, banking houses or trust companies as may be designated by the comptroller, to the credit of the comptroller. Such an account may be established in one or more of such depositories. Such deposits shall be kept separate and apart from all other money in the possession of the comptroller. The comptroller shall require adequate security from all such depositories. Of the total revenue collected or received under such articles of this chapter, the comptroller shall retain in the comptroller's hands such amount as the commissioner may determine to be necessary for refunds or

reimbursements under such articles of this chapter out of which amount the comptroller shall pay any refunds or reimbursements to which taxpayers shall be entitled under the provisions of such articles of this chapter. The commissioner and the comptroller shall maintain a system of accounts showing the amount of revenue collected or received from each of the taxes imposed by such articles. The comptroller, after reserving the amount to pay such refunds or reimbursements, shall, on or before the tenth day of each month, pay into the state treasury to the credit of the general fund all revenue deposited under this section during the preceding calendar month and remaining to the comptroller's credit on the last day of such preceding month, (i) except that the comptroller shall pay to the state department of social services that amount of overpayments of tax imposed by article twenty-two of this chapter and the interest on such amount which is certified to the comptroller by the commissioner as the amount to be credited against past-due support pursuant to subdivision six of section one hundred seventy-one-c of this article, (ii) and except that the comptroller shall pay to the New York state higher education services corporation and the state university of New York or the city university of New York respectively that amount of overpayments of tax imposed by article twenty-two of this chapter and the interest on such amount which is certified to the comptroller by the commissioner as the amount to be credited against the amount of defaults in repayment of guaranteed student loans and state university loans or city university loans pursuant to subdivision five of section one hundred seventy-one-d and subdivision six of section one hundred seventy-one-e of this article, (iii) and except further that, notwithstanding any law, the comptroller shall credit to the revenue arrearage account, pursuant to section ninety-one-a of the state finance law, that amount of overpayment of tax imposed by article nine, nine-A, twenty-two, thirty, thirty-A, thirty-B or thirty-three of this chapter, and any interest thereon, which is certified to the comptroller by the commissioner as the amount to be credited against a past-due legally enforceable debt owed to a state agency pursuant to paragraph (a) of subdivision six of section one hundred seventy-one-f of this article, provided, however, he shall credit to the special offset fiduciary account, pursuant to section ninety-one-c of the state finance law, any such amount creditable as a liability as set forth in paragraph (b) of subdivision six of section one hundred seventy-one-f of this article, (iv) and except further that the comptroller shall pay to the city of New York that amount of overpayment of tax imposed by article nine, nine-A, twenty-two, thirty, thirty-A, thirty-B or thirty-three of this chapter and any interest thereon that is certified to the comptroller by the commissioner as the amount to be credited against city of New York tax warrant judgment debt pursuant to section one hundred seventy-one-l of this article, (v) and except further that the comptroller shall pay to a non-obligated spouse that amount of overpayment of tax imposed by article twenty-two of this chapter and the interest on such amount which has been credited pursuant to section one hundred seventy-one-c, one hundred seventy-one-d, one hundred seventy-one-e, one hundred seventy-one-f or one hundred seventy-one-l of this article and which is certified to the comptroller by the commissioner as the amount due such non-obligated spouse pursuant to paragraph six of subsection (b) of section six hundred fifty-one of this chapter; and (vi) the comptroller shall deduct a like amount which the comptroller shall pay into the treasury to the credit of the general fund from amounts subsequently payable to the department of social services, the state university of New York, the city university of New York, or the higher education services corporation, or the revenue arrearage account or special offset fiduciary account pursuant to section ninety-one-a or ninety-one-c of the state finance law, as the case may be, whichever had been credited the amount originally withheld from such overpayment, and (vii) with respect to amounts originally withheld from such overpayment pursuant to section one hundred seventy-one-l of this article and paid to the city of New York, the comptroller shall collect a like amount from the city of New York.

§ 5. Subdivisions 2, 3 and paragraph (a) of subdivision 5 of section 92-z of the state finance law, subdivision 2 as amended by section 30 of part T of chapter 57 of the laws of 2007, and subdivision 3 and paragraph (a) of subdivision 5 as added by section 1 of part I of chapter 383 of the laws of 2001, are amended to read as follows:

2. Such fund shall consist of [~~twenty-five~~] **(a) fifty** percent of receipts from the imposition of personal income taxes pursuant to article twenty-two of the tax law, less such amounts as the commissioner of taxation and finance may determine to be necessary for refunds**, and (b) fifty percent of receipts from the imposition of employer compensation expense taxes pursuant to article twenty-four of the tax law, less such amounts as the commissioner of taxation and finance may determine to be necessary for refunds**.

3. **(a)** Beginning on the first day of each month, the comptroller shall deposit all of the receipts collected pursuant to section six hundred seventy-one of the tax law in the revenue bond tax fund until the amount of monthly receipts anticipated to be deposited pursuant to the certificate required in paragraph (b) of subdivision five of this section are met. On or before the twelfth day of each month, the commissioner of taxation and finance shall certify to the state comptroller the amounts specified in **paragraph (a) of** subdivision two of this section relating to the preceding month and, in addition, no later than March thirty-first of each fiscal year the commissioner of taxation and finance shall certify such amounts relating to the last month of such fiscal year. The amounts so certified shall be deposited by the state comptroller in the revenue bond tax fund.

**(b) Beginning on the first day of each month, the comptroller shall deposit all of the receipts collected pursuant to section eight hundred fifty-four of the tax law in the revenue bond tax fund until the amount of monthly receipts anticipated to be deposited pursuant to the certificate required in paragraph (b) of subdivision five of this section are met. On or before the twelfth day of each month, the commissioner of taxation and finance shall certify to the state comptroller the amounts specified in paragraph (b) of subdivision two of this section relating to the preceding month and, in addition, no later than March thirty-first of each fiscal year the commissioner of taxation and finance shall certify such amounts relating to the last month of such fiscal year. The amounts so certified shall be deposited by the state comptroller in the revenue bond tax fund.**

(a) The state comptroller shall from time to time, but in no event later than the fifteenth day of each month (other than the last month of the fiscal year) and no later than the thirty-first day of the last month of each fiscal year, pay over and distribute to the credit of the general fund of the state treasury all moneys in the revenue bond tax fund, if any, in excess of the aggregate amount required to be set aside for the payment of cash requirements pursuant to paragraph (b) of this subdivision, provided that an appropriation has been made to pay all amounts specified in any certificate or certificates delivered by the director of the budget pursuant to paragraph (b) of this subdivision as being required by each authorized issuer as such term is defined in section sixty-eight-a of this chapter for the payment of cash requirements of such issuers for such fiscal year. Subject to the rights of holders of debt of the state, in no event shall the state comptroller pay over and distribute any moneys on deposit in the revenue bond tax fund to any person other than an authorized issuer pursuant to such certificate or certificates (i) unless and until the aggregate of all cash requirements certified to the state comptroller as required by such authorized issuers to be set aside pursuant to paragraph (b) of this subdivision for such fiscal year shall have been appropriated to such authorized issuers in accordance with the schedule specified in the certificate or certificates filed by the director of the budget or (ii) if, after having been so certified and appropriated, any payment required to be made pursuant to paragraph (b) of this subdivision has not been made to the authorized issuers which was required to have been made pursuant to such certificate or certificates; provided, however, that no person, including such authorized issuers or the holders of revenue bonds, shall have any lien on moneys on deposit in the revenue bond tax fund. Any agreement entered into pursuant to section sixty-eight-c of this chapter related to any payment authorized by this section shall be executory only to the extent of such revenues available to the state in such fund. Notwithstanding subdivisions two and three of this section, in the event the aggregate of all cash requirements certified to the state comptroller as required by such authorized issuers to be set aside pursuant to paragraph (b) of this subdivision for the fiscal year beginning on April first shall not have been appropriated to such authorized issuers in accordance with the schedule specified in the certificate or certificates filed by the director of the budget or, (ii) if, having been so certified and appropriated, any payment required to be made pursuant to paragraph (b) of this subdivision has not been made pursuant to such certificate or certificates, all receipts collected pursuant to section six hundred seventy-one of the tax law **and section eight hundred fifty-four of the tax law** shall be deposited in the revenue bond tax fund until the greater of [~~twenty-five~~] **forty** percent of the **aggregate of the** receipts from the imposition of **(A)** the personal income tax imposed by article twenty-two of the tax law **and (B) the employer compensation expense tax imposed by article twenty-four of the tax law** for the fiscal year beginning on April first and as specified in the certificate or certificates filed by the director of the budget pursuant to this paragraph or [~~six~~] **a total of twelve** billion dollars has been deposited in the revenue bond tax fund. Notwithstanding any other provision of law, if the state has appropriated and paid to the authorized issuers the amounts necessary for the authorized issuers to meet their requirements for the current fiscal year pursuant to the certificate or certificates submitted by the director of the budget pursuant to paragraph (b) of this section, the state comptroller shall, on the last day of each fiscal year, pay to the general fund of the state all sums remaining in the revenue bond tax fund on such date except such amounts as the director of the budget may certify are needed to meet the cash requirements of authorized issuers during the subsequent fiscal year.

§ 6. Subdivision 5 of section 68-c of the state finance law, as added by section 2 of part I of chapter 383 of the laws of 2001, is amended to read as follows:

5. Nothing contained in this article shall be deemed to restrict the right of the state to amend, repeal, modify or otherwise alter statutes imposing or relating to the taxes imposed pursuant to article twenty-two **and article twenty-four** of the tax law. The authorized issuers shall not include within any resolution, contract or agreement with holders of the revenue bonds issued under this article any provision which provides that a default occurs as a result of the state exercising its right to amend, repeal, modify or otherwise alter the taxes imposed pursuant to article twenty-two **and article twenty-four** of the tax law.

§ 7. This act shall take effect immediately; provided, however, that the amendments to subdivision 1 of section 171-a of the tax law made by section three of this act shall not affect the expiration of such subdivision and shall expire therewith, when upon such date the provisions of section four of this act shall take effect.

PART NN

Section 1. The opening paragraph of subdivision 7 of section 221 of the racing, pari-mutuel wagering and breeding law, as amended by section 2 of part SS of chapter 59 of the laws of 2017, is amended to read as follows:

In order to pay the costs of the insurance required by this section and by the workers' compensation law and to carry out its other powers and duties and to pay for any of its liabilities under section fourteen-a of the workers' compensation law, the New York Jockey Injury Compensation Fund, Inc. shall ascertain the total funding necessary and establish the sums that are to be paid by all owners and trainers licensed or required to be licensed under section two hundred twenty of this article, to obtain the total funding amount required annually. In order to provide that any sum required to be paid by an owner or trainer is equitable, the fund shall establish payment schedules which reflect such factors as are appropriate, including where applicable, the geographic location of the racing corporation at which the owner or trainer participates, the duration of such participation, the amount of any purse earnings, the number of horses involved, or such other factors as the fund shall determine to be fair, equitable and in the best interests of racing. In no event shall the amount deducted from an owner's share of purses exceed two per centum; provided, however, for two thousand [~~seventeen~~] **eighteen** the New York Jockey Injury Compensation Fund, Inc. may use up to two million dollars from the account established pursuant to subdivision nine of section two hundred eight of this article to pay the annual costs required by this section and the funds from such account shall not count against the two per centum of purses deducted from an owner's share of purses. The amount deducted from an owner's share of purses shall not exceed one per centum after April first, two thousand twenty. In the cases of multiple ownerships and limited racing appearances, the fund shall equitably adjust the sum required.

§ 2. Paragraph (a) of subdivision 9 of section 208 of the racing, pari-mutuel wagering and breeding law, as amended by section 2 of part PP of chapter 60 of the laws of 2016, is amended to read as follows:

(a) The franchised corporation shall maintain a separate account for all funds held on deposit in trust by the corporation for individual horsemen's accounts. Purse funds shall be paid by the corporation as required to meet its purse payment obligations. Funds held in horsemen's accounts shall only be released or applied as requested and directed by subdivision shall be equivalent to, and shall not be more restrictive than, those established by the New York State Urban Development Corporation, doing business as the Empire State Development Corporation, in the grant programs it administered pursuant to part H of chapter 56 of the laws of 2011. In providing assistance pursuant to this subdivision, the New York state urban development corporation shall give preference to applicants that demonstrate the greatest need, based on available flood damage data provided by applicable state and/or federal agencies.

§ 2. Paragraph (c) of subdivision 3 of section 1 of part A of chapter 85 of the laws of 2017, relating to creating the Lake Ontario-St. Lawrence Seaway flood recovery and International Joint Commission Plan 2014 mitigation grant program, as amended by section 2 of part J of chapter 61 of the laws of 2017, is amended to read as follows:

(c) The affordable housing corporation shall administer this grant program, which shall not exceed in the aggregate $15,000,000 **plus any funds directed from the programs authorized in subdivisions 2 and 4 of this section**. Such corporation and other relevant state agency or state authorities are hereby empowered to establish grant guidelines and additional eligibility criteria as deemed necessary to effectuate the administration of this program. Any grant guidelines and eligibility criteria established by the corporation pursuant to this subdivision shall be equivalent to, and shall not be more restrictive than, those established by the New York State Urban Development Corporation, doing business as the Empire State Development Corporation, in the grant programs it administered pursuant to part H of chapter 56 of the laws of 2011. In providing assistance pursuant to this subdivision, the affordable housing corporation shall give preference to applicants that demonstrate the greatest need, based on available flood damage data provided by applicable state and/or federal agencies.

§ 3. Paragraph (c) of subdivision 4 of section 1 of part A of chapter 85 of the laws of 2017, relating to creating the Lake Ontario-St. Lawrence Seaway flood recovery and International Joint Commission Plan 2014 mitigation grant program, as amended by section 2 of part J of chapter 61 of the laws of 2017, is amended to read as follows:

(c) The housing trust fund corporation shall administer this grant program, which shall not exceed in the aggregate $15,000,000 **plus any funds directed from the programs authorized in subdivisions 2 and 3 of this section**. Such corporation, and other relevant state agencies or state authorities, is hereby empowered to establish grant guidelines and additional eligibility criteria, based on available flood damage data provided by applicable state and/or federal agencies, as it deems necessary to effectuate the administration of this program. Any grant guidelines and eligibility criteria established by the corporation pursuant to this subdivision shall be equivalent to, and shall not be more restrictive than, those established by the New York State Urban Development Corporation, doing business as the Empire State Development Corporation, in the grant programs it administered pursuant to part H of chapter 56 of the laws of 2011. In providing assistance pursuant to this subdivision, the corporation shall give preference to applicants that demonstrate the greatest need, based on available flood damage data provided by applicable state and/or federal agencies.

§ 4. This act shall take effect immediately.

PART EEE

Section 1. The tax department shall be required to set up an online application system for taxpayers to submit claims for reimbursements of payments of interest on fixed and final determinations of underpayments of federal tax liability for the 2019, 2020 and 2021 tax year that arise from the taxpayers' reliance on amendments to the tax law enacted in the year 2018. In order to receive such reimbursement, taxpayers shall be required to submit their reimbursement claims to the department of taxation and finance within 60 days of making their payments of interest to the internal revenue service.

§ 2. This act shall take effect immediately.

PART FFF

Section 1. This Part enacts into law major components of legislation relating to the conversion of certain entities that have been issued certificates of authority pursuant to article forty-four of the public health law. Each component is wholly contained within a Subpart identified as Subparts A and B. The effective date for each particular provision contained within such Subpart is set forth in the last section of such Subpart. Any provision in any section contained within a Subpart, including the effective date of the Subpart, which makes a reference to a section "of this act", when used in connection with that particular component, shall be deemed to mean and refer to the corresponding section of the Subpart in which it is found. Section three of this Part sets forth the general effective date of this Part.

SUBPART A

Section 1. The state finance law is amended by adding a new section 92-hh to read as follows:

**§ 92-hh. Health care transformation fund. 1. There is hereby established in the joint custody of the state comptroller and the commissioner of taxation and finance a fund to be known as the "health care transformation fund".**

**2. Such fund shall consist of moneys paid thereto from (a) contingent reserves redeployed pursuant to section forty-four hundred sixteen of the public health law, (b) moneys transferred to such fund pursuant to law, and (c) contributions, consisting of grants of any money, including grants or other financial assistance from any agency of government or any other source, to be paid into this fund.**

**3. Moneys in the health care transformation fund shall be kept separate and shall not be commingled with any other moneys in the custody of the state comptroller and the commissioner of taxation and finance.**

**4. Notwithstanding any provision of law to the contrary, moneys of the health care transformation fund shall be available for transfer to any other fund of the state as authorized and directed by the director of the budget to support health care delivery, including for capital investment, debt retirement or restructuring, housing and other social determinants of health, or transitional operating support to health care providers.**

**5. Within fifteen days after executing or modifying an allocation, transfer, distribution or other use of the health care transformation fund, the commissioner shall provide written notice to the chairs of the senate finance committee, the assembly ways and means committee, the senate and assembly insurance committees, and the senate and assembly health committees. Such notice shall include, but shall not be limited**

MAYER • BROWN

Mayer Brown Legal Update
18 May 2018

# Using a Sledgehammer to Kill a Fly: New York State Considers Unincorporated Business Tax and Seeks Comments

The New York State Department of Taxation and Finance (Department) just released for comment a draft bill to enact a new unincorporated business tax (UBT). The Department's stated purpose for the new UBT is to provide relief to individual New York State (State) taxpayers who would be subject to the new federal $10,000 state tax deduction limitation, part of the federal Tax Cuts and Jobs Act of 2017. While that is a laudable goal, the proposal as currently drafted appears to generate substantially more revenue for the State—at the expense of partnerships doing business in New York—than the benefit to individual partners would seem to justify. In other words, enactment of the proposed UBT appears to be a revenue raiser, and a substantial one at that. If the goal of the State's UBT proposal is to provide the same type of relief as it provided to wage earners via its recently enacted voluntary employer payroll tax, then the State's UBT should likewise allow companies to opt in rather than be mandatory.

We applaud the Department for releasing a draft of the UBT proposal and seeking comments from interested parties. This is consistent with the open, collaborative relationship between the Department, taxpayers and practitioners that existed during New York State's 2014 tax reform. To that end, Mayer Brown will be submitting comments on its own behalf and for clients and would be happy to discuss possible additional comments or submissions.

***Current regime***

Currently, the State does not directly impose tax on partnerships and multi-member limited liability companies doing business in the State.[1] However, New York State previously had a UBT. The State's original UBT was enacted in 1935 as a "temporary" tax, making it permanent in 1960 as Article 23 of the Tax Law. The State's stated goal in enacting the original UBT was to impose a tax on noncorporate enterprises that competed with corporations subject to the State's franchise tax. The State's UBT was repealed in 1978 effective for taxable years beginning after December 31, 1981, and was phased out via rate reductions during the interim period. New York City also enacted its own UBT (City UBT) in 1966, which was patterned after the State's original UBT. The City UBT is imposed on partnerships and multi-member limited liability companies doing business in New York City, with long-standing exemptions for certain self-trading and real estate management activities.

After our overview of the current proposal, we consider how the proposed State UBT would handle some of the issues that we regularly encounter in City UBT audits.

***Overview of the State's UBT proposal***

The proposed UBT would apply to entities treated as partnerships for federal purposes. As currently drafted, that includes partnerships and multi-member limited liability companies but not single-member limited liability companies, which would continue to be disregarded into their members.

A 5% tax would be imposed on those partnerships "doing business" in New York State. The term "doing business" is not defined, but as proposed, the personal income tax provisions in Article 22 would apply. New York State's Article 9-A was recently changed to an economic nexus standard from a physical presence nexus standard, but that change was not made for insurance companies or utilities and—most importantly—Article 22's personal income tax. Coupled with the apportionment provision—which assigns gross income in connection with activities occurring in New York State—a physical presence would likely be required before a partnership would have apportionable income.

The City UBT excludes companies engaged in self-trading activities and those whose activities are limited to managing real estate from the tax. The State UBT proposal does not *explicitly* carve out those activities from "doing business" or eliminate the resulting income from the tax base. However, as discussed in the next paragraph, such income may not be included in the State UBT tax base at all. In addition, there is a possibility the State's UBT will be voluntary—which would create an opportunity for those entities not to opt in. If self-trading and real estate partnerships are taxable under the proposed regime, this would be a major shift in policy and one that could cause New York City to reconsider its exemptions as it continues its efforts to reform the City UBT.

The Department is expressly seeking comments on what should be treated as unincorporated taxable income. As currently proposed, the tax base would be federal ordinary business income with an addback for UBT tax and an addback for guaranteed payments to partners. The reference to federal ordinary business income includes a reference to I.R.C. § 702(a)(8), which describes taxable income that is not separately stated under other provisions of § 702(a). Rental income and portfolio income may fall outside of (a)(8) because they may require separate computation in (a)(1) through (7). This suggests that self-trading and real estate managing partnerships would not include such income in their State UBT tax base. We look forward to clarification on this point and hope that any clarification offered recognizes the long-standing non-taxability of partnerships engaged in those activities and the ease of moving investment activities out-of-state.

The tax base portion of the proposed UBT is notably silent on some of the more contentious income-affecting provisions found in federal tax reform, including the section 163(j) interest expense deduction limitation, section 951A GILTI inclusion, and section 965 repatriation toll charge. Given that the stated purpose for the proposed UBT is to help New York taxpayers address unfavorable aspects of federal tax reform, we would urge the Department to address these aspects of the federal reform similarly (i.e., by providing relief).

Under Article 9-A, prior to apportionment, corporate income is divided into several buckets, some of which are exempt; under the City UBT, income is divided into investment income and business income, and each is apportioned separately. Here, with the State UBT, a lump sum of income would be apportioned by a single formula. If the reference to federal ordinary business income excludes investment income, then the regime would be consistent with New York's "headquarter's favorable" regime. Otherwise, this would be a departure from New York's historic approach to treating certain types of income more favorably than other income.

The proposal includes equally weighted three-factor apportionment, comprising property, payroll and gross income percentages. The proposal is short on details as to how each would be computed, and we assume regulations would flesh that out at a later date. The gross income factor, interestingly, could be read to include only sales of services and assigns those services to the office where the sales are negotiated, consummated or performed. However, the proposed statutory language is identical to the Article 22 regulation on "gross income percentage," 20 NYCRR 132.15(f), which the Department views as including receipts from all sales and not just those related to sales of services.

Partnerships will compute their tax on an entity-level basis, adding the already apportioned income of lower-tier partnerships to their own already apportioned income and receiving credits for the State UBT paid by lower-tier entities.

The proposed State UBT contains a credit for partners filing other New York returns. Recall that the purpose for restoring the State UBT is to generate a credit that can be applied against a partner's New York personal income tax liability. For partnerships whose partners are not New York taxpayers (e.g., where a partnership is doing business but its corporate or individual partners are not themselves New York taxpayers), the credit is of little to no value. For corporate and individual partners in an overall loss position, the credit is not refundable, but it can be carried forward indefinitely.

Two preliminary items should be explained before getting to the credit computations. First, for purposes of the credits, a partner's "ownership percentage" is not its technical actual ownership percentage. Rather, it is the partner's relative portion of distributed income, gain, loss and deductions, and guaranteed payments. This means that special allocations and other income distribution agreements could result in a 50/50 partnership—based on capital ownership— having a different "ownership percentage" for UBT purposes. Because the economics of many partnerships were designed without a State UBT in mind, perhaps the New York State Legislature should consider allowing partners to elect to allocate the credit consistent with the overall economics of the partnership rather than just based on proportionate distributions.

Second, a partnership that is itself a partner in a lower-tier partnership must compute its own unincorporated business credit (UBC) before its partners compute their credits. A partnership's UBC is the partnership's ownership percentage (i.e., relative distribution percentage) multiplied by the greater of the lower-tier partnership's UBT or the lower-tier partnership's UBC. In computing the UBC for determining various upstream entities' credits, there is no limitation applied to the UBC. However, when determining the UBC that a particular partner can actually take, the limitation discussed below is applied.

For partners who are partnerships, the UBC will be the taxpayer-partnership's ownership percentage multiplied by the greater of the UBT of the partnership or the partnership's UBC. For this computation, the limitation in proposed § 862(a)(3), which prevents the partnership from reducing tax below zero and prevents any carryforward of unused credit, applies.

For partners who are individuals, a credit against New York State Personal Income Tax is available. The credit would be the taxpayer-partner's ownership percentage in the partnership multiplied by 93% multiplied by the greater of the partnership's UBT or its UBC. Credit from multiple partnerships can be added together. If the credit exceeds the taxpayer-partner's tax, the excess can be carried indefinitely. For New York State residents, the value of the credit seems readily identifiable. But for nonresidents, receiving a credit against New York State tax may not provide any relief in the nonresident individual's home state resident tax return. For example, depending on how the state of residence determines what counts toward that state's credit for taxes paid to other jurisdictions, the nonresident may not receive any economic benefit at all. If that is the case, then the entire State UBT regime's purported benefit—to provide relief to those taxpayers impacted by the federal SALT deduction limitation—would be meaningless to nonresident partners.

For partners that are corporations, the credit would be the taxpayer's ownership percentage in the partnership multiplied by 93% multiplied by the greater of the partnership's UBT or its UBC. Credit from multiple partnerships can be added together. If the credit exceeds the taxpayer's tax in excess of the taxpayer's fixed dollar minimum tax, such excess can be carried forward indefinitely.

Finally, something that will likely be a relief to partners, but may be less of a relief to some partnerships: Under the proposal, the Department will have the authority to share partnership returns and "information" with the partners. A lack of partnership data was a significant concern for some corporate partners attempting to determine whether partnerships—the actions of which were not visible to those partners—had done certain things that are required under Article 9-A for income to qualify as investment income.

***Does the proposed State UBT resolve the murky issues that partners and partnerships regularly face under the City UBT?***

Yes, no, and maybe.

Some of the issues we see regularly are addressed here. For example, expense attribution takes a leading role in some City UBT audits; however, that would not appear to an issue here as only a limited set of expenses would be disallowed (UBT tax and guaranteed payments). Questions regularly arise regarding apportionment of flow-through income, particularly if the lower-tier entity has a full or partial exemption from the City UBT. Here, the entity-level apportionment is black-and-white (though we think the City's rules are clear on this point). Similarly, the State's UBT proposal addresses the implications of a change in accounting method (under I.R.C. § 481) more cleanly than do the City UBT's provisions.

However, the State UBT's silence on whether self-trading and real estate management are exempt may cause some consternation (though the reference to federal ordinary business income and I.R.C. § 702(a)(8) should alleviate that concern). Similarly, the rather limited apportionment guidance will be a problem. Then again, we expect that both of these issues will be addressed prior to enactment. The question, of course, is *how* they will be addressed. Deductibility of certain payments to partners is a common audit issue in the City; here it is clear that whatever payments are treated as guaranteed payments are not deductible, whereas other payments to partners would not be added back.

***Comments requested***

As mentioned earlier, the Department has asked for comments on its draft proposal. Our hope is that commentary will aid the Department in honing the UBT proposal to better address its stated purpose of swatting the federal SALT deduction limitation for New York taxpayers.

The deadline for submitting comments to the Department is July 16, 2018. The resulting UBT may be as game-changing as another event on that day in history, the July 16, 1969 launch of Apollo 11, carrying the first men to land on the moon.

[1] Although nonpayment can result in the partnership having liability, any "withholding tax" payments made by the partnership on behalf of nonresident partners is not considered a tax imposed on the partnership for this discussion.

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# BUSINESS COUNCIL
# FY 2019 BUDGET SUMMARY - TAXATION

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# Highlights from the 2019 Budget Bill

By Timothy P. Noonan on April 11, 2018

Yesterday we put out an "Alert" the Governor's final 2019 budget bill. It contains everything you need to know about what tax provisions passed in the budget (and what did not pass).

Here at the Noonan's Notes Blog, we've been following the process closely (see my prior report on the proposed budget here). Here's my take on how everything shook out:

**The New ECET System.** The new "payroll tax" passed! I'll admit that I was skeptical of this. I didn't think that the Legislature would actually pass the payroll tax bill, which essentially is one of the countermeasures set forth by Governor Cuomo to combat the negative effects felt by New Yorkers from the loss of the SALT deduction. More on that proposal here. But, alas, the Legislature passed the bill, and now there is a new "Employer Compensation Expense Tax" system on the books. This is not a mandatory tax; an employer would have to elect into the program. Will anyone do so? At this point it's hard to tell. The ECET system appears pretty complicated, and will affect different employers and employees in significantly different ways.

## About This Blog

Noonan's Notes Blog is written by a team of Hodgson Russ tax attorneys led by the blog's namesake, Tim Noonan. Noonan's Notes Blog regularly provides analysis of and commentary on developments in the world of New York and multistate tax law. Noonan's Notes Blog is a winner of CreditDonkey's Best Tax Blogs Award 2017.

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## Topics

**"Charitable" Tax Payments.** The charitable deduction thing passed too! This was part two of the Governor's SALT deduction countermeasure, essentially allowing taxpayers to substitute charitable contributions for tax payments. Details are in our Alert, and at this point it's unclear whether the IRS would actually allow the claimed charitable deduction that this New York tax provision contemplates. Overall, good for New York for giving it a try. It will be interesting to see if it works.

**New statute of limitations rule for amended tax returns.** Under prior law, if I filed an amended return a couple days before the expiration of the normal three year statute of limitations, this didn't reopen the statute of limitations for the entire tax return. Instead, the Tax Department could audit my amended return and challenge my refund claim. They could even look to other areas of my tax return to offset any potential refund. But they could not assess me any additional taxes if they found problems on my amended return. Well, that's now changed. Now the tax department has an extra year to find additional tax liabilities for taxpayers who file amended returns. We're not wild about the approach here (see commentary from the infamous TiNY blogger here), in part because it's unnecessary, and in part because it seems to be a clear way to discourage the filing of amended returns seeking refunds. Whatever the case, this is now something additional that taxpayers will have to consider before filing amended returns.

***Sobotka* Reversed.** A couple years ago we won the Sobotka case, where an administrative law judge in New York's Division of Tax Appeals held that the "183-day rule" under New York's statutory residency rule did not apply to taxpayers who had a change of domicile during the tax year. More specifically, the judge held that the only days that counted for the 183-day rule test were days in the non-resident portion of the taxpayer's tax year. The tax department did not like this decision, and legislation was proposed to reverse the result. But the proposal was styled as a "clarification," meaning that the change was supposed to apply to all open tax years. Well, the change went through it, but it was not retroactive! Instead, this is a prospective change only, beginning for tax years in 2019. That means that for tax years prior to 2019, the *Sobotka* issue is very much alive!

**Responsible Person Relief**: This is just a codification of current tax department policy set forth in a 2011 technical memorandum (that apparently no longer exists; the tax department pulled in from their website). Basically, the idea is to limit the harshness of New York's *per*

Credits and Incentives
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Multistate Matters
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New York Residency Stuff

*se* liability rule for members of limited liability companies and limited partners. Again, the tax department has been applying this policy for years, but arguably the policy was inconsistent with the statute. This change just codifies that policy. Kudos to the tax department for doing this; it is sensible to put this policy into law.

**What didn't pass?** The somewhat goofy law to subjecting carried interest to an additional seventeen percent (17%) tax didn't pass. Also—and thankfully as far as I'm concerned—the proposal to allow the tax department to appeal adverse Tax Appeals Tribunal decisions didn't make it. Finally, the tax department's effort to impose nexus obligations on "marketplace providers" like Amazon sellers also didn't pass. Of course, this whole nexus discussion may all be moot if the U.S. Supreme Court overturns the *Quill* physical presence rule in the upcoming *Wayfair* case. Oral arguments in that case are set for this month, so we'll be following it closely.

Topics: Tax Reform

Guidance on Certain Payments Made in Exchange for State and Local Tax Credits

NOTICE 2018-54

SECTION 1. PURPOSE

This notice informs taxpayers that the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) intend to propose regulations addressing the federal income tax treatment of certain payments made by taxpayers for which taxpayers receive a credit against their state and local taxes.

SECTION 2. BACKGROUND

Section 11042 of "The Tax Cuts and Jobs Act," Pub. L. No. 115-97, limits an individual's deduction under § 164 for the aggregate amount of state and local taxes paid during the calendar year to $10,000 ($5,000 in the case of a married individual filing a separate return). State and local tax payments in excess of those amounts are not deductible. This new limitation applies to taxable years beginning after December 31, 2017, and before January 1, 2026.

In response to this new limitation, some state legislatures are considering or have adopted legislative proposals that would allow taxpayers to make transfers to funds controlled by state or local governments, or other transferees specified by the state, in exchange for credits against the state or local taxes that the taxpayer is required to pay. The aim of these proposals is to allow taxpayers to characterize such transfers as fully deductible charitable contributions for federal income tax purposes, while using the same transfers to satisfy state or local tax liabilities.

Despite these state efforts to circumvent the new statutory limitation on state and local tax deductions, taxpayers should be mindful that federal law controls the proper characterization of payments for federal income tax purposes.

SECTION 3. GUIDANCE TO BE ISSUED

The Treasury Department and the IRS intend to propose regulations addressing the federal income tax treatment of transfers to funds controlled by state and local governments (or other state-specified transferees) that the transferor can treat in whole or in part as satisfying state and local tax obligations. The proposed regulations will make clear that the requirements of the Internal Revenue Code, informed by substance-over-form principles, govern the federal income tax treatment of such transfers. The proposed regulations will assist taxpayers in understanding the relationship between the federal charitable contribution deduction and the new statutory limitation on the deduction for state and local tax payments.

SECTION 4. DRAFTING INFORMATION

The principal authors of this notice are Mon Lam and Merrill Feldstein of the Office of Associate Chief Counsel (Income Tax & Accounting). Other personnel from the Treasury Department and the IRS participated in its development. For further information regarding this notice, contact Ms. Lam or Ms. Feldstein at (202) 317-5100 (not a toll-free call).

MAYER • BROWN

Mayer Brown Legal Update
23 May 2018

# IRS to Propose Regulations on Certain States' SALT Deduction Charitable Contribution Workaround

The US Internal Revenue Service (IRS) issued Notice 2018-54 (Notice) announcing its intention to propose regulations that could impact the viability of the charitable contribution workaround to the state and local tax deduction limitation enacted in the Tax Cuts and Jobs Act (the "Tax Act"). The annual $10,000 limitation ($5,000 for individuals) hit taxpayers in certain states particularly hard and several states such as New York, California, Illinois, Rhode Island and Vermont quickly responded by proposing legislation that would allow their citizens to make charitable contributions to state-created funds and receive credits that could be applied against their state tax liabilities. On April 12, 2018, New York became the first state to sign into law provisions that would allow individuals to deduct 85% of the donations they make to certain newly created funds and charitable organizations.

The Notice reminds taxpayers to "be mindful that federal law controls the proper characterization of payments for federal income tax purposes" and warns that the " proposed regulations will make clear that the requirements of the Internal Revenue Code, informed by substance-over-form principles, govern the federal income tax treatment of such transfers."

The tenor of the Notice strongly suggests that the IRS will distinguish Chief Counsel Advice Memorandum 201105010 (CCA), released February 4, 2011, which addressed whether a payment to a state agency is considered a charitable contribution if the payment entitles the taxpayer to a state tax credit and concluded that a reduction in tax liability attributable to a charitable contribution of cash and appreciated stock is not consideration that might constitute a quid pro quo for purposes of the charitable deduction. However, the CCA cautioned that "there may be unusual circumstances in which it would be appropriate to recharacterize a payment of cash or property that was, in form, a charitable contribution as, in substance, a satisfaction of tax liability."

Given the reference in the Notice to substance-over-form principles, we expect that the proposed regulations will view the states' charitable deduction workaround as an appropriate circumstance to warrant recharacterization of the charitable deductions as state tax payments subject to the Tax Act's limitation.

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May 23, 2018

# SALT/Charitable Workaround Credits Require a Broad Fix, Not a Narrow One

REPORT (/category/reports)

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### *Narrow Federal Action Would be Unfair, Arbitrary, and Ineffective*

## EXECUTIVE SUMMARY

The federal Tax Cuts and Jobs Act (TCJA) enacted last year temporarily capped deductions for state and local tax (SALT) payments at $10,000 per year. The cap, which expires at the end of 2025, disproportionately impacts taxpayers in higher-income states and in states and localities more reliant on income or property taxes, as opposed to sales taxes. Increasingly, lawmakers in those states who feel their residents were unfairly targeted by the federal law are debating and enacting tax credits that can help some of their residents circumvent this cap—a policy this report will refer to as “workaround credits.” Specifically, states are offering sizeable tax credits in return for making so-called charitable gifts, rather than ordinary SALT payments, to support public services. This is advantageous to some taxpayers because charitable gifts are treated much more favorably than SALT payments under the new federal tax code.

For taxpayers, using these credits will result in a somewhat higher payment to their state governments (or in some cases, local governments) because the credits only offset part of the cost of donating. In New York, for instance, 85 percent of the donation is returned to the donor with tax credits. But for high-income taxpayers able to itemize at the federal level, the added benefits of the federal charitable deduction will often be large enough to both offset that higher state payment and return a net financial benefit to the taxpayer. Notably, most of the high-income taxpayers likely to benefit from these credits already received significant federal tax cuts under the TCJA.

One unusual result of this arrangement is that for state governments, the “tax cut” associated with the credits will produce an overall revenue gain because the donations expected to flow into state coffers will be larger than the credits flowing out (as noted above, every dollar received by New York’s government only triggers 85 cents of state tax credit payouts). More fundamentally, these credits shift state funding streams away from partly deductible tax payments and toward fully deductible payments that the federal government considers to be charitable gifts. The magnitude of this shift remains to be seen, however, as it will depend on how many taxpayers choose to take advantage of these credits.

Now that a critical mass of states has adopted these credits (including New York, New Jersey, Connecticut, and Oregon as of this writing), the focus of the debate will shift toward the federal level and whether the Internal Revenue Service (IRS), Treasury Department, and/or Congress will allow these workaround credits to proceed as state lawmakers have planned. This report makes the following findings about potential federal responses to these new workaround credits, and to state charitable tax credits more broadly:

- **During last year's rushed debate over the TCJA, Congress was informed that states and localities were likely to respond to the SALT cap with these types of tax credit schemes, but it ultimately did nothing to prevent them.** Much of the debate around this topic has now shifted to whether the IRS has the authority to clean up the mess that Congress left behind, or whether legislation will be needed to address this issue.
- **Many observers have responded to these workaround credits with skepticism and shock, and understandably so.** The gifts being made under these schemes are not truly "charitable" according to any commonsense definition of that word, since the taxpayers are made financially better off by their gifts.
- **But fixing this problem will be more difficult than many observers have recognized, as it runs much deeper than these new workaround credits.** While these workaround credits have attracted significant attention in recent months, this type of abuse of the charitable giving deduction has been occurring for many years. Taxpayers have long claimed federal charitable deductions on so-called "charitable gifts" for which the taxpayer received a reimbursement from their state government via a tax credit.
- **The closest parallel to these workaround credits in existing tax law is a policy typically favored by conservatives: tax credits that steer funding to**

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**private K-12 school vouchers. Tax accountants, private schools, and others in states with such credits have long marketed these programs as tools for exploiting the federal charitable deduction, and in the wake of the new federal tax law they are now using language that mirrors that used by proponents of the new workaround credits.** While blue-state efforts to circumvent the SALT cap have attracted more attention, financial advisors in deep-red Alabama and elsewhere are touting the ability of their existing charitable tax credits to help their residents "avoid losing" their SALT deductions. And the sales pitch has proven persuasive. Alabama's entire allotment of private school tax credits was claimed more quickly this year than ever before.

- **Some observers have suggested that the IRS or Treasury Department could intervene with narrowly targeted guidance or a regulation affecting these new workaround credits, but not other pre-existing state charitable credits.** This approach would be highly problematic because the new workaround credits have much more in common with existing charitable tax credits than is commonly understood.
- **Narrow federal action would be unfair because it would treat similarly situated taxpayers differently depending on the types of causes to which they donate.** For example, narrow federal action would likely involve denying tax-credit-reimbursed deductions on donations to public schools, but not private schools, even if the impact of those two types of donations on taxpayers and state coffers was identical.
- **Narrow federal action would require making arbitrary distinctions between different types of organizations receiving donations.** Existing state charitable tax credits steer donations to a wide range

of entities, including government agencies, public institutions, other levels of government, public-private partnerships, and private nonprofits providing services very similar to what a state government might otherwise provide. There is no way to draw a defensible line between the various types of organizations within this broad spectrum.

- **Narrow federal action would be ineffective because limiting the federal charitable deduction only for gifts to certain types of organizations would inevitably cause state and local leaders to become more creative in their tax credit designs, tweaking them so that they fall just outside of whatever restrictions the federal government might create.** For example, states could replace much of their direct aid to public universities or local governments with tax credit schemes that steer donations to those entities. Or if even those schemes were shut down (a policy change that would affect not just the new workaround credits, but many pre-existing credits as well), states could devise sophisticated programs routing donations through private nonprofits.
- **A better approach would address not just the new breed of workaround credits, but other state charitable tax credit schemes as well.** Rather than denying the federal charitable deduction for donations to some entities but not others, this approach would focus on the real economic impact of so-called "charitable gifts" from the perspective of the donor, and would reserve the deduction only for gifts that involve a genuine financial sacrifice. This approach would be simpler, fairer, and more effective.
- **While the IRS or Treasury Department may have the authority to take some action on this issue with new guidance or a regulation, Congress is far better suited to resolve this in a fair and administratively simple fashion.** There appears to

be no basis in existing law for reducing the federal charitable deduction when some types of tax benefits are received (e.g., large state tax credits, including the new workaround credits) but not others (e.g., small state tax credits, state tax deductions, or even the federal deduction itself). This makes IRS or Treasury action an all-or-nothing proposition: either all types of tax benefits impact the size of the federal charitable deduction (an administratively complex outcome) or none of them do (that is, the problem remains unresolved). Congress, of course, faces no such limitations in rewriting the charitable deduction laws. It could either craft a more tailored law reducing the deduction when large state tax credits are received, or it could revisit its decision to cap the SALT deduction. If the SALT cap were replaced with a broader reform that did not preference charitable giving over SALT payments, the benefits of attempting to recast tax payments as charitable gifts would be eliminated entirely.

## INTRODUCTION

The federal Tax Cuts and Jobs Act (TCJA) enacted last year temporarily capped deductions for state and local tax (SALT) payments at $10,000 per year, through 2025. Prior to the bill's enactment, numerous tax experts warned Congress that the bill was "riddled with problems" and that the SALT cap could be circumvented by state and local lawmakers using a variety of techniques.[1] Congress chose to ignore those warnings, and in the months following the bill's enactment state and local lawmakers responded as predicted. A growing number of states have implemented tax credit schemes that allow their residents to pay much less in (partly- or non-deductible) state and local tax if they make (deductible) charitable gifts to the same types of public institutions or public services that their taxes might have otherwise funded. As of this writing New York, New

Jersey, Connecticut, and Oregon have enacted workaround credits while other states such as California, Illinois, and Rhode Island continue to debate similar proposals.

In New York, for instance, a new law allows taxpayers donating to state funds supporting education or health care to receive up to 85 percent of their donation back from the state via a tax credit. Assuming that donation is fully deductible at the federal level, New York taxpayers will also receive a federal deduction worth up to 37 percent of the amount donated.[2] Summing these two breaks (85 and 37 percent) yields tax cuts of up to 122 percent of the amount donated—meaning that the taxpayer comes out ahead by making the gift.

Many observers have responded to these tax credits with disbelief, using words like "silly" and "ridiculous."[3] And rightfully so. It is illogical for a taxpayer to receive a charitable deduction in return for doing something that satisfies nobody's commonsense definition of charity. The hypothetical taxpayer described in Figure 1, for example, is $22,000 richer *after* donating than before. This is a far cry from genuine philanthropy.

Some observers have suggested that the Internal Revenue Service (IRS) or the Treasury Department can, and should, intervene to shut down these tax credit schemes in the wake of Congress's failure to address them in the TCJA. But this will be more difficult than is commonly understood, as this general type of scheme is neither new nor unique. The federal government has allowed similar abuses of the charitable deduction to persist for many years, and as this report will show, it is impossible to shut down these new tax credit schemes in a fair and effective manner without also impacting a wide range of existing state tax credits. Put another way, a partial fix aimed just at stopping the most recent flurry of state tax credits would be highly problematic. These new tax credits have much in common with existing state tax policies, and their proliferation should spur Congress, or perhaps the IRS or Treasury Department, to take a long-overdue look at this broad issue, not a narrow one focused only on the newest types of credits.

**Figure 1: Illustrating the Impacts of a SALT/Charitable Workaround Credit for a Hypothetical High-Income Taxpayer**

| | Prior to Workaround Credit | After New Workaround Credit | *Change* |
|---|---|---|---|
| **State Level** | | | |
| State Income Tax Bill, Before Credits | $95,000 | $95,000 | *No change* |
| "Charitable Gift" to State-Approved Fund or Organization | N/A | $100,000 | *+$100,000* |
| State Tax Savings from Workaround Credit (85% of Gift Amount) | N/A | ($85,000) | *($85,000)* |
| **State Income Tax Bill, After Credits** | **$95,000** | **$10,000** | ***($85,000)*** |
| **Combined Payments (Taxes and Charitable Gifts)** | **$95,000** | **$110,000** | ***+$15,000*** |
| **Federal Level** | | | |
| Federal SALT Deduction (capped) | $10,000 | $10,000 | *No change* |
| Federal Charitable Deduction | N/A | $100,000 | *+$100,000* |
| Total Relevant Deductions (SALT + Charitable) | $10,000 | $110,000 | *+$100,000* |
| **Federal Tax Savings from Relevant Deductions @ 37% Rate** | **($3,700)** | **($40,700)** | ***($37,000)*** |

| **Summary of Impacts** | |
|---|---|
| Charitable Gift | *$100,000* |
| Total State Tax Cut (85% credit) + Federal Tax Cut (37% deduction) | *($122,000)* |
| **Financial Profit: Tax Cuts in Excess of Amount Donated** | ***$22,000*** |

**Source:** Institute on Taxation and Economic Policy (ITEP), May 2018

**(http://itep.org/wp-content/uploads/Figure1-SALT.jpg)**

## WHAT ARE THESE NEW WORKAROUND CREDITS?

This report uses the term “workaround credits” as a shorthand for a broad group of state charitable tax credits that have been debated or enacted this year because of the new cap on the SALT deduction. As this report will show, this categorization is made difficult by the fact that the new credits are often not much different from existing state charitable tax credits.

New York’s workaround credits have received the bulk of the attention thus far and offer a useful illustration of the variety of approaches available to states and localities. [4] The New York law allows taxpayers to donate to a new state fund with separate accounts for education and health care expenditures, and to receive an 85 percent tax credit in return. Alternatively, taxpayers can now receive an 85 percent credit for donating to private nonprofits supporting either the State University of New York (SUNY) or the City University of New York (CUNY)—a policy that bears close resemblance to an existing tax credit program in Indiana. [5] Finally, the law also gives localities the option to create property tax credits worth up to 95 percent of the amount donated to new funds called Charitable Gift Reserve Funds.

The local tax credit approach is similar to one enacted by New Jersey lawmakers this year, which allows localities to establish "charitable funds for specific public purposes" that "shall be kept separate from the other accounts of the local unit," and to distribute tax credits in return for such donations.[6]

Connecticut enacted a variation on the local tax credit option that will allow localities to offer credits of up to 85 percent of the amount donated to nonprofit "community supporting organizations" that are "organized solely to support municipal expenditures for public programs and services, including public education."[7]

And Oregon also enacted a program this year that, while less widely reported in the media, was described as a SALT cap workaround by its author, State Sen. Mark Hass.[8] The new law allows for large tax credits to be paid out in return for donations to the state's Opportunity Grant Fund, which is used by the state's Higher Education Coordinating Commission to provide financial aid to help students attend college. [9] This credit is very similar to an existing California credit that funds student financial aid.[10]

As of this writing, states such as California, Illinois, and Rhode Island are continuing to debate new tax credits that could fit the definition of "workaround credits."

But these new credits are not the only ones being marketed to taxpayers as SALT cap workarounds. Alabama, for instance, has offered its taxpayers a 100 percent tax credit since 2013 in return for donations to organizations that provide vouchers to families that send their children to private K-12 schools. And Pennsylvania has offered a variety of similar credits since 2001 worth 75, 90, or 100 percent of the amount donated.[11]

In both states, tax accountants, financial advisors, and the organizations benefiting from these credits have been eager to point out to potential donors that the credits can be used to get around the new federal cap on SALT deductions. A sampling of statements along these lines is available in Figure 2.

## Figure 2: Voucher Tax Credits Are SALT Cap Workarounds, Too

- An article written for, and promoted by, the Medical Association of the State of Alabama advises the association's members (high-income physicians) that donating to the state's private school voucher program is "an opportunity to preserve your state tax deduction."[i]
- A Pennsylvania accountant refers to the state's voucher tax credit as a tool for "bypassing the $10k state and local tax deduction limitation."[ii]
- An economist with Iowa's Department of Revenue expects that a newly increased voucher tax credit may be claimed by "higher-income taxpayers attempting to get around the federal SALT cap."[iii]
- An Alabama accountant is advertising the credit as "one way to mitigate the impact of this adverse tax change," meaning the federal SALT cap.[iv]
- The Gwynedd Mercy Academy High School in Pennsylvania explains to prospective donors that, under the new SALT cap, the state's voucher tax credit can be used such that "participants can effectively turn limited state tax deductions into less limited charitable contribution deductions."[v]
- An accounting firm in Alabama says that making a private school voucher donation is "the best strategy" and "moves your federal deduction from a state taxes deduction (which are now limited to $10,000 annually – that's income and property taxes) to a charitable deduction."[vi]
- A financial advisor in Alabama writes that the voucher tax credit is "a way to avoid losing" a portion of the taxpayer's SALT deduction. He goes on to elaborate that "you are basically converting a State of Alabama income tax deduction (limited to $10,000) to a charitable deduction (which has no limit under the new tax law)."[vii]
- The Alabama Opportunity Scholarship Fund, one of the state's largest organizations accepting tax credit voucher donations, explains on its "Donors" page that "with the new tax laws … taxpayers now have even more incentive to donate."[viii]

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[i] Evans, Sae, Maddox Casey, and Jim Stroud. "Tips for Preserving Tax Deductions in 2018." Feb. 16, 2018. Available at: http://alabamamedicine.org/tips-preserving-tax-deductions-2018/.

[ii] Moyseyenko, Irina. "Bypassing the $10K State and Local Tax Deduction Limitation." Feb. 6, 2018. Available at: http://www.taxwarriors.com/blog/bypassing-the-10k-state-and-local-tax-deduction-limitation.

[iii] Harris, Amy Rehder. Iowa Department of Revenue, Research and Analysis Division. Letter to Jeff Robison, Legislative Services Agency. May 2, 2018.

[iv] Pearce, Bevill, Leesburg, Moore, P.C. "New Tax Deduction Limitations." Jan. 17, 2018. Available at: https://www.pearcebevill.com/new-tax-deduction-limitations/.

[v] Gwynedd Mercy Academy High School. "EITC and OSTC." Accessed Apr. 18, 2018. Available at: https://www.gmahs.org/support/eitc.

[vi] Bragg, Bobby M. "Using Alabama Accountability Act to Maximize Your State and Local Tax Deduction." Jamison Money Farmer PC. Feb. 28, 2018. Accessed Apr. 18, 2018. Available at: https://jmf.com/2018/02/using-alabama-accountability-act-to-maximize-your-state-and-local-tax-deduction/.

[vii] Welch, Stewart. "This tax strategy…going, going, GONE!" AL.com Feb. 23, 2018. Available at: http://www.al.com/business/index.ssf/2018/02/this_tax_strategygoing_going_g.html.

[viii] Alabama Opportunity Scholarship Fund. "Donors." Accessed Apr. 23, 2018. Available at: https://alabamascholarshipfund.org/donors/.

(http://itep.org/wp-content/uploads/Figure2-SALT.jpg)

Some observers have suggested that in deciding which types of state tax credits will be subject to stricter federal rules, state lawmakers' intent may be factored into the IRS's decision making.[12] But once the law is enacted, lawmakers' original intent matters much less than the manner in which the credit is presented to potential claimants and the ways in which it is used.

The types of statements presented in Figure 2 are not merely idle chatter. In Alabama, a surge of interest among taxpayers seeking to circumvent the SALT cap led to the state's entire allotment of tax credits ($30 million) being claimed more quickly this year than at any time in the program's history.[13] ITEP predicted this would happen in a report issued last December.[14] And accountants in the state anticipated a similar outcome with disclaimers like: "beware: credits will not last" and "act quickly ... before the opportunity is gone."[15] It turns out that high-income taxpayers living in states such as Alabama and Pennsylvania are already enjoying the personal financial benefits of SALT cap workarounds, while those living in California, New York, and elsewhere are still waiting for their lawmakers to finish debating or implementing workaround credits.

## NARROW ACTION AGAINST WORKAROUND CREDITS WOULD BE UNFAIR, VIOLATING TAX PRINCIPLE OF HORIZONTAL EQUITY

The most objectionable feature of these new workaround credits is a familiar one: taxpayers will receive federal charitable deductions for behavior that meets almost nobody's commonsense definition of philanthropy. If a taxpayer makes a so-called "donation" only to later be reimbursed (in full or in part) by their state government with tax credits, then the part of the donation that was reimbursed is clearly not charitable because it involved no financial sacrifice.

This concept is already well established in the context of other types of reimbursements. A donor who receives a tote bag or a steak dinner, for example, in return for donating must reduce their federal charitable deduction by the value of the item or service they received. This is consistent with the original intent of the charitable deduction to encourage genuine charitable giving rather than self-interested tax avoidance, a fact reiterated by more recent reforms to the deduction's treatment of donations of property that has grown in value.[16]

But federal tax law is blind to reimbursements that come in the form of state tax credits, even if those credits are so large that they wipe out of the cost of “donating” entirely.

Rather than broadly improving the federal tax code’s measurement of real philanthropy by requiring taxpayers to reduce their deductions by the amount of state tax credits they receive in return, the narrow type of federal action being considered would allow some pseudo-donors to continue receiving full deductions while denying or reducing those deductions for others. This distinction would not be based on the taxpayers’ actual level of financial sacrifice, but rather on the type of organization that accepts the donation.[17]

Under a narrow federal approach, a donation to a fund supporting public schools, for instance, would likely not be deductible if it was reimbursed with a tax credit. An identically-reimbursed donation to an organization supporting private schools, however, would remain deductible. In effect, pseudo-donations flowing to public institutions would be categorized as tax payments subject to the new SALT cap, while pseudo-donations supporting private ones would continue to be treated as genuine, fully deductible charitable gifts.

This type of distinction would amount to a clear violation of the tax fairness concept of “horizontal equity,” under which similar taxpayers should be treated similarly by the tax code.

In the real world, this would mean that a New York taxpayer making a pseudo-donation to support public education would lose most of their federal charitable deduction if they claimed the state’s 85 percent tax credit for such donations. An Alabama taxpayer making an even-less-charitable donation to support private school vouchers, by contrast, would continue to receive their full federal deduction even if they claimed a 100 percent tax credit from their state in return for making such a gift. As explained earlier, both of these tax credits are being marketed to taxpayers as ways to circumvent the SALT cap. And indeed, the Alabama credit is actually the more lucrative option in this regard, since it reimburses 100 percent of the amount donated rather than only 85 percent. But nonetheless, the narrow federal approach would deny the New Yorker's charitable deduction while leaving the Alabamian's deduction intact.

**Figure 3: "Narrow Action" versus "Broad Action"**

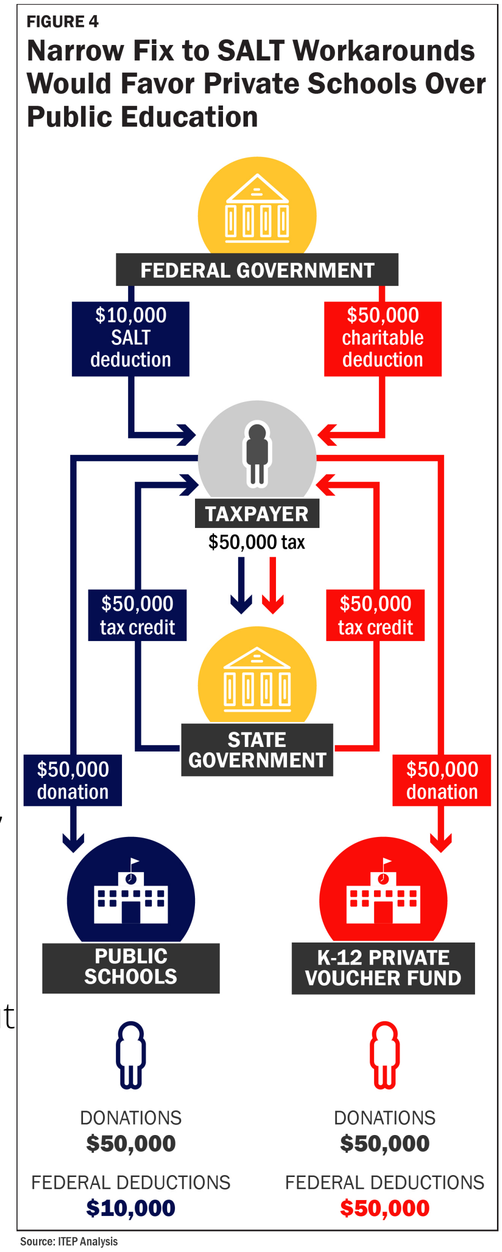
This report envisions two broad categories of action that the federal government might take in response to the proliferation of SALT/charitable workaround credits.

- Under a **narrow action**, the federal government would examine each entity (government agency, public university, nonprofit organization, etc.) receiving a donation that benefited from a state charitable tax credit. Based on the outcome of that examination (using criteria that are not yet known), it would then decide to either (a) turn a blind eye and grant a full federal charitable deduction even when the alleged "donation" was reimbursed with a state tax credit, or (b) categorize the reimbursed portion of the "donation" as a state tax payment subject to the $10,000 SALT cap.
- Under a **broad action,** the federal government would focus its attention on the donor and would devise a better measure of when a genuine "charitable gift" has been made. When taxpayers receive significant state tax benefits in return for donating, those tax benefits would be subtracted from the donation amount to determine the truly "charitable" portion of the gift. Under this type of action, there would be no need for the IRS to make new distinctions between the different types of organizations currently eligible to receive tax deductible charitable gifts.

The central conclusions of this report are that broad action is needed, and that narrow action would be unfair and arbitrary, and ultimately ineffective as well.

(http://itep.org/wp-content/uploads/Figure3-SALT.jpg)

Some observers have tried to defend this inconsistency by suggesting that the IRS may only limit or deny deductibility for donations that support services that would have been funded even if the donation was not made.[18] According to this line of reasoning, these types of donations are most akin to tax payments and should be subject to the SALT deduction cap. But implementing this test would require proving a counterfactual and is therefore impractical. How is the IRS to know, for example, whether Alabama would have funded a $30 million private school voucher program through a direct appropriation in the absence of its $30 million voucher tax credit program? There is little logic in capping a taxpayer's SALT deductions for state income tax payments that are used to fund a private school voucher program, but allowing that same taxpayer an uncapped charitable deduction for state-reimbursed "donations" funding a nearly identical program. The result of both arrangements on taxpayers, state coffers, and funding for school vouchers is the same.




(http://itep.org/wp-content/uploads/Figure-4-Narrow-SALT-Workarounds-Private-vs-Public-Education.jpg)The heart of this problem is an abuse of the charitable giving deduction, whereby pseudo-donors who have given up little or nothing of value are nonetheless able to enjoy a federal income tax break. As ITEP showed last year in a report co-authored with AASA, the School Superintendents Association, voucher tax credits are routinely marketed as tools for generating federal charitable deductions without having to make genuine charitable donations.[19] Private schools and financial advisors commonly use phrases like “make money” and “profit” when describing the lucrative state and federal tax cuts generated by a pseudo-donation.

Donors who choose to act on this type of advice often do not care where their money is going. For evidence of this, look no further than Alabama which has fully reimbursed pseudo-donations with 100 percent tax credits for several years, and yet has still often struggled to generate enough interest in its private school voucher program to reach its full $30 million allotment. Anybody in Alabama with a real interest in supporting private school vouchers would have been donating to this program already, as the state's 100 percent credit made those donations costless to the taxpayer. It was not until the donations actually became profitable for a larger group of taxpayers—because of the SALT cap—that the state began easily distributing its full credit allotment. It would be inappropriate for the federal government to treat New York "donors" supporting public education less favorably than Alabama "donors" supporting private schools, when both groups' behavior shows the same lack of charitable intent or effect.

In fact, it is not even necessary to compare different states for the inequities of a narrow federal approach to become apparent. Arizona, for instance, offers significant tax credits for donating to support private school vouchers, as well as a smaller credit for donating to support public schools.[20] Under the narrow approach, Arizonans seeking to make smart financial decisions for their families would continue to see profit potential in donating to support private school vouchers, but would lose the ability to turn an even smaller profit from donating to support public schools.

## NARROW ACTION WOULD REQUIRE ARBITRARY CUTOFFS

Some observers have suggested that these workaround credits are somehow unique, and that the IRS, Treasury, or Congress could take narrow action against them without impacting the deductibility of gifts benefiting from many pre-existing state charitable tax credits. This argument seems to hinge on the idea that credits for donating to public services that would have been funded with taxes anyway can be neatly distinguished from credits for donating to private institutions. But the reality is that these new workaround credits are extremely similar to many existing tax credits.

Earlier this year, a team of academics working on this topic identified more than one hundred state charitable tax credits across 33 states.[21] Many of those credits are offered in return for donating to government agencies, public institutions, or regulated nonprofits performing services of the same type that states often provide directly.[22] The types of entities benefiting from these credits vary widely in their level of connection to governments, and it is impossible to draw a reasonable, definitive line between tax credits supporting public services and those only benefiting private institutions.

The below discussion offers an overview of some of the types of entities to which states seek to encourage donations by offering charitable tax credits. This is not a comprehensive accounting of these types of state policies.

- ***Credits for donating to governmental funds.*** This is the most common type of tax credit structure being pursued in the wake of the new federal tax law. Earlier this year **New York** lawmakers created the New York Charitable Gifts Trust Fund, with separate accounts for health and for education.[23] In the same bill, lawmakers also gave localities the ability to create Charitable Gift Reserve Funds to accept donations. Meanwhile in **New Jersey**, localities can now establish "charitable funds for specific public purposes" that "shall be kept separate from the other accounts of the local unit."[24] Other states continue to debate similar funds. **Illinois** lawmakers, for instance, are considering creating the Illinois Excellence Fund, which is a special fund subject to appropriation by the legislature exclusively for public education purposes.[25] **California** lawmakers are debating a new California Excellence Fund, which would be housed in the state general fund but would give donors some control over how their donations would be spent, including on K-12 education, higher education, or state parks. **Rhode Island** lawmakers are contemplating a new Rhode

Island Ocean State Fund, housed in the state's general fund and under the control of the legislature.[26] And **District of Columbia** lawmakers have proposed creating the District of Columbia Public Education Investment Fund, administered by the District's Chief Financial Officer.[27] The money in the fund must be used for public education and cannot be transferred into the general fund.

- ***Credits for donating to specific government agencies.*** These types of tax credits have a longer history at the state level, though Oregon lawmakers opted to implement this type of credit this year as a response to the SALT cap. Specifically, **Oregon** has created a new tax credit designed to reward donations to the Opportunity Grant Fund, from which funds are continuously appropriated to the Higher Education Coordinating Commission inside the state's Chief Education Office.[28] This is very similar to a tax credit in **California** used to provide financial aid to students by encouraging donations to the College Access Tax Credit Fund, administered by the State Treasurer.[29] In **Arkansas**, the state offers a tax credit for donations to the Public Roads Incentives Fund, managed by the Arkansas Economic Development Commission to be used to aid in the construction of public roads.[30] **Georgia** offers a tax credit for donations to the Innovation Fund Foundation, which is controlled by the Georgia Governor's Office of Student Achievement.[31] **Louisiana** offers a tax credit for donations to Family Responsibility Programs administered by the state's Department of Health and Hospitals. Separately, the state also offers a tax credit for donations to state-owned playgrounds in economically depressed areas. **Missouri** offers tax credits for donations to the Missouri Agricultural and Small Business Development Authority, which is housed in the state's Department of Agriculture.[32] Oregon offers a tax credit for donations to the Child Care

Contribution Tax Credit program, managed by the Oregon Department of Education's Early Learning Division. The donations are described as "supporting a statewide early learning system that is safe, high quality and accessible," and the funds are distributed to child care businesses throughout Oregon.[33] And finally, many states offer tax credits for donations of land or easements to state agencies for conservation purposes.[34]

- ***Credits for donating to public institutions.*** **Indiana** and **Montana** offer tax credits for donations to institutions of higher education within the state.[35] This includes public universities that also receive funding from state appropriations. **Idaho** offers a broader tax credit for donations to elementary and secondary schools, as well as higher education and other organizations.[36] And **Louisiana** offers a tax credit for technology donated to a very wide variety of schools.[37]
- ***Credits for donating to other levels of government.*** Taxpayers in **Arizona, Hawaii, Idaho, Louisiana**, and **Montana** can receive state tax credits for donating to public K-12 schools. These credits are similar to state aid to localities, since state revenues are being diminished for the benefit of local schools. Similar intergovernmental credit programs include **Colorado's** tax credit for donations to enterprise zone administrators, many of which are local governments' economic development offices.[38] And **Nebraska** offers a credit for donations to community development programs, some of which are administered by local government units.[39]
- ***Credits for donating to nonprofits with purpose of benefiting public organizations.*** **Indiana** allows a tax credit not just for direct donations to colleges and universities, but also to "corporations and foundations organized and operated exclusively for the benefit of any eligible colleges or universities."[40] This is very

similar to a new workaround credit enacted in **New York** this year, which offers tax credits for donations to two separate 501(c)(3) foundations: one benefiting the State University of New York (SUNY) system and another benefiting the City University of New York (CUNY).[41] **Oklahoma** offers a tax credit for donations to Educational Improvement Granting Organizations, which provide grants to rural public schools.[42] And **Connecticut** lawmakers enacted a workaround option for its localities that will allow them to choose to offer tax credits to property tax payers who donate to "community supporting organizations," which are 501(c)(3) organizations "organized solely to support municipal expenditures for public programs and services, including public education." [43]

- ***Credits for donating to public-private partnerships.*** **Missouri** offers a tax credit for donations to "Innovation Campuses," which are partnerships between high schools, higher educational institutions, technical colleges, and/or businesses.[44]
- ***Credits for donating to nonprofits created and/or managed by the state.*** **Kansas** offers a tax credit for donations to Network Kansas, a 501(c)(3) nonprofit organization that was established by the state to "promote an entrepreneurial environment."[45] Network Kansas often works with the Kansas Department of Commerce, which is listed as a "founding partner."[46] **Oregon** offers a tax credit for donations to the Oregon Cultural Trust, a nonprofit created by the state as "an ongoing funding engine for arts and culture across the state."[47] The Trust works with a number of state agencies. **South Carolina** offers a tax credit for donations to the Industry Partnership Fund, which is managed by the South Carolina Research Authority, a non-profit organization created by the state.[48] Additionally, South Carolina's private school voucher tax credit flows through a 501

(c)(3) organization created by the state and governed by political appointees and extensive state laws.[49]

- ***Credits for donating to nonprofits providing services that a state may have provided directly in the nonprofit's absence.*** Some skeptics of the new workaround credits have suggested that their downfall may be that they are funding services that the state would have funded even in the absence of the credit.[50] This is a counterfactual that is impossible to prove, and it could apply equally to many existing state charitable credits. For instance, many of the eighteen states providing funding for private K-12 school vouchers via a tax credit program may have provided that funding through a direct appropriation in the absence of the tax credit.[51] Separately, states such as **Arizona, Colorado, Idaho, Missouri**, and **Utah** fund various social services programs via state tax credits.[52] These include tax credits for donating to organizations that provide foster care, substance abuse counseling, or care for the disabled. Missouri's tax credit for donating to licensed residential treatment facilities is particularly notable, since it is only available for donations to facilities that "are under contract with the Department of Social Services (DSS) to provide treatment services for children who are residents or wards of residents of … this state."[53] Missouri also administers a separate program designed to promote positive youth development, but only allows donations to organizations whose detailed proposals for tax credit support receive a high score from the state's Department of Economic Development.[54] This same design—state tax credit support only for nonprofit organizations with very specific proposals approved by government agencies—is also used in **Indiana** to steer donations to private nonprofits that help low-income families build wealth.[55]

The multitude and variety of organizations eligible to receive tax-credit-reimbursed donations poses serious problems for any attempt to allow federal charitable deductions for some pseudo-donations but not others. An earlier section of this report already discussed the unfairness of allowing deductions for donations to private schools but not public ones. But the definitional problems could become even more complex than this.

For instance, if the critical distinction is one between donations to "public" versus "private" entities, how would donations of the following types be treated?

- Donations to a private entity that supports public schools, such as Oklahoma's Educational Improvement Granting Organizations.
- Donations to a publicly operated fund that awards the money to private nonprofits.
- Donations to a heavily regulated nonprofit that is only eligible to receive tax-credit-reimbursed donations if it meets a host of criteria spelled out by legislators or government employees.

A narrow approach that allows federal charitable deductions for some pseudo-donations but not others won't just be unfair, it will also prove to be arbitrary and confusing. It will inevitably raise difficult questions about why some organizations are exempt from the new rules but not others. In short, it would be a step backward for federal tax policy.

## NARROW ACTION WOULD BE INEFFECTIVE

If the IRS, Treasury, or Congress takes narrow action against these workaround credits, they may start by denying charitable giving deductions when tax-credit-reimbursed donations flow to the types of funds discussed at beginning of the previous section: state and local general fund accounts and other similar accounts. This action would have the intended effect of only impacting new workaround credits proposed in the wake of the SALT deduction cap, but it would fall far short of ending these workaround schemes. Some new workaround credits created this year would be unaffected, and lawmakers in states that would be affected by this action would almost surely respond by becoming more creative in their tax credit designs.

For instance, unless federal action also targeted donations to specific government agencies, Oregon's new workaround credit for donations to the Higher Education Coordinating Commission's financial aid program would remain unaffected, and more states would undoubtedly seek to fund agency functions with tax-credit-reimbursed donations. On the other hand, if federal lawmakers sought to deny tax deductions for tax-credit-reimbursed donations to government agencies, tax credits in states such as Arkansas, California, Georgia, Louisiana, and Missouri would also be impacted and the scope of the action would no longer be limited to the new workaround credits.

If the federal government decided to deny the charitable deduction on donations to government agencies, the next logical step might be for states to use such tax credits to raise funding for somewhat more independent entities, such as public colleges and universities, that it would otherwise have funded through direct appropriations. This arrangement offers one strategy for getting around some commenters' suggestions that the IRS should treat charitable tax credits unfavorably if the recipient of the donation (state governments) is the same entity that pays out the benefit to donors (state tax credits). Under this arrangement, colleges and universities would be receiving the donations, but state governments would be providing the tax credits. Of course, the federal government could attempt to stop these types of workaround schemes as well, but not without impacting long-running credits in Idaho, Indiana, Louisiana, and Montana.

States could also attempt to replace a significant portion of their aid to local governments and school districts with a charitable tax credit scheme. Federal action broad enough to prevent this type of workaround would impact a variety of existing state tax credits, including those used for the benefit of public schools in Arizona, Hawaii, Idaho, Louisiana, and Montana.

Under a narrow federal approach, it would be especially difficult to shut down workaround credits that steer donations to nonprofit organizations rather than governments. In Connecticut, for instance, lawmakers recently granted localities the authority to offer tax credits to fund nonprofits that advance public purposes that the government may otherwise have pursued. In states such as Indiana, New York, and Oklahoma, tax credits are available for donating to nonprofits that exist only to benefit public educational institutions—most often higher education. The New York credits were created as new workarounds this year, while the Indiana and Oklahoma credits have existed for years. In Kansas, a nonprofit created by the state performs an economic development role very similar to state agencies. And nonprofits providing social services in many states also benefit from tax credits. Despite being independent entities, state governments exercise substantial control over the work of these organizations through laws, regulations, and sometimes even requirements that detailed applications must be submitted to the state before those organizations can receive tax-credit-financed funding for particular projects.

Notably, a new workaround credit proposal in California relies heavily on non-profit organizations in its design precisely because this type of credit is less vulnerable to narrow federal action. The proposal from the chair of the California Assembly's tax-writing committee would allow taxpayers to donate to independent non-profit organizations and receive an 80 percent tax credit in return.[56] The state would recoup its costs, and then some, by requiring nonprofits to acquire those tax credits from the state, at a cost of 90 cents per credit, prior to accepting tax-credit-eligible donations.

The least narrow of the “narrow fix” options would involve the federal government denying or reducing the charitable deduction when tax-credit-reimbursed donations flow not only to state and local governments, but also to nonprofits judged to be significantly entangled with those governments. Under this approach, most of the credits impacted would be existing tax credits rather than the new workaround credits. This approach would allow abuses of the charitable giving deduction to continue when the donations are judged to be flowing to truly independent nonprofits, and it would raise difficult line-drawing questions regarding which nonprofits are sufficiently independent to be exempt from the new federal rules.

One particularly worrisome result of this approach is that it would incentivize democratically elected state and local governments to relinquish control over many of their current functions, even as they still funded those functions via their tax credit programs. If Alabama’s nonprofit “scholarship granting organizations” are judged to be sufficiently independent of the state, for example, high-income taxpayers in Alabama would find that using the state’s 100 percent tax credit program to effectively earmark their tax dollars to private schools would be more financially beneficial than either supporting public schools by paying their state income taxes or using a (hypothetical) workaround tax credit related to public school funding. In effect, conservative-leaning states that are willing to “charitize” large swaths of their public education systems, human services, etc. would be best positioned to grant their taxpayers an opportunity to circumvent the SALT cap. Consider the following examples:

- **Scenario 1:** Taxpayer pays $50,000 in state income tax that the state uses to fund public schools and other services. Maximum federal deduction is $10,000 because of the SALT deduction cap.

- **Scenario 2:** Taxpayer "donates" $50,000 to public schools and receives a $50,000 state "workaround credit" in return. In effect, the state has funded this "donation" because the taxpayer's financial standing is unchanged from Scenario 1 (they have made a $50,000 "donation" rather than paid a $50,000 tax) while the state's revenues are $50,000 lower. Under a narrow federal fix, the $50,000 "donation" would be categorized as a tax payment for federal tax purposes and the taxpayer's maximum federal deduction would be $10,000—the same as in Scenario 1.
- **Scenario 3:** Taxpayer "donates" $50,000 to fund private K-12 school vouchers and receives a $50,000 state tax credit in return. Again, the state has funded this "donation" for the same reasons described in Scenario 2. Under a narrow fix that overlooked nonprofits distributing private school vouchers, this "donation" would be treated as if it were truly charitable and the taxpayer would receive a federal charitable deduction of up to $50,000. In this scenario, the taxpayer's federal deduction ($50,000) is 5 times larger than in Scenarios 1 or 2 ($10,000) even though the taxpayer's financial standing is the same, before federal taxes. The relevant difference between this scenario and Scenario 2 is that the state government is paying for children to be educated in private schools, rather than public ones.

This discussion should make clear that any attempt to crack down on some pseudo-donations but not others is sure to raise more questions than it answers. Even proponents of the narrow approach concede that their solutions are not comprehensive answers to this brand of charitable deduction abuse. Andy Grewal at the University of Iowa, for instance, has admitted that "whether the charitable contribution strategy works will depend on the details of a given state's plans."[57] And in contemplating some iterations of the charitable credit scheme, Eric Rasmusen of Indiana University conceded that “the amended proposal might be valid, though I am not sure even in my own mind.”[58] Peter Faber of McDermott Will & Emery similarly goes back and forth between discussing state charitable schemes that might work, and those that might not, in his writing on the topic.[59]

As long as some version of the workaround credit scheme is left open for abuse, states, localities, and taxpayers are sure to exploit it to generate federal charitable deductions for acts that are not genuinely charitable. A narrow approach to this issue would be a missed opportunity at real reform and would make the tax code less fair, more arbitrary, and more confusing, without solving the root problem to which these new workaround credits have drawn so much attention.

## BROAD ACTION WOULD BE FAIRER, SIMPLER, AND MORE EFFECTIVE

With the creation of new SALT workaround credits, a growing number of taxpayers can now make so-called “charitable donations” that are nothing of the sort because they receive state tax credits and federal tax deductions worth more than their actual donations. Some observers have suggested that the IRS should shut down some of these abuses, but not others, by drawing what would amount to arbitrary distinctions between different tax credit programs based on the nature of the organization receiving the donations. Peter Faber, for instance, has suggested denying the deduction only if the donations fund programs that the state would have funded anyway.[60] As with all counterfactuals, this would be impossible to prove in practice. The result would be unnecessary complexity and an incomplete solution to the problem of charitable deduction abuse.

(http://itep.org/wp-content/uploads/Figure5-SALT.jpg)

## Figure 5: Recommendations for Federal Action

- Congress, rather than the IRS or Treasury Department, is best situated to address this problem. While the comparative ease of executive branch action is tempting, it will be difficult to achieve a fair and administratively simple solution without changing current law.
- Federal charitable deduction reform should be blind to the type of organization receiving the donation. Attempting to deny or reduce the federal deduction for donations related to public services but not private charities would be unfair and arbitrary, and ultimately ineffective as well.
- When calculating the amount of an alleged charitable gift that is truly "charitable," taxpayers should be required to subtract out any significant state tax benefits that they received in return for donating. This is consistent with how many other types of donor perks are treated in the law, such as tote bags or event tickets received in return for donating.
- For administrative simplicity, Congress should consider allowing a full federal charitable deduction even when ordinary state charitable deductions or smaller state tax credits are received in return for donating. By focusing a new law only on large state tax benefits (greater than 20 percent of the amount donated, for example), Congress could prevent this type of charitable deduction abuse without imposing new administrative requirements on most types of charitable gifts.
- Of course, this type of charitable deduction abuse is only possible because the federal income tax treats charitable donations more favorably than SALT payments. Replacing the $10,000 SALT cap with a broader limit on itemized deductions, or a new itemized deduction credit, is also worthy of consideration. This type of reform could improve the yield and progressivity of the federal tax code while also ending the type of gaming discussed in this report.

A much better approach would be for Congress to set its focus squarely on the donors, and to devise a more sophisticated method for determining when an alleged charitable gift is truly charitable, and what portion of each gift is actually charitable. As most commenters on this issue have pointed out, the tax code already requires taxpayers to reduce their charitable deductions by many types of financial benefits they receive in return—such as an NPR tote bag, Super Bowl tickets, or a steak dinner. Extending this same approach to include state tax credits would improve federal tax law.

But while the general notion of denying charitable deductions for reimbursed donations is simple enough, there are a few thorny issues that would need to be overcome to implement this ideal. For this reason, it would be preferable for Congress to take the lead in crafting policy that strikes a careful balance between the need for an improved measurement of genuine charity and the administrative difficulties involved in certain aspects of that measurement.

For example, would taxpayers in the roughly thirty states offering ordinary charitable deductions need to reduce the amount of their federal deduction by the value of the state tax deduction they received?[61] Or how about the value of the federal charitable deduction itself? Would that amount need to be subtracted in calculating the true “charitable” portion of the deduction?[62] Calculating the precise benefit received from these tax deductions could be complicated in practice.[63] For simplicity’s sake, the federal government should consider overlooking these run-of-the-mill tax deductions in favor of a new rule focused only on state tax credits. Because such a distinction is not included in current law, however, this would likely require legislative action rather than new guidance or a regulation from the executive branch.[64] The IRS or Treasury Department would have a difficult time explaining why the federal charitable deduction must now be reduced when some types of tax benefits are received (e.g., large state tax credits, including the new workaround credits) but not others (e.g., smaller state tax credits, state tax deductions, or perhaps even the federal deduction itself).

One possible template for federal legislative action is Rep. Terri Sewell’s H.R. 4269, the *Public Funds for Public Schools Act*. [65] The bill, which was introduced prior to the enactment of the TCJA, deals only with state tax subsidies for donations to private K-12 school voucher funds. These types of donations were, and still are, the most common type of tax-credit-related abuse of the federal charitable deduction as they allow so-called “donors” in at least eleven states to receive tax cuts larger than the amount they donate.[66] Under H.R. 4269, taxpayers can receive a full federal charitable deduction even for donations to private school voucher funds that benefited from a state tax deduction. But the federal deduction is reduced in cases where the state tax benefit is provided in the form of a tax credit: under a 60 percent state tax credit, for example, only the 40 percent of the donation not offset by the credit would remain federally deductible. And to prevent gaming, the bill also claws back some or all of the federal charitable deduction if states offer deductions larger than the amount donated: say 200, or 300, or even 1000 percent of the donation. The basic structure contained in this bill could be expanded to apply not just to private school voucher credits, but to state charitable tax credits more broadly.

If Congress is interested in enacting a solution that would be even simpler to administer, it could write a law that only overlooks state tax benefits equal to, say, 20 percent or less of the amount donated. This would provide a level playing field across states where even the largest state tax deductions (taken against California's top tax rate of 13.3 percent, for instance) would be allowed, as would any state credit or deduction of an equivalent amount. Any state tax benefit worth more than 20 percent of the donation, however, would require the taxpayer to calculate the precise amount of the state tax benefit they received and reduce their federal charitable deduction by a corresponding amount in order to arrive at the true "charitable" portion of the donation.

In the extreme cases of 100 percent personal income tax credits such as those received in return for donating to private school voucher funds in Alabama, Arizona, Georgia, Montana, and South Carolina, the taxpayer would receive no federal charitable deduction because the donation amount is reimbursed in full by the state. In the context of New York's new workaround credits, only the modest 15 percent of the donation not reimbursed by the state's 85 percent tax credit would be considered a charitable gift for federal tax purposes.

One drawback of this approach is that it would create a modest "cliff effect," where taxpayers who itemize at the federal level would find 20 percent state tax credits that are exempt from this new law to be more beneficial than somewhat larger state tax credits to which the law would apply. But this effect would be small in practice. For taxpayers in the top federal tax bracket of 37 percent, for instance, only credits in the range of 21-31 percent would be less beneficial than a 20 percent option. State credits of

32 percent and above would remain more beneficial than 20 percent credits despite being impacted by this new law.[67] And for states that offer, or wish to offer, credits in the range of 21-31 percent, the impact of this cliff could be mitigated by offering taxpayers the option of claiming a smaller, 20 percent credit, with the understanding that some itemizers may find it preferable to claim this smaller credit to remain below the federal threshold described above. Under the circumstances, this mild and partly avoidable cliff effect is a small price to pay for a dramatic and administratively feasible improvement to the federal charitable deduction's measurement of true charity.

But while a 20 percent limit of this type may be the most targeted option available for resolving the specific problem at issue here, Congress may also consider taking this opportunity to reopen a broader debate over the $10,000 cap on the SALT deduction.

For starters, broader reform of the SALT cap will likely be needed anyway if lawmakers wish to close other widely recognized loopholes, such as the ability of states to shift away from deductible income taxes and toward deductible payroll taxes or business taxes designed to be nearly identical in their effect.[68]

In the context of the workaround credits, any reform that puts SALT payments and charitable gifts on an even footing under federal income tax law would effectively shut down the schemes described in this report. If charitable gifts were not treated more favorably than tax payments, then states and localities would have no reason to help their residents launder the latter into the former.

Ultimately, the SALT deduction and charitable deduction are similar in adjusting for taxpayers' ability to pay federal income tax, and they often relate to funding for the same types of services, such as education and social services. While a detailed discussion of reforming itemized deductions more broadly is beyond the scope of this report, there are good reasons to consider putting these two deductions on a more even footing. Depending on the details, lifting the $10,000 SALT cap and replacing it with a broader limit on itemized deductions, or a new itemized deduction credit, could improve the yield and progressivity of the federal tax code while also ending the type of gaming outlined in this report.

**CONCLUSION**

Several states have responded to the new federal cap on SALT deductions by debating or enacting tax credits that allow their residents to claim federal charitable deductions on so-called "donations" that meet almost nobody's definition of genuine charity. This abuse of the federal charitable giving deduction is certainly absurd, but it is far from new and seeking to shut down the new workaround credits without impacting any existing charitable giving credits would be ill-advised. Any attempt at a narrow fix will introduce more unfairness and arbitrariness into the federal tax code without actually stopping states from exploiting this broad and long-running loophole.

The surge of interest in these workaround credits should be used as an opportunity to fix a part of the federal tax code that is long-overdue for reform. Adding a more sophisticated measure of charitable giving into the tax code—one that considers significant state tax benefits received in return for donating—is necessary to ensure that the charitable giving deduction is reserved for its original purpose of encouraging actual philanthropy, not sophisticated tax sheltering. It is well within Congress's power to implement this type of reform in an administratively simple fashion, though the ability of either the IRS or Treasury Department to do so on its own is much more doubtful.

Alternatively, Congress may consider using this debacle as an opportunity to revisit its hastily devised cap on the SALT deduction. Any itemized deduction reform that puts SALT payments and charitable donations an even footing would also have the effect of ending the type of gaming outlined in this report.

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[1] Kamin, David and Gamage, David and Glogower, Ari D. and Kysar, Rebecca M. and Shanske, Darien and Avi-Yonah, Reuven S. and Batchelder, Lily L. and Fleming, J. Clifton and Hemel, Daniel Jacob and Kane, Mitchell and Miller, David S. and Shaviro, Daniel and Viswanathan, Manoj. "The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the New Legislation." First published Dec. 7, 2017. Last updated Feb. 26, 2018. Available at: https://ssrn.com/abstract=3089423 (https://ssrn.com/abstract=3089423).

[2] The value of the deduction depends on the taxpayer's marginal federal income tax rate. The top tax rate for high-income taxpayers is 37 percent.

[3] Stein, Jeff. "California has a plan to skirt the GOP tax law. IRS veterans say it is likely doomed." *Washington Post Wonkblog*. Feb. 12, 2018. Available at: https://www.washingtonpost.com/news/wonk/wp/2018/02/12/california-has-a-plan-to-skirt-the-gop-tax-law-irs-veterans-say-its-doomed/ (https://www.washingtonpost.com/news/wonk/wp/2018/02/12/california-has-a-plan-to-skirt-the-gop-tax-law-irs-veterans-say-its-doomed/).

[4] State of New York. S. 7509 / A. 9509. Jan. 18, 2018. Available at: http://legislation.nysenate.gov/pdf/bills/2017/s7509c (http://legislation.nysenate.gov/pdf/bills/2017/s7509c).

[5] Indiana Department of Revenue. "Income Tax Credit for Donations to Colleges." Informational Bulletin #14. July 2015. Available at: https://www.in.gov/dor/files/ib14.pdf (https://www.in.gov/dor/files/ib14.pdf).

[6] State of New Jersey 218th Legislature. Senate, No. 1893. Enacted May 4, 2018. Available at: http://www.njleg.state.nj.us/2018/Bills/S2000/1893_R1.PDF (http://www.njleg.state.nj.us/2018/Bills/S2000/1893_R1.PDF).

[7] State of Connecticut General Assembly, Session Year 2018. Substitute Senate Bill No. 11. Available at: https://www.cga.ct.gov/asp/cgabillstatus/cgabillstatus.asp?selBillType=Bill&which_year=2018&bill_num=11 (https://www.cga.ct.gov/asp/cgabillstatus/cgabillstatus.asp?selBillType=Bill&which_year=2018&bill_num=11).

[8] Jones, Paul. "State Looks to Decouple From Federal Passthrough Deduction." *State Tax Notes*. Mar. 5, 2018.

[9] State of Oregon 79th Legislative Assembly. Senate Bill 1528. Available at: https://olis.leg.state.or.us/liz/2018R1/Downloads/MeasureDocument/SB1528/Enrolled (https://olis.leg.state.or.us/liz/2018R1/Downloads/MeasureDocument/SB1528/Enrolled).

[10] Office of the State Treasurer of California. "College Access Tax Credit Fund." Accessed Apr. 23, 2018. Available at: http://www.treasurer.ca.gov/cefa/fact_sheet.pdf (http://www.treasurer.ca.gov/cefa/fact_sheet.pdf).

[11] Davis, Carl. "State Tax Subsidies for Private K-12 Education." Institute on Taxation and Economic Policy. Oct. 12, 2016. Available at: https://itep.org/state-tax-subsidies-for-private-k-12-education/ (https://itep.org/state-tax-subsidies-for-private-k-12-education/).

[12] Jared Walczak of the Tax Foundation writes: "Public statements by the proponents of the strategy essentially admitting that as the goal would be instructive for an IRS action to disallow it." *See* Walczak, Jared. "State Strategies to Preserve SALT Deductions for High-Income Taxpayers: Will

They Work?" Tax Foundation Fiscal Fact No. 569. Jan. 5, 2018. Available at: https://taxfoundation.org/state-strategies-preserve-state-and-local-tax-deduction/ (https://taxfoundation.org/state-strategies-preserve-state-and-local-tax-deduction/). And Eric Rasmusen of Indiana University writes, regarding a hypothetical school voucher tax credit: "He does receive something of value from a third party, but that is okay. This is clearly not an attempt to use state laws to reduce the taxes of West Dakota residents." *See* Rasmusen, Eric Bennett. "Getting Around the State and Local Tax Deduction Limit." Kelley School of Business Research Paper No. 18-8. Jan. 9, 2018. Available at: https://ssrn.com/abstract=3099296 (https://ssrn.com/abstract=3099296).

[13] Crain, Trisha Powell. "$30 million in AAA tax credits already claimed for 2018." AL.com. Apr. 27, 2018. Available at: http://www.al.com/news/index.ssf/2018/04/30_million_in_aaa_tax_credits.html (http://www.al.com/news/index.ssf/2018/04/30_million_in_aaa_tax_credits.html).

[14] Davis, Carl. "Tax Bill Would Increase Abuse of Charitable Giving Deduction, with Private K-12 Schools as the Biggest Winners." Institute on Taxation and Economic Policy. Dec. 14, 2017. Available at: https://itep.org/tax-bill-would-increase-abuse-of-charitable-giving-deduction-with-private-k-12-schools-as-the-biggest-winners/ (https://itep.org/tax-bill-would-increase-abuse-of-charitable-giving-deduction-with-private-k-12-schools-as-the-biggest-winners/).

[15] Ely, Bruce, Page Stalcup, Lesley Searcy, and Bri Jackson. "The New Federal Tax Law and Tax Credit Scholarship Donation Benefits for Alabama Taxpayers." Presentation for the Alabama Opportunity Scholarship Fund. Feb. 16, 2018. Available at: https://alabamascholarshipfud.org/_pdfs/Tax_Credit_Scholarship_Donation_Webinar_02_16_2(
(https://alabamascholarshipfud.org/_pdfs/Tax_Credit_Scholarship_Donation_Webinar_02_16_2
Hindsman, Todd. "Alabama Accountability Act – Tax

Planning Opportunity for You." Barfield, Murphy, Shank & Smith LLC. Feb. 1, 2018. Available at: http://bmss.com/alabama-accountability-act-tax-planning-opportunity/ (http://bmss.com/alabama-accountability-act-tax-planning-opportunity/).

[16] For some discussion of this point, see pages 4 and 16 of: Colinvaux, Roger. "Failed Charity: Taking State Tax Benefits into Account for Purposes of the Charitable Deduction." Buffalo Law Review, Forthcoming. Apr. 30, 2018. Available at: https://ssrn.com/abstract=3172179 (https://ssrn.com/abstract=3172179).

[17] Rasmusen, Eric Bennett. "Getting Around the State and Local Tax Deduction Limit." Kelley School of Business Research Paper No. 18-8. Jan. 9, 2018. Available at: https://ssrn.com/abstract=3099296 (https://ssrn.com/abstract=3099296). Grewal, Andy. "Can States Game the Republican Tax Bill with the Charitable Contribution Strategy?" Notice & Comment, A Blog from the Yale Journal on Regulation. Jan. 3, 2018. Available at: http://yalejreg.com/nc/can-states-game-the-republican-tax-bill-with-the-charitable-contribution-strategy/ (http://yalejreg.com/nc/can-states-game-the-republican-tax-bill-with-the-charitable-contribution-strategy/). Walczak, Jared. "State Strategies to Preserve SALT Deductions for High-Income Taxpayers: Will They Work?" Tax Foundation Fiscal Fact No. 569. Jan. 5, 2018. Available at: https://taxfoundation.org/state-strategies-preserve-state-and-local-tax-deduction/ (https://taxfoundation.org/state-strategies-preserve-state-and-local-tax-deduction/). Faber, Peter L. "Do Charitable Contributions Avoid The TCJA SALT Deduction Limit?" State Tax Notes. Apr. 23, 2018.

[18] Faber, Peter L. "Do Charitable Contributions Avoid The TCJA SALT Deduction Limit?" State Tax Notes. Apr. 23, 2018.

[19] Pudelski, Sasha and Carl Davis. "Public Loss, Private Gain: How School Voucher Tax Shelters Undermine Public Education." AASA and ITEP. May 17, 2017. Available at:

https://itep.org/public-loss-private-gain-how-school-voucher-tax-shelters-undermine-public-education/ (https://itep.org/public-loss-private-gain-how-school-voucher-tax-shelters-undermine-public-education/).

[20] Bankman, Joseph and Gamage, David and Goldin, Jacob and Hemel, Daniel Jacob and Shanske, Darien and Stark, Kirk J. and Ventry, Dennis J. and Viswanathan, Manoj. "Federal Income Tax Treatment of Charitable Contributions Entitling Donor to a State Tax Credit." UCLA School of Law, Law-Econ Research Paper No. 18-02; UC Hastings Research Paper No. 264. Jan. 8, 2018. Available at: https://ssrn.com/abstract=3098291 (https://ssrn.com/abstract=3098291).

[21] Ibid.

[22] Credits for donating to school voucher organizations tend to offer the highest rates of return, with reimbursements up to 100 percent of the amount donated. But credits for donating to other causes are large enough that the IRS or Treasury would find it exceedingly difficult to ignore them entirely in targeted action. While it may be reasonable for the IRS to treat 100 percent credits differently than credits in the range of 1 to 99 percent on the grounds that 100 percent credits involve zero financial sacrifice by the donor, drawing a bright line at any other specific percentage is likely impossible via the regulatory process and is a task best left to Congress. This helps explain why many of the new workaround credits are set at levels somewhat below 100 percent. It will be difficult for the IRS to treat New York's 85 percent workaround credit less favorably than Alabama's 100 percent voucher credit or even Indiana's 50 percent credit for donating to institutions of higher education.

[23] State of New York. S. 7509 / A. 9509. Jan. 18, 2018. Available at: http://legislation.nysenate.gov/pdf/bills/2017/s7509c (http://legislation.nysenate.gov/pdf/bills/2017/s7509c).

[24] State of New Jersey 218th Legislature. Senate, No. 1893. Enacted May 4, 2018. Available at: http://www.njleg.state.nj.us/2018/Bills/S2000/1893_R1.PDF (http://www.njleg.state.nj.us/2018/Bills/S2000/1893_R1.PDF).

[25] State of Illinois 100th General Assembly. House Bill 4237. Introduced Jan. 11, 2018. Available at: http://www.ilga.gov/legislation/BillStatus.asp?DocNum=4237&GAID=14&DocTypeID=HB&LegId=108676&SessionID=91&GA=100 (http://www.ilga.gov/legislation/BillStatus.asp?DocNum=4237&GAID=14&DocTypeID=HB&LegId=108676&SessionID=91&GA=100).

[26] State of Rhode Island, Session Year 2018. S. 2216. Feb. 1, 2018. Available at: http://webserver.rilin.state.ri.us/BillText/BillText18/SenateText18/S2216.pdf (http://webserver.rilin.state.ri.us/BillText/BillText18/SenateText18/S2216.pdf).

[27] Council of the District of Columbia. B22-0667. Introduced Jan. 23, 2018. Available at: http://lims.dccouncil.us/Legislation/B22-0667 (http://lims.dccouncil.us/Legislation/B22-0667).

[28] State of Oregon 79th Legislative Assembly. Senate Bill 1528. Available at: https://olis.leg.state.or.us/liz/2018R1/Downloads/MeasureDocument/SB1528/Enrolled (https://olis.leg.state.or.us/liz/2018R1/Downloads/MeasureDocument/SB1528/Enrolled).

[29] Office of the State Treasurer of California. "College Access Tax Credit Fund." Accessed Apr. 23, 2018. Available at: http://www.treasurer.ca.gov/cefa/fact_sheet.pdf (http://www.treasurer.ca.gov/cefa/fact_sheet.pdf).

[30] Arkansas Economic Development Commission. "Rules." May 4, 2016. Available at: http://www.arkansasedc.com/sites/default/files/content/users/lcogbill/2016_aedc_rules_book_ (http://www.arkansasedc.com/sites/default/files/content/users/lcogbill/2016_aedc_rules_book_

[31] Tagami, Ty. "Lawmakers debate tax credit for school 'innovation' fund." *The Atlanta Journal-Constitution*. Mar. 21, 2017. Available at: https://www.ajc.com/news/state –regional-education/lawmakers-debate-tax-credit-for-

school-innovation-fund/0xuUPUvO8bv64uxrrVPbPN/ (https://www.ajc.com/news/state--regional-education/lawmakers-debate-tax-credit-for-school-innovation-fund/0xuUPUvO8bv64uxrrVPbPN/).

[32] Missouri Department of Agriculture. “Agricultural Products Utilization Contributor Tax Credit Program.” Accessed Apr. 23, 2018. Available at: http://agriculture.mo.gov/abd/financial/agproductcontr.php (http://agriculture.mo.gov/abd/financial/agproductcontr.php).

[33] Oregon Department of Education, Early Learning Division. “Child Care Contribution Tax Credit Overview.” Accessed Apr. 23, 2018. Available at: https://oregonearlylearning.com/administration/tax-credit/ (https://oregonearlylearning.com/administration/tax-credit/).

[34] Examples include Colorado, Delaware, Georgia, Maryland, and Massachusetts. See Appendix A of: Bankman, Joseph and Gamage, David and Goldin, Jacob and Hemel, Daniel Jacob and Shanske, Darien and Stark, Kirk J. and Ventry, Dennis J. and Viswanathan, Manoj. “Federal Income Tax Treatment of Charitable Contributions Entitling Donor to a State Tax Credit.” UCLA School of Law, Law-Econ Research Paper No. 18-02; UC Hastings Research Paper No. 264. Jan. 8, 2018. Available at: https://ssrn.com/abstract=3098291 (https://ssrn.com/abstract=3098291).

[35] Indiana Department of Revenue. “Income Tax Credit for Donations to Colleges.” Informational Bulletin #14. July 2015. Available at: https://www.in.gov/dor/files/ib14.pdf (https://www.in.gov/dor/files/ib14.pdf).

[36] A list of “qualified educational entities” in Idaho is printed on page 25 of the state’s 2017 income tax instruction booklet, available at: https://tax.idaho.gov/forms/EIN00046_10-12-2010.pdf (https://tax.idaho.gov/forms/EIN00046_10-12-2010.pdf).

[37] La. Rev. Stat. Ann. §47:37. Available at: http://www.legis.la.gov/legis/Law.aspx?d=102097 (http://www.legis.la.gov/legis/Law.aspx?d=102097)

[38] “Enterprise Zone Administrators.” ChooseColorado.com. Accessed Apr. 23, 2018. Available at: https://choosecolorado.com/doing-business/incentives-financing/ez/administrators/ (https://choosecolorado.com/doing-business/incentives-financing/ez/administrators/).

[39] Neb. Rev. Stat. §13-203.

[40] Indiana Department of Revenue. “Indiana College Credit.” Schedule CC-40. State Form 20152. R13 / 9-17. 2017. Available at: https://www.in.gov/dor/files/20152-2017.pdf (https://www.in.gov/dor/files/20152-2017.pdf).

[41] State of New York. S. 7509 / A. 9509. Jan. 18, 2018. Available at: http://legislation.nysenate.gov/pdf/bills/2017/s7509c (http://legislation.nysenate.gov/pdf/bills/2017/s7509c).

[42] Julian, Sarah. “Supporting innovation in Oklahoma’s rural schools.” Oklahoma Policy Institute, guest blog post. Dec. 10, 2014. Available at: https://okpolicy.org/supporting-innovation-oklahomas-rural-schools-guest-post-sarah-julian/ (https://okpolicy.org/supporting-innovation-oklahomas-rural-schools-guest-post-sarah-julian/).

[43] State of Connecticut General Assembly, Session Year 2018. Substitute Senate Bill No. 11. Available at: https://www.cga.ct.gov/asp/cgabillstatus/cgabillstatus.asp?selBillType=Bill&which_year=2018&bill_num=11 (https://www.cga.ct.gov/asp/cgabillstatus/cgabillstatus.asp?selBillType=Bill&which_year=2018&bill_num=11).

[44] Missouri Department of Economic Development. “Innovation Campus Program.” Accessed Apr. 23, 2018. Available at: https://ded.mo.gov/programs/community/innovation-

campus-program
(https://ded.mo.gov/programs/community/innovation-campus-program).

[45] NetWork Kansas. “About Us.” NetWorkKansas.com Accessed Apr. 23, 2018. Available at: https://www.networkkansas.com/about (https://www.networkkansas.com/about).

[46] Kansas Department of Commerce. “Network Kansas.” KansasCommerce.gov. Accessed Apr. 23, 2018. Available at: https://www.kansascommerce.gov/209/NetWork-Kansas (https://www.kansascommerce.gov/209/NetWork-Kansas).

[47] Cultural Trust. “Who We Are.” CulturalTrust.org. Accessed Apr. 23, 2018. Available at: http://culturaltrust.org/about-us/who-we-are/ (http://culturaltrust.org/about-us/who-we-are/).

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[49] South Carolina Department of Revenue. “Exceptional SC.” DOR.SC.gov. Accessed Apr. 23, 2018. Available at: https://dor.sc.gov/exceptional-sc (https://dor.sc.gov/exceptional-sc).

[50] Faber, Peter L. “Do Charitable Contributions Avoid The TCJA SALT Deduction Limit?.” State Tax Notes. Apr. 23, 2018.

[51] Illinois is the most recent state to enact such a credit. The other seventeen states are identified in: Davis, Carl. “State Tax Subsidies for Private K-12 Education.” Institute on Taxation and Economic Policy. Oct. 12, 2016. Available at: https://itep.org/state-tax-subsidies-for-private-k-12-education/ (https://itep.org/state-tax-subsidies-for-private-k-12-education/).

[52] See Appendix A of: Bankman, Joseph and Gamage, David and Goldin, Jacob and Hemel, Daniel Jacob and Shanske, Darien and Stark, Kirk J. and Ventry, Dennis J. and Viswanathan, Manoj. "Federal Income Tax Treatment of Charitable Contributions Entitling Donor to a State Tax Credit." UCLA School of Law, Law-Econ Research Paper No. 18-02; UC Hastings Research Paper No. 264. Jan. 8, 2018. Available at: https://ssrn.com/abstract=3098291 (https://ssrn.com/abstract=3098291). A few examples of such programs include tax credits for contributions to the following programs: Arizona foster care, Colorado child care, Idaho youth facilities and substance abuse centers, Missouri child services and maternity homes, and Utah disability services.

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[54] Missouri Department of Economic Development. "Youth Opportunity Program." DED.MO.gov. Accessed Apr. 23, 2018. Available at: https://ded.mo.gov/programs/community/YOP (https://ded.mo.gov/programs/community/YOP).

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[58] Rasmusen, Eric Bennett. “Getting Around the State and Local Tax Deduction Limit.” Kelley School of Business Research Paper No. 18-8. Jan. 9, 2018. Available at: https://ssrn.com/abstract=3099296 (https://ssrn.com/abstract=3099296).

[59] Faber, Peter L. “Comment on Professor Stark’s Prompt.” 9 Colum. J. Tax L. Tax Matters 9. Available at: https://taxlawjournal.columbia.edu/article/comment-on-professor-starks-prompt/ (https://taxlawjournal.columbia.edu/article/comment-on-professor-starks-prompt/).

[60] Faber, Peter L. “Do Charitable Contributions Avoid The TCJA SALT Deduction Limit?” State Tax Notes. Apr. 23, 2018.

[61] Institute on Taxation and Economic Policy. “State Treatment of Itemized Deductions.” Jun. 2, 2016. Available at: https://itep.org/state-treatment-of-itemized-deductions-1/ (https://itep.org/state-treatment-of-itemized-deductions-1/).

[62] Bankman, Joseph, David Gamage, Jacob Goldin, Daniel J. Hemel, Darien Shanske, Kirk J. Stark, Dennis J. Ventry Jr., and Manoj Viswanathan. “Caveat IRS: Problems With Abandoning the Full Deduction Rule.” Tax Notes. May 7, 2018.

[63] Ibid.

[64] Ibid.

[65] 115th US Congress (2017-2018). "Public Funds for Public Schools Act." H.R. 4269. Introduced Nov. 7, 2017. Another aspect of this bill relates to donations of stock or other property, which some taxpayers can effectively "sell," tax-free, by donating the property to a nonprofit and then receiving a full payment in the form of tax-free state charitable tax credits. This type of abuse is discussed in more detail in: Davis, Carl. "Tax Bill Would Increase Abuse of Charitable Giving Deduction, with Private K-12 Schools as the Biggest Winners." Institute on Taxation and Economic Policy. Dec. 14, 2017. Available at: https://itep.org/tax-bill-would-increase-abuse-of-charitable-giving-deduction-with-private-k-12-schools-as-the-biggest-winners/ (https://itep.org/tax-bill-would-increase-abuse-of-charitable-giving-deduction-with-private-k-12-schools-as-the-biggest-winners/). Davis, Carl. "Private School Voucher Credits Offer a Windfall to Wealthy Investors in Some States." Institute on Taxation and Economic Policy. Aug. 30, 2017. Available at: https://itep.org/private-school-voucher-credits-offer-a-windfall-to-wealthy-investors-in-some-states/ (https://itep.org/private-school-voucher-credits-offer-a-windfall-to-wealthy-investors-in-some-states/).

[66] Those states are Alabama, Arizona, Georgia, Kansas, Louisiana, Montana, Oklahoma, Pennsylvania, Rhode Island, South Carolina, and Virginia. Louisiana's credit became newly profitable because of recent state legislative changes and is not described in the following report: Davis, Carl. "Tax Bill Would Increase Abuse of Charitable Giving Deduction, with Private K-12 Schools as the Biggest Winners." Institute on Taxation and Economic Policy. Dec. 14, 2017. Available at: https://itep.org/tax-bill-would-increase-abuse-of-charitable-giving-deduction-with-private-k-12-schools-as-the-biggest-winners/ (https://itep.org/tax-bill-would-increase-abuse-of-charitable-giving-deduction-with-private-k-12-schools-as-the-biggest-winners/).

[67] Under this potential law, a 32 percent credit would result in the taxpayer being able to deduct 68 percent of their donation at the federal level. For a high-income taxpayer deducting $68 of a $100 donation against a 37 percent federal tax rate, the federal savings associated with donating would be $25.16 which, when added to the $32 state tax credit, would result in $57.16 in tax savings overall. For a high-income taxpayer receiving only a 20 percent state credit and deducting the full $100 at the federal level, the savings would be $20 at the state level and $37 at the federal level, or a slightly smaller $57 overall.

[68] Kamin, David and Gamage, David and Glogower, Ari D. and Kysar, Rebecca M. and Shanske, Darien and Avi-Yonah, Reuven S. and Batchelder, Lily L. and Fleming, J. Clifton and Hemel, Daniel Jacob and Kane, Mitchell and Miller, David S. and Shaviro, Daniel and Viswanathan, Manoj. "The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the New Legislation." First published Dec. 7, 2017. Last updated Feb. 26, 2018. Available at: https://ssrn.com/abstract=3089423 (https://ssrn.com/abstract=3089423).

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CHAPTER 59
S. 7509–C
Approved and effective April 12, 2018

**PART H**

Section 1. Subsection (c) of section 683 of the tax law is amended by adding a new paragraph 12 to read as follows:

<< NY TAX § 683 >>

**(12) Except as otherwise provided in paragraph three of this subsection, or as otherwise provided in this section where a longer period of time may apply, if a taxpayer files an amended return, an assessment of tax (if not deemed to have been made upon the filing of the amended return), including recovery of a previously paid refund, attributable to a change or correction on the amended return from a prior return may be made at any time within one year after such amended return is filed.**

§ 2. Subsection (c) of section 1083 of the tax law is amended by adding a new paragraph 12 to read as follows:

<< NY TAX § 1083 >>

**(12) Except as otherwise provided in paragraph three of this subsection, or as otherwise provided in this section where a longer period of time may apply, if a taxpayer files an amended return, an assessment of tax (if not deemed to have been made upon the filing of the amended return), including recovery of a previously paid refund, attributable to a change or correction on the amended return from a prior return may be made at any time within one year after such amended return is filed.**

§ 3. Subdivision (c) of section 11–1783 of the administrative code of the city of New York is amended by adding a new paragraph 9 to read as follows:

**(9) Except as otherwise provided in paragraph three of this subdivision, or as otherwise provided in this section where a longer period of time may apply, if a taxpayer files an amended return, an assessment of tax (if not deemed to have been made upon the filing of the amended return), including recovery of a previously paid refund, attributable to a change or correction on the amended return from a prior return may be made at any time within one year after such amended return is filed.**

<< Note: NY TAX §§ 683, 1083 >>

§ 4. This act shall take effect immediately and shall apply to amended returns filed on or after the effective date of this act.

# Bankers Trust Corp. v. New York City

Supreme Court of New York, Appellate Division, First Department

November 19, 2002, Decided ; November 19, 2002, Entered

1048

**Reporter**
301 A.D.2d 321 *; 750 N.Y.S.2d 29 **; 2002 N.Y. App. Div. LEXIS 11231 ***

Bankers Trust Corporation, Respondent, v. New York City Department of Finance et al., Appellants.

**Subsequent History: [***1]** As Corrected November 21, ***2002***.

Appeal granted by *Bankers Trust Corp. v. N.Y. City **Dep't** of Fin., 99 N.Y.2d 507, 787 N.E.2d 1164, 2003 N.Y. LEXIS 207, 757 N.Y.S.2d 818 (2003)*

Motion granted by *Bankers Trust Corp. v. N.Y. City **Dep't** of Fin., 2003 N.Y. LEXIS 3309 (N.Y., Oct. 21, 2003)*

Affirmed in part and modified in part by *Bankers Trust Corp. v. New York City **Dep't** of Fin., 2003 N.Y. LEXIS 3983 (N.Y., Nov. 25, 2003)*

**Prior History:** Appeal from an order and judgment (one paper) of the Supreme Court (Marcy Friedman, J.), entered May 7, 2001 in New York County, which (***1***) granted plaintiff's motion for summary judgment declaring that it was entitled to the tax refunds it had claimed from the City, and (2) denied defendants' cross motion for summary judgment.

**Disposition:** Reversed.

## Core Terms

refund, adjustments, refund claim, net income, computing, changes, deductions, taxpayer's, exhaustion, returns, expenses, overpayment, allocated, audit, banking corporation, expiration, allocation of income, foreign subsidiary, summary judgment, subsidiaries, disallowance, challenges, taxation, statute of limitations, limitations period, tax year, reexamine, agency's, declaratory judgment action, administrative remedy

## Case Summary

**Procedural Posture**
Defendant City of New York Department of Finance appealed from an order and judgment of the Supreme Court, New York County (New York), which granted summary judgment to plaintiff banking corporation and declared that it was entitled to a tax refund, and which denied the city's cross-motion for summary judgment in the corporation's declaratory judgment action.

**Overview**

The corporation claimed tax refunds for certain years based on changes to its state tax returns that had allowed previously disallowed deductions. The city denied the claims due to other adjustments that offset the refunds. The trial court's judgment in favor of the corporation was reversed on appeal. The court affirmed the trial court's determination that the action was maintainable even though all administrative remedies had not been exhausted because the corporation was challenging the city's statutory authority and not the accuracy of its determination. The court reversed the trial court's holding that the adjustments were ultra vires, finding that the reallocation of expenses made by the city did not violate New York City, N.Y., *Admin. Code § 11-678(3)(c)*. The court held that the city had acted within its statutory authority in making the adjustments to the corporation's entire net income. The corporation's argument that when the city was determining the refund amount on claims filed after the three-year limitations period for assessments, the scope of the audit should have been restricted to the proposed adjustments on which the refund claim was based, was rejected.

**Outcome**
The court reversed the trial court's judgment, directed the denial of the corporation's motion, and granted the city's motion for summary judgment. The court declared that the corporation was not entitled to the tax refunds.

## LexisNexis® Headnotes

Governments > Local Governments > Claims By & Against

Tax Law > ... > Tax Credits & Liabilities > Credits, Overassessments & Refunds > General Overview

Governments > Legislation > Statute of Limitations > General Overview

Tax Law > State & Local Taxes > Administration & Procedure > General Overview

**HN1**[] **Local Governments, Claims By & Against**

See New York City, N.Y., *Admin. Code § 11-678(3)(c)*.

Tax Law > ... > Foreign Base Company Income > Foreign Personal Holding Companies > Foreign Estates, Partnerships & Trusts

Tax Law > ... > Tax Accounting > Allocations of Deductions & Income > General Overview

Tax Law > State & Local Taxes > Administration & Procedure > General Overview

**HN2**[] **Foreign Personal Holding Companies, Foreign Estates, Partnerships & Trusts**

Pursuant to New York City's authority under New York City, N.Y., *Admin. Code § 11-646(g)*, the city is empowered to adjust items of income or deduction in computing entire net income in order to eliminate the effect of any agreement, understanding or arrangement between the taxpayer and any other corporation whereby the income of the taxpayer within the city is improperly or inaccurately reflected.

Administrative Law > Judicial Review > Reviewability > Exhaustion of Remedies

Civil Procedure > ... > Justiciability > Exhaustion of Remedies > Administrative Remedies

Tax Law > ... > Tax Credits & Liabilities > Credits, Overassessments & Refunds > General Overview

Civil Procedure > ... > Justiciability > Exhaustion of Remedies > General Overview

Tax Law > State & Local Taxes > Administration & Procedure > General Overview

**HN3**[] **Reviewability, Exhaustion of Remedies**

A change of the allocation of income or capital upon which a taxpayer's return was based is forbidden by the City of New York to make, pursuant to New York City, N.Y., *Admin. Code § 11-678(3)(c)*, when it is computing the amount of the credit or refund to be granted based upon a correction of the federal or state return. *N.Y. Tax Law § 1087(c)(**1**)*.

Administrative Law > Judicial Review > Reviewability > Exhaustion of Remedies

Civil Procedure > ... > Justiciability > Exhaustion of Remedies > Administrative Remedies

Tax Law > State & Local Taxes > Estate & Gift Taxes > General Overview

Civil Procedure > ... > Justiciability > Exhaustion of Remedies > General Overview

Tax Law > State & Local Taxes > Administration & Procedure > General Overview

Tax Law > State & Local Taxes > Administration & Procedure > Credits, Overassessments & Refunds

**HN4**[] **Reviewability, Exhaustion of Remedies**

New York City, N.Y. *Admin. Code § 11-678(3)(c)*, like *N.Y. Tax Law § 1086(a)*, authorizes the refunding of a tax "overpayment," and requires that the City of New York determine that there was actually an "overpayment" of tax before it may issue a refund.

Administrative Law > Judicial Review > Reviewability > Exhaustion of Remedies

Environmental Law > Administrative Proceedings & Litigation > Judicial Review

Administrative Law > Judicial Review > General

Overview

Administrative Law > Judicial Review > Reviewability > Standing

Civil Procedure > ... > Justiciability > Exhaustion of Remedies > General Overview

Civil Procedure > ... > Justiciability > Exhaustion of Remedies > Administrative Remedies

**HN5[] Reviewability, Exhaustion of Remedies**

A person aggrieved by the action of a government agency is generally required to exhaust the available administrative remedies before seeking judicial review of the agency's action. New York City, N.Y., *Admin. Code § 11-681(2)*. However, the exhaustion rule is not an inflexible one, being subject to important qualifications. Among the recognized qualifications to the exhaustion rule is an exception to its applicability where an agency's action is challenged as wholly beyond its grant of power.

Civil Procedure > ... > Declaratory Judgments > State Declaratory Judgments > General Overview

Civil Procedure > Judgments > Declaratory Judgments > General Overview

**HN6[] Declaratory Judgments, State Declaratory Judgments**

A plaintiff may use a declaratory judgment action to challenge administrative action where, although the agency's general authority to act on the plaintiff was unquestioned, the plaintiff contended that the agency had purported to exercise that authority in a manner beyond its statutory power.

Governments > Local Governments > Claims By & Against

Governments > Legislation > Statute of Limitations > General Overview

Governments > Local Governments > Duties & Powers

Governments > Local Governments > Finance

Tax Law > State & Local Taxes > Administration & Procedure > General Overview

Tax Law > State & Local Taxes > Administration & Procedure > Credits, Overassessments & Refunds

**HN7[] Local Governments, Claims By & Against**

New York City, N.Y., *Admin. Code § 11-677(**1**)* authorizes the Commissioner of Finance to issue a refund only if it is determined that the taxpayer made an "overpayment" of taxes for the relevant tax year. Although *§ 11-677* does not define "overpayment," in the absence of any indication to the contrary, the term should be construed, in accordance with its usual sense, to mean any payment in excess of that which is properly due, or the payment of more than is rightfully due. Thus, upon the filing of a refund claim on any basis, the City of New York is required to compute the correct tax for the year in question, and therefore may reexamine any aspect of the return. The audit is not restricted to consideration of the particular items of adjustment proposed in the refund claim, even where the refund claim is based on state changes that were made after the statute of limitations for the assessment of deficiencies had expired. While the expiration of the assessment limitation period precludes the city from collecting any unpaid deficiency that may be discovered (except to the extent provided by New York City, N.Y., *Admin. Code § 11-674(3)(c)*, no refund may issue unless it appears that the taxpayer in fact overpaid its taxes.

Tax Law > State & Local Taxes > Administration & Procedure > General Overview

**HN8[] State & Local Taxes, Administration & Procedure**

See New York City, N.Y., *Admin. Code § 11-677(**1**)*.

Tax Law > ... > Income Taxes > Corporations & Unincorporated Associations > General Overview

Tax Law > Federal Income Tax Computation > General Overview

**HN9[] Income Taxes, Corporations & Unincorporated Associations**

In determining how the tax due under New York City's Banking Corporation Tax is calculated, the following steps are used: first, one determines the taxpayer's "entire net income," which is defined as total net income from all sources which shall be the same as the entire taxable income which the taxpayer is required to report to the United States treasury department. New York City, N.Y., *Admin. Code § 11-641(a)(**1**)*, i.e., gross income less allowable deductions for expenses and losses, etc., subject to certain modifications and adjustments. Next, where the taxpayer does business both within and without New York City, one determines the taxpayer's "allocation percentage," which is the fraction of worldwide entire net income that is deemed to be derived from business within the city. The allocation percentage is computed based on the percentages of the taxpayer's total deposits, receipts, and payroll that reflect business activity within the city. New York City, N.Y., *Admin. Code § 11-642*. To derive the dollar amount of entire net income allocable to the city, one multiplies entire net income by the allocation percentage. Finally, to derive the amount of tax due, one multiplies entire net income allocable to the city by the tax rate.

Tax Law > State & Local Taxes > Administration & Procedure > General Overview

Tax Law > State & Local Taxes > General Overview

***HN10***[] **State & Local Taxes, Administration & Procedure**

It is clear from the statutory context that New York City, N.Y., *Admin. Code § 11-678(3)(c)* uses the words, "the allocation of income or capital upon which the taxpayer's return was based," to refer specifically to the "allocation percentage" utilized to derive the amount of the taxpayer's entire net income or capital subject to municipal taxation. New York City, N.Y., *Admin. Code § 11-642(b)(**1**)*.

Governments > Legislation > Interpretation

***HN11***[] **Legislation, Interpretation**

In the absence of anything in a statute indicating an intention to the contrary, where the same word or phrase is used in different parts of a statute, it will be presumed to be used in the same sense throughout, and the same meaning will be attached to similar expressions in the same or a related statute.

Tax Law > State & Local Taxes > Administration & Procedure > General Overview

***HN12***[] **State & Local Taxes, Administration & Procedure**

New York City, N.Y., *Admin. Code § 11-678(3)(c)* is construed to prohibit only changes of the taxpayer's allocation percentage.

Tax Law > ... > Income Taxes > Individuals, Estates & Trusts > Deductions

Tax Law > Federal Income Tax Computation > Losses > Related Taxpayers

Tax Law > State & Local Taxes > Administration & Procedure > General Overview

Tax Law > State & Local Taxes > Estate & Gift Taxes > General Overview

Tax Law > ... > Estate & Gift Taxes > Estate & Inheritance Tax > Imposition of Tax

Tax Law > ... > Income Taxes > Individuals, Estates & Trusts > General Overview

Tax Law > ... > Income Taxes > Individuals, Estates & Trusts > Imposition of Tax

***HN13***[] **Individuals, Estates & Trusts, Deductions**

Entire net income and allocation percentage are independent variables in the tax-computation formula, and New York City, N.Y., *Admin. Code § 11-678(3)(c)* is concerned with allocation percentage only. Nothing in *§ 11-678(3)(c)* prohibits an adjustment that, increases entire net income (worldwide) by shifting a deduction claimed by a taxpayer to a related entity whose income is not included in the taxpayer's entire net income. Stated otherwise, *§ 11-678(3)(c)* permits an adjustment disallowing a deduction based on a finding that the expenses generating the deduction were not incurred in the production of any part of the taxpayer's entire net income, from either within or without the City of New York, and therefore were not properly deductible in computing entire net income. New York City, N.Y., *Admin. Code § 11-646(f)(4)(i)* and *N.Y. Tax Law § 1462(f)(4)(i)*.

## Headnotes/Syllabus

**Headnotes**

Administrative Law - Failure to Exhaust Administrative Remedies - Challenge to Taxing Agency's Statutory Authority to Deny Tax Refund

***1***. Plaintiff is not barred by the exhaustion of administrative remedies rule from bringing a declaratory judgment action to challenge the denial by defendant New York City Department of Finance of its tax refund claims made following changes to plaintiff's state tax returns, which allowed certain deductions of interest from second-tier and lower subsidiaries that defendant had initially disallowed on plaintiff's municipal banking corporation tax returns for the tax years 1986, 1987 and 1993. Plaintiff is not challenging the adjustments that resulted in the denial of its refund claims as exercises of duly granted authority that were tainted by factual or mathematical errors, or that were otherwise arbitrary, capricious or irrational. Such a challenge would be subject to the exhaustion rule. Rather, plaintiff challenges the adjustments as unauthorized both because the adjustments were "extraneous" to the state changes that occasioned the audit after expiration of the general three-year limitation period for deficiency assessments (*Administrative Code of City of NY § 11-674 [**1**]*), and because the adjustments violated the specific statutory prohibition of changes of the "allocation of income or capital" in computing the amount of refund due as the result of the state changes (*Administrative Code § 11-678 [3] [c]*). Plaintiff's challenges to the adjustments raise only pure issues of statutory construction, without any substantive factual dispute being involved.

Taxation - Tax Refund - New York City Banking Corporation Tax - Refund Based on State Tax Return

2. Defendant New York City Department of Finance did not act unreasonably in denying plaintiff's tax refund claims made following changes to plaintiff's state tax returns, which allowed certain deductions of interest from second-tier and lower subsidiaries that defendant had initially disallowed on plaintiff's municipal banking corporation tax returns for the tax years 1986, 1987 and 1993. Defendant acted within its statutory power in refusing to issue any refund because of other adjustments that offset the claimed refunds. Defendant, in computing the amount of refund due as the result of state changes (*Administrative Code of City of NY § 11-678 [3] [c]*), is authorized to reexamine all aspects of the municipal return to determine whether any refund is payable, and is not limited to making adjustments only reflecting the state changes. When plaintiff filed its refund claims based on the state changes, it placed at issue other aspects of its returns for purposes of determining whether any refundable "overpayment" had been made (*see Administrative Code § 11-677 [**1**]*), even though the three-year limitation period for deficiency assessments had expired.

Taxation - Tax Refund - New York City Banking Corporation Tax - Refund Based on State Tax Return

3. Defendant New York City Department of Finance did not act unlawfully in denying plaintiff's tax refund claims made following changes to plaintiff's state tax returns, which allowed certain deductions of interest from second-tier and lower subsidiaries that defendant had initially disallowed on plaintiff's municipal banking corporation tax returns for the tax years 1986, 1987 and 1993. Defendant offset plaintiff's refund by disallowing certain operating-expense deductions attributable to foreign subsidiaries not included in plaintiff's returns. Defendant's adjustments in computing the amount of refund due as the result of state changes did not violate the statutory prohibition against any "change of the allocation of income or capital upon which the taxpayer's return … was based" (*Administrative Code of City of New York § 11-678 [3] [c]*). While defendant's adjustments increased the entire net income figure reported on plaintiff's returns by disallowing certain expense deductions, they made no change in plaintiff's "allocation" percentage computed under *Administrative Code § 11-642*. The statute prohibits only changes of the taxpayer's "allocation" percentage, and does not prohibit an adjustment that increases entire net income by shifting a deduction claimed by the taxpayer to a related entity whose income is not included in the taxpayer's entire net income.

**Counsel:** *Kenneth I. Moore* of counsel (*Stephen L. Solomon* on the brief; *Hutton & Solomon LLP,* attorneys), for respondent.

*Robert J. Firestone* of counsel (*Paul T. Rephen, Elizabeth Dvorkin* and *Rita D. Dumain* on the brief; *Michael A. Cardozo, Corporation Counsel* of New York

City, attorney), for appellants.

**Judges:** Richard T. Andrias, J.P., Ernst H. Rosenberger, Israel Rubin, David Friedman, JJ. Andrias, J.P., Rosenberger and Rubin, JJ., concur.

**Opinion by:** David Friedman

## Opinion

**[*323]** **[**31]** Friedman, **[***2]** J.

Plaintiff (Bankers Trust), a banking corporation subject to the New York City banking corporation tax (Administrative Code of City of NY, tit 11, ch 6, subch 3, part 4), commenced this declaratory judgment action to challenge the denial by defendant New York City Department of Finance (the City) of Bankers Trust's claims for tax refunds for certain years. The refund claims were based on changes to Bankers Trust's state tax returns, which allowed certain deductions the State Department of Taxation and Finance (the State) had previously disallowed. When Bankers Trust filed the refund claims, the City adopted the state changes but nevertheless refused to issue any refund because of other adjustments that offset the claimed refunds. These adjustments involved the disallowance of certain deductions on the ground that the underlying expenses were incurred on behalf of foreign subsidiaries of Bankers Trust whose income was not included on Bankers Trust's returns. The IAS court granted summary judgment to Bankers Trust, and the City has appealed.

The issues raised by this appeal concern (***1***) the scope of the doctrine of exhaustion of remedies, (2) whether, upon **[***3]** the filing of a refund claim after expiration of the limitation period for deficiency assessments, the City may consider matters other than those raised by the refund claim itself, and (3) what is the meaning of *Admin. Code § 11-678(3)(c)*, which provides that, ***HN1***[ ] where a municipal refund is based on a change in federal or state returns, such refund shall be computed "without change of the allocation of income or capital upon which the taxpayer's return … was based."

FACTS

In computing its "entire net income" (as defined by *Admin. Code § 11-641 [a]*) on its banking corporation tax returns for each of the tax years 1986, 1987 and 1993, Bankers Trust claimed a deduction for 17% of "interest income from subsidiary capital," as permitted by *Admin. Code § 11-641 (e) (11) (i)*. In claiming this deduction, Bankers Trust included 17% of its interest income from its subsidiaries of the second tier and lower. Upon auditing each return, the City disallowed the deduction of interest from second-tier and lower subsidiaries. The City based this disallowance on its position that the Administrative Code authorized **[***4]** the deduction of subsidiary interest for interest received from subsidiaries of the first tier only.

**[*324]** The City's disallowance of the subsidiary interest deductions was consistent with adjustments the State made to Bankers Trust's New York State tax returns for 1986 and 1987 under the corresponding provision of the State's franchise tax on banking corporations (*Tax Law § 1453 [e] [11] [i]*). Bankers Trust, however, filed refund claims with the State, arguing that a subsequent decision of the State Tax Appeals Tribunal established that the State should not have disallowed the deductions. The ensuing state administrative proceedings were ultimately resolved by an August 1997 settlement agreement, under which, among other things, the State allowed the deductions **[**32]** for interest from second-tier and lower subsidiaries for several prior tax years.

As required by *Admin. Code § 11-646 (e)*, Bankers Trust made a report to the City, in November 1997, of the changes in its taxable income that had been effected by the August 1997 settlement agreement with the State, including the State's allowance of the aforementioned deductions. Based on the **[***5]** correction of its state returns, Bankers Trust timely filed claims, pursuant to *Admin. Code §§ 11-677* and *11-678 (3)*, for refunds from the City for the tax years 1986, 1987 and 1993, among others, in the amounts of $ ***1***,272,475, $ ***1***,300,107 and $ 3,824,106, respectively. In response to the refund claims, the City reaudited Bankers Trust's returns for these tax years.

In January 1999, the City notified Bankers Trust that it was disallowing the refund claims for 1986, 1987 and 1993 in their entirety. While it followed the State in allowing the deductions for 17% of interest from second-tier and lower subsidiaries, the City reexamined other aspects of the returns ***HN2***[ ] pursuant to its authority under *Admin. Code § 11-646 (g)*, which empowers the City, as here relevant, "to adjust items of income or deductions in computing entire net income" in order to eliminate the effect of "any agreement, understanding or arrangement … between the taxpayer [here, Bankers Trust] and any other corporation [here, its foreign subsidiaries] … whereby the … income … of the taxpayer within the city is improperly or inaccurately reflected **[***6]** " (*compare 26 USC § 482*). As described below, the new matter the City raised resulted in a redetermination of the tax due for each year that totally offset the claimed refund.

The City found that certain of the operating expenses Bankers Trust had deducted in determining its entire net income should have been attributed to its "non-combined" foreign subsidiaries, **[*325]** that is, foreign subsidiaries whose income was not included in Bankers Trust's tax returns and, as is apparently undisputed, were not subject to City taxation. In essence, the City took the position that, because these expenses were incurred on behalf of the foreign subsidiaries whose income was not included on Bankers Trust's returns, such expenses were not properly deductible by Bankers Trust. The City multiplied the resulting additional entire net income by Bankers Trust's "allocation percentage," i.e., the percentage of its income deemed to be derived from business within New York City pursuant to *Admin. Code § 11-642 (b) (**1**)*, and multiplied the portion of the additional entire net income thus allocated to the City by the nine percent tax rate (*Admin. Code § 11-643.5 [a]*). **[***7]** Although the three-year statute of limitations (*Admin. Code § 11-674 [**1**]*) prevented the City from seeking to collect the additional amounts of tax due resulting from its calculations, those amounts completely offset the refunds Bankers Trust claimed.

Instead of challenging the denial of the refund claims through the administrative channels prescribed by statute (*see Admin. Code §§ 11-680*, *11-681*), Bankers Trust commenced this action against the City in February 2000, seeking a judicial declaration that the City's denial of the refund claims was an ultra vires act beyond the City's statutory power. Bankers Trust's main argument in support of its motion for summary judgment was that, after expiration of the general three-year limitation period for assessments (*Admin. Code § 11-674 [**1**]*), the City, in reauditing municipal tax returns upon receiving a refund claim based on a correction to the taxpayer's corresponding federal or state returns, has authority to recalculate taxable income only for the limited purpose of giving effect to the decrease or increase in federal **[**33]** or state taxable **[***8]** income (*Admin. Code § 11-678 [3] [d]*). Bankers Trust asserted that the adjustment to taxable income on which the City based its denial of the refund was entirely "extraneous," and not in any way attributable, to the adjustment of the state return that occasioned the reaudit in the first place.

In addition to its primary argument that the City had authority to make only adjustments reflecting the state corrections, Bankers Trust made a second argument that the Administrative Code specifically prohibited the City's shifting of expenses from Bankers Trust to its foreign subsidiaries in determining the amount of the refund. Bankers Trust argued that this adjustment in fact constituted ***HN3***[] a "change of the allocation **[*326]** of income or capital upon which the taxpayer's return … was based," which *Admin. Code § 11-678 (3) (c)* forbids the City to make in computing the amount of the credit or refund to be granted based upon a correction of the federal or state return (*see also Tax Law § 1087 [c] [**1**]*).

In opposing Bankers Trust's motion and cross-moving for summary judgment in its own favor, the City argued, **[***9]** first, that the action should be dismissed on the ground that Bankers Trust had not exhausted its administrative remedies, and, second, that the City had not exceeded its statutory authority in denying the refund claims. In support of the second argument, the City contended that *Admin Code § 11-677 (**1**)*, ***HN4***[] which, like *Tax Law § 1086 (a)*, authorizes the refunding of a tax "overpayment," requires that the City determine that there was actually an "overpayment" of tax before it may issue a refund. Therefore, the City argued, the scope of the audit to be conducted upon receipt of Bankers Trust's refund claims was not limited to the specific subject matter of the state changes.

The City also denied Bankers Trust's claim that the adjustment that offset the refunds constituted a "change of the allocation of income or capital" forbidden by *Admin. Code § 11-678 (3) (c)*. The City took the position that the "allocation" to which *Admin. Code § 11-678 (3) (c)* refers is the "allocation percentage" of entire net income deemed to be derived from business within the City and therefore taxable **[***10]** by the City (*see Admin. Code § 11-642 [b] [**1**]*; *see also Admin. Code § 11-643.5 [a]* [banking corporation tax is imposed on "the taxpayer's entire net income, or *the portion thereof allocated to the city*" (emphasis added)]), which allocation percentage is calculated by the method set forth in *Admin. Code § 11-642*. The City noted that, in calculating the refund, if any, to which Bankers Trust was entitled for each year, it had used the very same allocation percentage that Bankers Trust had used in calculating its refund claim.

The IAS court granted summary judgment to Bankers Trust, declaring that Bankers Trust was entitled to the claimed refunds. The court found that the action was not barred by the failure to exhaust administrative remedies because Bankers Trust was contending that the City lacked statutory authority to make the adjustments it invoked as grounds for denying the refunds. The court then determined that the adjustments in question were ultra vires based on Bankers Trust's second argument that each adjustment was a change of allocation **[*327]** prohibited by [Admin. Code § 11-678 (3) (c)](). **[***11]** The court based this conclusion on its mistaken belief that the City "does not deny that the reallocation of expenses which it made in computing plaintiff's refund claim violated … [Administrative Code § 11-678 (3) (c)]() ."

ANALYSIS

We concur with the IAS court that this case falls within the exception to the exhaustion-of-remedies **[**34]** doctrine for challenges asserting that an administrative action was beyond the agency's statutory authority. Nevertheless, we conclude that the City acted within its statutory authority in making the challenged adjustments to Bankers Trust's entire net income that resulted in the denial of the refunds. We therefore reverse.

*Exhaustion of Administrative Remedies*

It is well established that ***HN5***[] a person aggrieved by the action of a government agency is generally required to exhaust the available administrative remedies before seeking judicial review of the agency's action (*see* *Admin. Code § 11-681 [2]*; *Watergate II Apts. v Buffalo Sewer Auth., 46 N.Y.2d 52, 57, 412 N.Y.S.2d 821, 385 N.E.2d 560*). It is equally well established, however, that the exhaustion rule "is **[***12]** not an inflexible one," being "subject to important qualifications" (*id.*). Among the recognized qualifications to the exhaustion rule is an exception to its applicability where an agency's action is challenged as "wholly beyond its grant of power" (*id.*).

It is the exhaustion rule's exception for challenges to administrative action as beyond the scope of the agency's power that Bankers Trust contends to be applicable here. We agree. Bankers Trust is not challenging the adjustments that resulted in the denial of its refund claims as exercises of duly granted authority that were tainted by factual or mathematical errors, or that were otherwise arbitrary, capricious or irrational. Such a challenge would be subject to the exhaustion rule (*see e.g. Reader's Digest Assn. v Friedlander, 100 A.D.2d 871, 872, 474 N.Y.S.2d 131, lv denied 64 NY2d 601, 474 N.E.2d 259*). Rather, Bankers Trust challenges the adjustments as unauthorized by the relevant statute (*Admin. Code § 11-678 [3]*), both because the adjustments were "extraneous" to the state changes that occasioned the audit after expiration of the statute of limitations for assessments, **[***13]** and because the adjustments violated the specific statutory prohibition of "change[s] of the allocation of income or capital" in computing the amount of refund due as the result of the state changes (*Admin. Code § 11-678 [3] [c]*). The propriety of Bankers Trust's maintenance of this declaratory judgment **[*328]** action is highlighted by the fact that the challenges to the adjustments raise only pure issues of statutory construction, without any substantive factual dispute being involved (*see e.g. Dun & Bradstreet v City of New York, 276 NY 198, 206, 11 N.E.2d 728*; *Apex Air Freight v O'Cleireacain, 210 A.D.2d 7, 8, 619 N.Y.S.2d 38 lv denied 86 NY2d 712, 635 N.Y.S.2d 949, 659 N.E.2d 772*; *Matter of Herberg v Perales, 180 A.D.2d 166, 169, 585 N.Y.S.2d **1***).

The City argues that the exception to the exhaustion rule for challenges to administrative actions allegedly in excess of the agency's power is limited to cases where there is a contention that the relevant statute is entirely inapplicable (*see e.g. Dun & Bradstreet v City of New York, supra*; *GTE Spacenet Corp. v New York State Dept. of Taxation & Fin., 201 A.D.2d 429, 430, 607 N.Y.S.2d 677*). **[***14]** Therefore, the City contends, the exception does not apply, since Bankers Trust does not dispute either that it was subject to the tax in question, or that the City was authorized to audit the refund claims.

Contrary to the City's view, the Court of Appeals has upheld ***HN6***[] the use of a declaratory judgment action to challenge administrative action where, although the agency's general authority to act on the plaintiff was unquestioned, the plaintiff contended that the agency had purported to exercise that authority in a manner beyond its statutory power (*see* *Watergate II Apts. v Buffalo Sewer Auth., supra, 46 N.Y.2d 52 at 58, 412 **[**35]** N.Y.S.2d 821, 385 N.E.2d 560* [exhaustion rule did not apply to plaintiff's challenge to sewer charges on the ground they constituted taxes beyond the authority's jurisdiction, based on the manner in which such charges were computed]). This is precisely the nature of the challenge in this case. While it is undisputed that the banking corporation tax was applicable and that the City had jurisdiction to conduct the audits in question, Bankers Trust contends that the City was without statutory authority to make the particular adjustments that resulted in denial of the refund claims. The challenge **[***15]** is based on the general nature of the adjustments, and does not require us to determine their accuracy by delving into the underlying facts or computations on which they were based. Under these circumstances, the exhaustion rule does not apply.

*Scope of Audit To Determine Amount of Refund*

Having established that this declaratory judgment action is not barred by the exhaustion rule, we proceed to consider the merits of the challenge to the City's action. As previously discussed, Bankers Trust's primary argument in the IAS court was that when the City conducts an audit to determine the amount of refund payable, if any, based on a claim filed after expiration of the three-year statute of limitations for assessments, **[*329]** the scope of the audit is restricted to the proposed adjustments on which the refund claim is based (in this case, the adjustments that would conform the municipal return to the adjusted state return pursuant to *Admin. Code § 11-678 [3]*). The IAS court did not address this argument, instead deciding the case based on its acceptance of Bankers Trust's second argument (addressed in the next section of this opinion) that the adjustments **[***16]** were changes of allocation specifically prohibited by *Admin. Code § 11-678 (3) (c)*.

We reject the contention that the scope of the audit of the refund claims was limited to the proposed adjustments on which the claims were based, i.e., adjustments corresponding to the state changes of entire net income. As the City correctly observes, ***HN7***[] the Administrative Code authorizes the Commissioner of Finance to issue a refund only if it is determined that the taxpayer made an "overpayment" of taxes for the relevant tax year (*Admin. Code § 11-677 [**1**]*). ***1***[1] Although the statute does not define "overpayment," it is well established in tax jurisprudence that, in the absence of any indication to the contrary, the term should be construed, in accordance with its usual sense, to mean "any payment in excess of that which is properly due," or "the payment of more than is rightfully due" (*Jones v Liberty Glass Co., 332 U.S. 524, 531, 92 L. Ed. 142, 68 S. Ct. 229*). Thus, upon the filing of a refund claim on any basis, the City is required to compute the correct tax for the year in question, and therefore may reexamine any aspect **[***17]** of the return. The audit is not restricted to consideration of the particular items of adjustment proposed in the refund claim, even where, as in this case, the refund claim is based on state changes that were made after the statute of limitations for the assessment of deficiencies had expired. While the expiration of the assessment limitation period precludes **[**36]** the City from collecting any unpaid deficiency that may be discovered (except to the extent provided by *Admin. Code § 11-674 [3] [c]*), no refund may issue unless it appears that the taxpayer in fact overpaid its taxes.

**[***18]** The conclusion that the City was authorized to reexamine all aspects of the return in determining whether any refund was **[*330]** payable, notwithstanding that any deficiency assessment was time-barred, receives direct support from the decision of the United States Supreme Court in *Lewis v Reynolds (284 U.S. 281, 76 L. Ed. 293, 52 S. Ct. 145*, *mod on other grounds 284 U.S. 599*). In *Lewis,* the taxpayer filed a claim for a refund of its payment of a deficiency assessment. The refund claim, although timely, was filed after expiration of the limitation period for assessments of deficiencies. The Government, while it agreed with the taxpayer that the prior deficiency assessment should be reversed, rejected the refund claim based on a different adjustment that resulted in an additional amount of tax greater than the claimed refund. In sustaining the Government's position, the Supreme Court stated (*id. at 283*):

> "While the statutes authorizing refunds do not specifically empower the Commissioner to reaudit a return whenever repayment is claimed, authority therefor is necessarily implied. *An overpayment must appear before **[***19]** refund is authorized.* Although the statute of limitations may have barred the assessment and collection of any additional sum, it does not obliterate the right of the United States to retain payments already received when they do not exceed the amount which might have been properly assessed and demanded." (Emphasis added.)

Bearing in mind that, as the parties agree, we may look for guidance to federal case law construing comparable provisions of the Internal Revenue Code, we find the Supreme Court's words in *Lewis* equally applicable to the present case. [2]

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[1] *Admin. Code § 11-677 (**1**)* provides:

"*§ 11-677*. ***HN8***[] *Overpayment.* ***1***. General. The commissioner of finance, within the applicable period of limitations, may credit *an overpayment of tax* and interest on such overpayment against any liability in respect of any tax imposed by any of the named subchapters of this chapter or [*sic*] on the taxpayer who made the overpayment, and the balance shall be refunded out of the proceeds of the tax." (Emphasis added.)

[2] The authorities cited by Bankers Trust on this point (*People ex rel. International Salt Co. v Graves, 267 NY 149, 196 N.E. 5*; *People ex rel. Jacob Doll & Sons v Graves, 257 App Div*

Before turning to the City's remaining argument, we note **[***20]** that the respondent's brief submitted by Bankers Trust includes an alternative argument in support of its position that the issues opened for reexamination by the refund claims were limited to the subject matter of the state corrections. Bankers Trust argues, apparently for the first time in opposition to this appeal, that the City agreed to such a limitation in the consent and waiver agreements the parties executed in 1992 and 1997. We cannot uphold the IAS court's decision on this ground, however, as a challenge to the denial of the refunds based on the consent and waiver agreements would not fall within any **[*331]** exception to the exhaustion-of-remedies doctrine. If the argument were not barred by Bankers Trust's failure to exhaust its administrative remedies, we would reject it as wholly lacking in merit. Nothing in the consent and waiver agreements purports to limit the scope of the issues the City would otherwise have legal authority to reexamine upon the filing of a refund claim.

*Whether the Challenged Adjustments Were Changes of Allocation Prohibited By Administrative*[*Admin. Code § 11-678(3)(c)*]()

Finally, we reach the issue on which Supreme Court ruled in Bankers **[***21]** Trust's favor. To reiterate, the question is whether the City violated the prohibition **[**37]** against any "change of the allocation of income or capital upon which the taxpayer's return … was based" ([*Admin. Code § 11-678 [3] [c]*]()) when, in computing the amount of refund to be issued based on state changes made after expiration of the limitation period for deficiency assessments, it disallowed Bankers Trust's deduction of certain expenses based on a finding that such expenses were properly deductible by Bankers Trust's foreign subsidiaries not included in its returns. In considering this issue, our concern is limited to whether the adjustments violated the statutory prohibition. Again, we do not consider whether the adjustments were factually, mathematically or logically supportable, because the exhaustion rule forbids us to do so.

In regard to this issue, it is helpful to keep in mind ***HN9***[] how the tax due under the City's banking corporation tax is calculated. First, one determines the taxpayer's "entire net income," which is defined as "total net income from all sources which shall be the same as the entire taxable income … which the taxpayer is required **[***22]** to report to the United States treasury department" ([*Admin. Code § 11-641 [a] [**1**]*]()), i.e., gross income less allowable deductions for expenses and losses, etc., subject to certain modifications and adjustments not relevant here. Next, where, as here, the taxpayer does business both within and without New York City, one determines the taxpayer's "allocation percentage," which is the fraction of worldwide entire net income that is deemed to be derived from business within the City. The allocation percentage is computed based on the percentages of the taxpayer's total deposits, receipts, and payroll that reflect business activity within the City ([*Admin. Code § 11-642*](); *see also* [*Admin. Code § 11-604 [3]*]() [prescribing similar method for computation of allocation percentages under City's general corporation tax]). To derive the dollar amount of entire net income allocable to the City, **[*332]** one multiplies entire net income by the allocation percentage. Finally, to derive the amount of tax due, one multiplies entire net income allocable to the City by the tax rate (here, nine percent). [3]

**[***23]** Turning to the question at hand, we again note that, in computing the amount to be refunded for each year, the only change the City made to the computations set forth in the refund claim was to increase entire net income by disallowing certain expense deductions. After deriving the increased entire net income figure, the City applied to it the identical allocation percentage that Bankers Trust had reported in the refund claim. Bankers Trust concedes this much in its appellate brief, acknowledging that the City made "no change in [its] allocation percentage." Nonetheless, Bankers Trust argues that the statutory prohibition of "change[s] of the allocation of income or capital upon which the taxpayer's return … was based" ([*Admin. Code § 11-678 [3] [c]*]()) is not limited to changes of the allocation percentage computed, for purposes of the banking corporation tax, under [*Admin. Code § 11-642*](). We cannot agree.

First, ***HN10***[] it is clear from the statutory context that

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[*481, 14 N.Y.S.2d 60*](); [*Matter of Ethyl Corp., 1999 NY City Tax LEXIS 26, 1999-**1***]() NY Tax Cases CT-158, CT-175--CT-178 [NY City Tax Appeals Tribunal, June 28, 1999]) are not to the contrary.

[3] By way of a simplified example, assume a taxpayer subject to the banking corporation tax has gross income of $ ***1***,000,000 and allowable deductions of $ 800,000. That taxpayer would report entire net income of $ 200,000 ($ ***1***,000,000 less $ 800,000). Further assuming the taxpayer's allocation percentage to be 50%, the taxpayer would report allocated income of $ 100,000 ($ 200,000 x 50%), and tax due of $ 9,000 ($ 100,000 x 9%).

Admin. Code § 11-678 (3) (c) uses the words in question ("the allocation of income or capital upon which the taxpayer's return **[***24]** ... was based") to refer **[**38]** specifically to the "allocation percentage" utilized to derive the amount of the taxpayer's entire net income or capital subject to municipal taxation (*see* Admin. Code § 11-642 [b] [***1***]). McKinney's Consolidated Laws of NY, Book ***1***, Statutes § 236 states:

> "***HN11***[] In the absence of anything in the statute indicating an intention to the contrary, where the same word or phrase is used in different parts of a statute, it will be presumed to be used in the same sense throughout, and the same meaning will be attached to similar expressions in the same or a related statute." (*See also* Riley v County of Broome, 95 N.Y.2d 455, 466, 719 N.Y.S.2d 623, 742 N.E.2d 98; 97 NY Jur 2d, Statutes § 126.)

Here, the words "allocation" and "allocated" appear numerous times throughout chapter 6 ("City Business Taxes") of title 11 **[*333]** of the Administrative Code, to which Admin. Code § 11-678 applies, and in almost every instance, the words are used in a manner that makes explicit that the reference is to the municipally taxable proportion of the taxpayer's entire net income or capital deemed **[***25]** to be derived from the City or located therein, as the case may be. For example, the words "allocation" and "allocated" are usually immediately followed by the phrase "to the city" or "within the city" when used in chapter 6; elsewhere in the chapter, "allocation" is immediately followed by the word "percentage." These usages are entirely inconsistent with the sense in which Bankers Trust would have us construe the word "allocation" in Admin. Code § 11-678 (3) (c), namely, as referring to the attribution of particular items of income or expense either to the taxpayer or to a separate but related entity not included in the same return. Accordingly, since nothing in Admin. Code § 11-678 (3) (c) indicates that it uses "allocation" in this sense, we ***HN12***[] construe the statute to prohibit only changes of the taxpayer's allocation percentage. [4]

**[***26]** Conceding that the City's adjustments did not change its allocation percentages, Bankers Trust essentially argues that the prohibition of Admin. Code § 11-678 (3) (c) should be applied beyond its literal scope to bar adjustments of entire net income that have the effect of shifting an increment of income to an entity subject to City taxation from related entities not subject to City taxation. The adjustments at issue did have this economic effect, since the City based its disallowance of certain of Bankers Trust's operating-expense deductions on the ground that such expenses were attributable to Bankers Trust's foreign subsidiaries, which apparently are not subject to taxation by the City. "This," contends Bankers Trust, "is as much a reallocation of income to the City as a change in the allocation percentage."

The flaw in Bankers Trust's reasoning is that ***HN13***[] entire net income and allocation percentage are independent variables in the tax-computation formula, and Admin. Code § 11-678 (3) (c) is concerned with allocation percentage only. **[*334]** Nothing in the statute prohibits an adjustment that, like those at issue here, increases entire **[***27]** net income (worldwide) by shifting a deduction claimed by the taxpayer to a related entity whose income is not included in **[**39]** the taxpayer's entire net income. Stated otherwise, the statute permits an adjustment disallowing a deduction based on a finding that the expenses generating the deduction were not incurred in the production of any part of the taxpayer's entire net income, *from either within or without the City,* and therefore were not properly deductible in computing entire net income (*see* Admin. Code § 11-646 [f] [4] [i]; *see also* Tax Law § 1462 [f] [4] [i]). Further, since the adjustments at issue were not based on any reexamination of the deposit, receipt and payroll records necessary for the computation of the allocation percentage (*see* Admin. Code § 11-642), the adjustments did not defeat the apparent purpose of Admin. Code § 11-678 (3) (c) to limit the time the taxpayer must retain such records. The challenged adjustments were therefore entirely consistent with the letter, purpose and spirit of Admin. Code § 11-678 (3) (c).

**[***28]** CONCLUSION

In sum, because Bankers Trust has chosen to pursue its attack on the City's denial of its refund claims through a declaratory judgment action, rather than through administrative proceedings, we approach this matter as one of statutory interpretation and disregard any

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[4] We recognize that the word "allocate" and its derivatives are commonly used in tax practice in the sense in which Bankers Trust would have us construe "allocation" in the statutory language. In fact, the City used the word "allocated" in this sense in the notice of proposed adjustment that accompanied the denial of the refunds, which stated, inter alia: "we *allocated* Home Office and Foreign Branch expenses to non-combined CFC's [controlled foreign corporations]" (emphasis added). As discussed above, however, this is not the kind of allocation prohibited by Admin. Code § 11-678 (3) (c).

particular factual or mathematical errors the City may have made. On this issue of statutory construction, we find that the Administrative Code did authorize the City to make adjustments of the kind that offset Bankers Trust's refund. When Bankers Trust filed its refund claims based on state changes, it placed at issue other aspects of its City returns for purposes of determining whether any refundable "overpayment" had been made, even though the statute of limitations for deficiency assessments had expired. Finally, the challenged adjustments did not violate *Admin. Code § 11-678 (3)(c)*'s specific prohibition against any "change of the allocation of income" in computing refunds based on state changes, because the City's adjustments, while increasing entire net income, made no change to Bankers Trust's allocation percentage computed under *Admin. Code § 11-642*.

**[***29]** Accordingly, the order and judgment (one paper) of the Supreme Court, New York County (Marcy Friedman, J.), entered May 7, 2001, which granted Bankers Trust's motion for summary judgment declaring that Bankers Trust was **[*335]** entitled to the tax refunds it had claimed from the City for the tax years 1986, 1987 and 1993, and denied the City's cross motion for summary judgment, should be reversed, on the law, without costs, Bankers Trust's motion should be denied, the City's cross motion for summary judgment should be granted, and it should be declared that Bankers Trust is not entitled to such tax refunds.

Andrias, J.P., Rosenberger and Rubin, JJ., concur.

Order and judgment (one paper), Supreme Court, New York County, entered May 7, 2001, reversed, on the law, without costs, plaintiff's motion for summary judgment denied, defendants' cross motion for summary judgment granted, and a declaration issued that plaintiff is not entitled to certain tax refunds.

**End of Document**

2018 Sess. Law News of N.Y. Ch. 59 (S. 7509-C) (McKINNEY'S)
McKINNEY'S 2018 SESSION LAW NEWS OF NEW YORK
241st LEGISLATURE
Additions are indicated by **Text**; deletions by
Text.
Vetoes are indicated by Text ;
stricken material by **Text** .
CHAPTER 59
S. 7509–C
Approved and effective April 12, 2018

**PART X**

Section 1. Subdivision 1 of section 1131 of the tax law, as amended by chapter 576 of the laws of 1994, is amended to read as follows:

<< NY TAX § 1131 >>

(1) "Persons required to collect tax" or "person required to collect any tax imposed by this article" shall include: every vendor of tangible personal property or services; every recipient of amusement charges; and every operator of a hotel. Said terms shall also include any officer, director or employee of a corporation or of a dissolved corporation, any employee of a partnership, any employee or manager of a limited liability company, or any employee of an individual proprietorship who as such officer, director, employee or manager is under a duty to act for such corporation, partnership, limited liability company or individual proprietorship in complying with any requirement of this article**, or has so acted**; and any member of a partnership or limited liability company. Provided, however, that any person who is a vendor solely by reason of clause (D) or (E) of subparagraph (i) of paragraph (8) of subdivision (b) of section eleven hundred one **of this article** shall not be a "person required to collect any tax imposed by this article" until twenty days after the date by which such person is required to file a certificate of registration pursuant to section eleven hundred thirty-four **of this part**.

§ 2. Subdivision (a) of section 1133 of the tax law, as amended by chapter 621 of the laws of 1967, is amended to read as follows:

<< NY TAX § 1133 >>

(a)**(1)** Except as otherwise provided in **paragraph two of this subdivision and in** section eleven hundred thirty-seven **of this part**, every person required to collect any tax imposed by this article shall be personally liable for the tax imposed, collected or required to be collected under this article. Any such person shall have the same right in respect to collecting the tax from his customer or in respect to nonpayment of the tax by the customer as if the tax were a part of the purchase price of the property or service, amusement charge or rent, as the case may be, and payable at the same time; provided, however, that the tax commission shall be joined as a party in any action or proceeding brought to collect the tax.

**(2) Notwithstanding any other provision of this article: (i) The commissioner shall grant the relief described in subparagraph (iii) of this paragraph to a limited partner of a limited partnership (but not a partner of a limited liability partnership) or a member of a limited liability company if such limited partner or member demonstrates to the satisfaction of the commissioner that such limited partner's or member's ownership interest and the percentage of the distributive share of the profits and losses of such limited partnership or limited liability company are each less than fifty percent, and such limited partner or member was not under a duty to act for such limited partnership or limited liability company in complying with any requirement of this article. Provided, however, the commissioner may deny an application for relief to any such limited partner**

**or member who the commissioner finds has acted on behalf of such limited partnership or limited liability company in complying with any requirement of this article or has been convicted of a crime provided in this chapter or who has a past-due liability, as such term is defined in section one hundred seventy-one-v of this chapter.**

**(ii) Such limited partner or member must submit an application for relief, on a form prescribed by the commissioner, and the information provided in such application must be true and complete in all material respects. Providing materially false or fraudulent information on such application shall disqualify such limited partner or member for the relief described in subparagraph (iii) of this paragraph, shall void any agreement with the commissioner with respect to such relief, and shall result in such limited partner or member bearing strict liability for the total amount of tax, interest and penalty owed by their respective limited partnership or limited liability company pursuant to this subdivision.**

**(iii) A limited partner of a limited partnership or member of a limited liability company, who meets the requirements set forth in this paragraph and whose application for relief is approved by the commissioner, shall be liable for the percentage of the original sales and use tax liability of their respective limited partnership or limited liability company that reflects such limited partner's or member's ownership interest of distributive share of the profits and losses of such limited partnership or limited liability company, whichever is higher. Such original liability shall include any interest accrued thereon up to and including the date of payment by such limited partner or member at the underpayment rate set by the commissioner pursuant to section eleven hundred forty-two of this part, and shall be reduced by the sum of any payments made by (A) the limited partnership or limited liability company; (B) any person required to collect tax not eligible for relief; and (C) any person required to collect tax who was eligible for relief but had not been approved for relief by the commissioner at the time such payment was made. Provided, however, such limited partner or member shall not be liable for any penalty owed by such limited partnership or limited liability company or any other partner or member of such limited partnership or limited liability company. Any payment made by a limited partner or member pursuant to the provisions of this paragraph shall not be credited against the liability of other limited partners or members of their respective limited partnership or limited liability company who are eligible for the same relief; provided, however that the sum of the amounts owed by all of the persons required to collect tax of a limited partnership or limited liability company shall not exceed the total liability of such limited partnership or limited liability company.**

§ 3. This act shall take effect immediately.

**Technical Memorandum**
**TSB-M-11(17)S**
Sales Tax
September 19, 2011

# New Policy Relating to Responsible Person Liability Under the Sales Tax Law

This memorandum restates and includes additional information regarding the department's new policy relating to responsible person liability under sections 1131(1) and 1133 of the Tax Law for persons who are limited partners of a limited partnership or members of a limited liability company (LLC), as previously explained in TSB-M-11(6)S. Accordingly, TSB-M-11(6)S is obsolete.

## General

Section 1133 of the Tax Law imposes personal responsibility for payment of sales and use taxes (sales taxes) on certain owners, officers, directors, employees, managers, partners, or members (responsible persons) of businesses that have outstanding sales tax liabilities. A responsible person is jointly and severally liable for the tax owed, along with the business entity or any of the business's other responsible persons. This means that the responsible person's personal assets could be taken by the Tax Department (the department) to satisfy the sales tax liability of the business.

In the case of a partnership or LLC, section 1131(1) of the Tax Law provides that each partner or member is a responsible person regardless of whether the partner or member is under a duty to act on behalf of the partnership or company. This means that these persons can be held responsible for 100% of the sales and use tax liability of a business. The department recognizes that this provision can result in harsh consequences for certain partners and members who have no involvement in or control of the business's affairs. Accordingly, the department has developed the following new policy that provides some relief from this *per se* personal liability for certain limited partners and members.

## Eligibility for relief

Under the department's new policy, the following limited partners and LLC members who are responsible persons under section 1131(1) may be eligible for relief:

- Limited partners (of a limited partnership) may be approved for relief if they demonstrate that they were not under a duty to act in complying with the Tax Law on behalf of the partnership.

- LLC members who can document that their ownership interest and percentage distributive share of the profits and losses of the LLC are each less than 50% may be approved for relief if they demonstrate that they were not under a duty to act on behalf of the company in complying with the Tax Law.

In addition to meeting one of the conditions stated above, the limited partner or member must also agree to the terms and conditions that the department sets forth in a written agreement for limiting a responsible person's liability, which shall include, but not be limited to:

- having the amount of their responsible person liability computed in the manner described under *Available relief* below, and

- cooperating with the department in providing substantiated information regarding the identities of other potentially responsible persons, particularly in identifying those persons who were involved in the day-to-day affairs of the business. In addition, in the case of tiered entities (for example, a partnership that is a partner in another partnership) the department will expect the limited partner's or member's assistance in detailing the overall ownership structure, including information regarding out-of-state entities. This requirement will be applied reasonably, with the recognition that certain partners or members, especially passive investors with only small ownership interests or distributive shares, may not know or have access to the information the department is seeking. The pending expiration of any statute of limitations in which to assess the sales and use tax due will also be taken into consideration in granting relief.

The following partners and members do not qualify for relief:

- any general partners of a partnership (including general partners of a limited partnership);

- any partners of a limited liability partnership (LLP); and

- any LLC member holding a 50% or more ownership interest in the LLC, or entitled to a distributive share of 50% or more of the profits and losses of the LLC.

**Available relief**

The eligible persons described above will qualify for the following relief:

- no penalty owed by the business or other responsible persons will be due from the eligible person; and

- the sales tax liability of the eligible person will be reduced to an amount determined by using the following steps:

Step 1: Add the amount of the business's original sales and use tax liability that has been assessed against the eligible person and the amount of accrued interest due on that liability. Interest will be computed using the minimum statutory (i.e., non-penalty) interest rate, and will be computed from the date the original tax was due through the date that the eligible person intends to pay his or her liability.

Step 2: Reduce the amount computed in Step 1 by the sum of any payments made by (a) the business, (b) any responsible persons not eligible for relief, and (c) any responsible persons who were eligible for relief but did not request relief at the time the payment was made.

Step 3: Multiply the amount determined in Step 2 by the higher of the eligible person's percentage of ownership in the business or the person's percentage share of the profits and losses of the business. This amount (or the amount of the business's remaining tax liability, if less) is the amount owed by the eligible responsible person.

Example 1: *An LLC originally owed $10,000 in sales tax. Member X is a 4% passive member of the LLC and receives 4% of the profits and losses of the LLC. Member X has also been assessed the $10,000 on the grounds that member X is a responsible person of the LLC. Member X has requested relief. If granted relief, Member X intends to pay the reduced amount on September 10, 2011. The amount of accrued interest due on the original $10,000 computed through September 10, 2011 is $1,600. If granted relief, Member X's reduced liability would be computed as follows: $10,000 + $1,600 = $11,600 x 4% =$464.*

Example 2: *Same facts as Example 1 except that member X is assessed for only $8,000 of the LLC's $10,000 liability because the statute of limitations barred the department from assessing X for one of the sales tax quarters in question. Interest on the original $8,000 through September 10, 2011, is $1,300. If granted relief, Member X's reduced liability would be computed as follows: $8,000 + $1,300 =$9,300 x 4% = $372.*

Example 3: *A limited partnership originally owed $20,000 in sales tax. Partner Z is a 4% limited partner of the partnership but receives 6% of the partnership's profits and losses. Partner Z has also been assessed the $20,000 on the grounds that Partner Z is a responsible person of the partnership. Partner Z has requested relief. If granted relief, Partner Z intends to pay the reduced amount on October 1, 2011. The amount of interest due on the original $20,000 liability, computed through October 1, 2011, is $3,100. In addition, at the time Partner Z applies for relief, the partnership, and other responsible persons who either were not eligible for or did not request relief, have paid $8,000 towards the partnership's liability. If granted relief, Partner Z's liability would be computed as follows: $20,000 + $3,100 = $23,100 - $8,000 = $15,100 x 6% = $906.*

In the case of tiered entities (e.g., a partnership that is a partner in another partnership), where the lower-tier entity is eligible for relief, the above steps would also be used to determine the lower-tier entity's reduced liability. Furthermore, if any members or partners of the lower-tier entity are also eligible for relief, their reduced liability would then be determined by multiplying the lower-tier entity's reduced liability by the higher of the member's or partner's percentage of ownership in, or percentage share of the profits or losses of, the lower-tier entity.

**Treatment of payments**

Payments made by responsible persons will be applied as follows:

- Payments made by responsible persons who are eligible for the relief described in this memorandum will not be credited against the liability of other responsible persons who are also eligible for relief. That is, those other eligible responsible persons must calculate their responsible person liability by applying their applicable percentage to the full value of their assessment, without any credit for payments made by other responsible persons under this policy. The amount owed by those eligible responsible persons would be the amount so calculated or the business's remaining sales or use tax liability, whichever is less. Also, any payments made by eligible responsible persons subject to this new policy will be credited to the business entity's liability. Penalties (if applicable) and interest at the full statutory rate will continue to accrue for liabilities owed by the business entity and by responsible persons other than as part of this new policy.

- Payments made by responsible persons other than as part of the new policy would continue to be applied to the liability of the business and other responsible persons as they are currently.

**Effective date**

This new policy took effect March 9, 2011.

NOTE: A TSB-M is an informational statement of existing department policies or of changes to the law, regulations, or policies. It is accurate on the date issued. Subsequent changes in the law or regulations, judicial decisions, Tax Appeals Tribunal decisions, or changes in department policies could affect the validity of the information presented in a TSB-M.

Neutral
As of: June 4, 2018 2:56 PM Z

# Ianniello v. New York Tax Appeals Tribunal

Supreme Court of New York, Appellate Division, Third Department

November 3, 1994, Decided ; November 3, 1994, Entered

68023

**Reporter**

209 A.D.2d 740 *; 617 N.Y.S.2d 973 **; 1994 N.Y. App. Div. LEXIS 10858 ***

In the Matter of Matthew Ianniello et al., Petitioners, v. New York Tax Appeals Tribunal et al., Respondents.

**Subsequent History:** **[***1]** As Amended November 10, 1994.

**Prior History:** Proceeding pursuant to CPLR article 78 (initiated in this Court pursuant to *Tax Law § 2016*) to review a determination of respondent Tax Appeals Tribunal which sustained a sales and use tax assessment imposed under *Tax Law articles 28* and 29.

## Core Terms

sales tax, audit, petitioners', notice of determination, reasonably calculated, taxes due, confirm

**Counsel:** Hoffman & Pollok (John L. Pollok of counsel), New York City, for Matthew Ianniello, petitioner.

G. Oliver Koppell, Attorney-General (Daniel Smirlock of counsel), Albany, for James Wetzler, respondent.

**Judges:** Mercure, J. P., Crew III and Casey, JJ., concur.

**Opinion by:** White, J.

## Opinion

**[*740]** **[**973]** White, J.

In September 1978, Paul Gelb, as president of P&G Funding Corporation (hereinafter P&G) leased property on Broadway in Manhattan. Thereafter P&G, doing business as Mardi Gras Bar, was licensed by the State Liquor Authority to operate a bar on said premises. The bar commenced operation in January 1979 and about that time petitioners acquired an interest in the profits of said bar, although they were not shareholders, officers or directors of P&G.

As a result of FBI surveillance of petitioners' business on 50th Street in Manhattan between September and December 1982, petitioners, Gelb **[***2]** and others, were indicted on a variety of Federal charges, including a scheme to evade a large portion of sales tax on the gross sales of P&G. After a jury trial, petitioners and Gelb were found guilty of, *inter alia,* a conspiracy to violate the Racketeer Influenced and Corrupt Organizations Act *(see, 18 USC § 1961 et seq.),* mail fraud regarding filing of State sales tax returns and tax evasion. These convictions were upheld by the Second Circuit Court of Appeals *(see, United States v Ianniello, 808* **[**974]** *F2d 184, cert denied 483 US 1006*). In its decision, the Second Circuit noted that Gelb had acted as a front for petitioners who actually, but secretly, directed and supervised the affairs of an enterprise which included the Mardi Gras as well as other bars and restaurants in Manhattan. The court further found that P&G, through its operation of the Mardi Gras, was the most profitable business of said enterprise and that from 1979 through 1982 petitioners and Gelb regularly "skimmed" its cash receipts, dividing over $ 2 million in unreported income equally among themselves.

Shortly thereafter, the State Department of Taxation and **[*741]** Finance **[***3]** (hereinafter Department) conducted a sales tax audit of P&G and, as a result, determined that from December 1, 1978 until February 4, 1986, the date the business was sold, there was an additional sales tax due in the amount of $ 292,902.50, and that by virtue of their actual ownership and control of P&G, petitioners were effectively officers of the corporation and responsible for said sales tax. Petitioners challenged the notice of determination, but waived a hearing and agreed to have the matter submitted to an Administrative Law Judge (hereinafter ALJ), who sustained the notices of determination and demands for payment of sales tax. Respondent Tax Appeals Tribunal affirmed the ALJ's determination and this appeal ensued.

Petitioners' main contention is that they were not persons required to collect sales tax pursuant to *Tax Law § 1131 (1)* since they were not officers, directors or employees of P&G and not under a duty to act for said corporation. We reject petitioners' narrow interpretation of the statute and agree with the ALJ, who found that petitioners possessed all the indicia of control that would impose liability upon an officer, director or employee of a corporation, **[***4]** and we also note that *Tax Law § 1131 (1)* includes, in a broad definition of persons required to collect sales tax, "every vendor of tangible personal property or services". As we stated in *Matter of Sunny Vending Co. v State Tax Commn. (101 AD2d 666, 667*, quoting *Matter of Chemical Bank v Tully, 94 AD2d 1, 3*, quoting *Matter of Albany Calcium Light Co. v State Tax Commn., 55 AD2d 502, 504*, *revd* *44 NY2d 986*), the construction by the Tax Commission is consistent with "this court's recognition that the broad and inclusive language of the taxing statute ' "clearly expresses an intent to encompass most transactions involving the transfer or use of commodities in the business world" ' ". The economic reality of a transaction should be considered regardless of the form of the transaction where it is necessary to avoid creation of a loophole in the Tax Law *(see, Matter of Schrier v Tax Appeals Tribunal, 194 AD2d 273*, *lv dismissed 83 NY2d 944*). Where, as here, examination of the record reveals overwhelming evidence supporting the Tax Tribunal's finding that petitioners were involved in the corporation and obtained substantial income from said corporation as **[***5]** silent partners, the Tax Tribunal's determination was reasonable and should be upheld *(see, Matter of Kim Poy Lee v Tax Appeals Tribunal, 202 AD2d 924*).

Petitioners also contend that the audit conducted by the Department was not reasonably calculated to reflect the taxes **[*742]** due. Here, however, the records provided by petitioners were patently false and thus inadequate to enable the auditor to conduct the necessary audit. Given these circumstances the Department could select a method of audit reasonably calculated to reflect the taxes due *(see, Matter of Shukry v Tax Appeals Tribunal, 184 AD2d 874*; *see also, Matter of A & J Gifts Shop--Vanni v Chu, 145 AD2d 877*, *lv denied 74 NY2d 603*; *Matter of Ace Provision & Luncheonette Supply v Chu, 135 AD2d 1070*). Therefore, we confirm the Tax Tribunal's determination since it has a **[**975]** rational basis and is supported by substantial evidence *(see, Matter of Buzzard v Tax Appeals Tribunal of State of N. Y., 205 AD2d 852*; *Matter of Cohen v State Tax Commn., 128 AD2d 1022*).

Mercure, J. P., Crew III and Casey, JJ., concur.

Adjudged that the determination is confirmed, without costs, and petition **[***6]** dismissed.

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# Matter of Luongo v. Tax Appeals Trib. of The State of New York

Supreme Court of New York, Appellate Division, Third Department

May 22, 2014, Decided; May 22, 2014, Entered

515599

**Reporter**

117 A.D.3d 1286 *; 987 N.Y.S.2d 114 **; 2014 N.Y. App. Div. LEXIS 3675 ***; 2014 NY Slip Op 3714 ****; 2014 WL 2118581

**[****1]** In the Matter of Jessie Luongo, Petitioner, v Tax Appeals Tribunal of the State of New York et al., Respondents.

## Core Terms

sales tax, Restaurant, sales

## Case Summary

### Overview

HOLDINGS: [1]-The Tax Appeals Tribunal properly determined that a shareholder was a responsible person and was personally liable under *Tax Law §§ 1131(1)* and *1133(a)* for the corporation's outstanding sales and use taxes because, while the shareholder did not control the day-to-day operations of the corporation, she retained the authority under the corporate bylaws to appoint and remove directors and officers.

### Outcome

Determination confirmed and petition dismissed.

## LexisNexis® Headnotes

Tax Law > State & Local Taxes > Administration & Procedure > Collection of Taxes

Tax Law > State & Local Taxes > Administration & Procedure > General Overview

**HN1[] Administration & Procedure, Collection of Taxes**

*Tax Law § 1133(a)* imposes personal liability on any person who is responsible for collecting tax under *Tax Law art. 28*.

Business & Corporate Law > Corporations > General Overview

Tax Law > State & Local Taxes > Administration & Procedure > Collection of Taxes

Business & Corporate Law > ... > Directors & Officers > Management Duties & Liabilities > General Overview

Tax Law > State & Local Taxes > Administration & Procedure > General Overview

**HN2[] Business & Corporate Law, Corporations**

A person required to collect tax includes any officer, director, or employee of a corporation who is under a duty to act for such corporation in complying with any requirement of *Tax Law art. 28*. *Tax Law § 1131(1)*.

Business & Corporate Law > ... > Directors & Officers > Management Duties & Liabilities > General Overview

Tax Law > State & Local Taxes > Administration & Procedure > Collection of Taxes

Business & Corporate Law > Corporations > General Overview

Tax Law > State & Local Taxes > Administration & Procedure > General Overview

**HN3[] Directors & Officers, Management Duties &**

**Liabilities**

A person who is not an officer, director, or employee of a corporation is required to collect tax if he or she possessed all the indicia of control that would impose liability upon an officer, director, or employee of a corporation.

Business & Corporate Law > ... > Directors & Officers > Management Duties & Liabilities > General Overview

Tax Law > State & Local Taxes > Administration & Procedure > Collection of Taxes

Business & Corporate Law > ... > Shareholders > Shareholder Duties & Liabilities > General Overview

Tax Law > State & Local Taxes > Administration & Procedure > General Overview

Tax Law > State & Local Taxes > Sales Taxes > General Overview

*HN4*[] **Directors & Officers, Management Duties & Liabilities**

Whether a person has a duty to act for a corporation and is responsible for collecting sales tax is a factual determination to be made on a case-by-case basis. Such determination turns on a variety of factors, including the status of a stockholder, the authority to hire and fire employees, and responsibility for the corporation's management. *20 NYCRR 526.11(b)(2)*. In this regard, an important consideration is the person's authority and responsibility to exercise control over the corporation, not his or her actual assertion of such authority.

Tax Law > State & Local Taxes > Administration & Procedure > Collection of Taxes

Tax Law > State & Local Taxes > Administration & Procedure > General Overview

*HN5*[] **Administration & Procedure, Collection of Taxes**

Although the Commissioner of Taxation and Finance has the authority to waive penalties, a petitioner bears the burden of establishing that the failure to pay tax was due to reasonable cause and not due to willful neglect. *Tax Law § 1145(a)(1)(iii)*, *20* NYCRR 536.1(c).

## Headnotes/Syllabus

**Headnotes**

Taxation—Sales and Use Taxes—Personal Liability for Outstanding Taxes Owed by Corporation

Taxation—Sales and Use Taxes—Penalties for Underpayment of Taxes

**Counsel:** **[***1]** Roberts & Holland, LLP, New York City (Ellen S. Brody of counsel), for petitioner.

Eric T. Schneiderman, Attorney General, Albany (Kathleen M. Arnold of counsel), for Commissioner of Taxation and Finance of the State of New York, respondent.

**Judges:** Before: Stein, J.P., McCarthy, Rose and Egan Jr., JJ. McCarthy, Rose and Egan Jr., JJ., concur.

**Opinion by:** Stein

## Opinion

**[**115] [*1286]** Stein, J.P. Proceeding pursuant to *CPLR article 78* (initiated in this Court pursuant to *Tax Law § 2016*) to review a determination of respondent Tax Appeals Tribunal, which, among other things, sustained a sales and use tax assessment imposed under *Tax Law articles 28* and *29*.

Petitioner was the sole shareholder of Fifth Avenue Restaurant Acquisition Corporation, which operated Tuscan Square Restaurant and Marketplace. Tuscan Square was originally **[*1287]** owned and operated by Toscorp[1]—the parent company of Tuscan Square and other restaurants—through Toscorp's subsidiary, Rock 51 PRTN Corporation, of which petitioner's husband, Giuseppe Luongo, was the chief executive officer. After Toscorp and Rock 51 filed petitions for bankruptcy, Fifth Avenue was formed for the purpose of acquiring the assets of Rock 51. On the advice of counsel,

[1] Petitioner was a minority shareholder of Toscorp.

**[***2]** petitioner agreed to take ownership of Fifth Avenue in an attempt to preserve the family's assets, but immediately named Luongo its sole director. Luongo, in turn, named himself its president, treasurer and secretary and, thereafter, ran the day-to-day operations of the restaurant.

Fifth Avenue eventually filed for bankruptcy and, as part of that process, the Department of Taxation and Finance conducted a sales tax field audit of its books and records for the period March 1, 2004 though November 30, 2006. That audit revealed that Fifth Avenue had underreported gross sales on its sales tax returns and owed sales and use taxes in excess of $230,000, plus applicable penalties and interest.[2] Consequently, the Department issued several notices of determination to petitioner, notifying her—as a "Responsible Person"—of the amount owed.***3***[1] After two conciliation conferences, the notices of determination were sustained.

Petitioner **[***3]** subsequently filed petitions with the Division of Tax Appeals, seeking a redetermination of the deficiency on the ground that petitioner was not responsible for Fifth Avenue's tax liabilities. A hearing was held before an Administrative Law Judge, who ultimately rejected petitioner's contention that she was not a person required to collect tax and denied the petitions. Petitioner filed a notice of exception with respondent Tax Appeals Tribunal, which affirmed the Administrative Law Judge's determination. This CPLR article 78 proceeding ensued.

**[**116]** We confirm. ***HN1***[] Tax Law § 1133 (a) imposes personal liability on any person who is responsible for collecting tax under *Tax Law article 28* (*see* *Matter of Coppola v Tax Appeals Trib. of State of N.Y., 37 AD3d 901, 902, 828 NYS2d 712 [2007]*). ***HN2***[] A person required to collect tax includes "any officer, director or employee of a corporation . . . who . . . is under a duty to act for such corporation . . . in complying with any requirement of [*Tax Law article 28*]" (*Tax Law § 1131 [1]*). Moreover, ***HN3***[] a person who is not an officer, director or employee of a corporation is required to collect tax if he **[*1288]** or she "possessed all the indicia of control that would impose liability upon **[***4]** an officer, director or employee of a corporation" (*Matter of Ianniello v New York Tax Appeals Trib., 209 AD2d 740, 741, 617 NYS2d 973 [1994]*). ***HN4***[] Whether a person has a duty to act for a corporation and is responsible for collecting sales tax is a factual determination to be made on a case-by-case basis (*see* *Matter of Coppola v Tax Appeals Trib. of State of N.Y., 37 AD3d at 903*; *Matter of Cohen v State Tax Commn., 128 AD2d 1022, 1023, 513 NYS2d 564 [1987]*; *20 NYCRR 526.11 [b] [1]*, *[2]*). Such determination turns on a variety of factors, including the status of a stockholder, the authority to hire and fire employees and responsibility for the corporation's management (*see* *Matter of Cohen v State Tax Commn., 128 AD2d at 1023*; *20 NYCRR 526.11 [b] [2]*). In this regard, an important consideration is "petitioner's authority and responsibility to exercise control over the corporation, not his [or her] actual assertion of such authority" (*Matter of Coppola v Tax Appeals Trib. of State of N.Y., 37 AD3d at 903*; *accord* *Matter of Ippolito v Commissioner of N.Y. State **Dept**. of Taxation & Fin., 116 AD3d 1176, 1177, 984 NYS2d 198, 200 [**2014**]*; *see* *Matter of Cohen v State Tax Commn., 128 AD2d at 1023*).

Here, it **[***5]** is undisputed that Luongo, not petitioner, controlled the day-to-day operations of Fifth Avenue. Petitioner did not sign checks, hire or fire employees, or assist in preparing tax returns. While petitioner's status as a shareholder, alone, may not be sufficient to impose tax collection responsibility on her, petitioner had the authority, in her capacity as the *sole* shareholder of Fifth Avenue, to appoint the board of directors and officers and, indeed, exercised that authority by appointing her husband as the sole director. Petitioner also retained the **[****2]** authority under the corporate bylaws to remove her husband from such position. Further, petitioner, along with Luongo, signed an alcoholic beverage retail license application for the restaurant and, perhaps most notably, petitioner *alone* signed an application for registration as a sales tax vendor. In such application, petitioner was listed as the sole owner/officer of the corporation and falsely averred that no "responsible officer[ ], director[ ], partner[ ], or employee[ ] owe[s] New York State or local sales and use taxes on [her] behalf, on behalf of another person, or as vendor of property or services."[4] As also noted by the Tribunal, **[***6]** petitioner reaped financial benefits

[2] The audit also revealed that Fifth Avenue underreported in other categories of taxes owed relating to capital purchases, expense purchases and tips not remitted to employees.

[3] Luongo was also assessed individually.

[4] By signing the registration application on her own and failing to list Luongo, the Department was not made aware that **[***7]** a corporate owner had outstanding tax liabilities in connection with his former corporations.

from the corporation, as Fifth Avenue was created to preserve the family's assets from the Rock 51 bankruptcy and to produce **[*1289]** income for petitioner and her husband. Under these circumstances, the Tribunal's determination that petitioner **[**117]** was a responsible person and was personally liable under *Tax Law §§ 1131 (1)* and *1133 (a)* for the outstanding sales and use taxes owed by the corporation is "rationally based upon and supported by substantial evidence," despite the existence of record evidence that would support a contrary conclusion (*Matter of Ippolito v Commissioner of N.Y. State **Dept**. of Taxation & Fin., 116 AD3d at 1178* [internal quotation marks and citations omitted]; *accord Matter of Ingle v Tax Appeals Trib. of the **Dept**. of Taxation & Fin. of the State of N.Y., 110 AD3d 1392, 1393, 973 NYS2d 877 [2013]*; *see Matter of Hwang v Tax Appeals Trib. of the State of N.Y., 105 AD3d 1151, 1152, 963 NYS2d 423 [2013]*; *Matter of Martin v Commissioner of Taxation & Fin., 162 AD2d 890, 891, 558 NYS2d 239 [1990]*). Therefore, we decline to disturb that determination.

We also reject petitioner's contention that the Tribunal erred by sustaining the penalties imposed upon petitioner for underpayment of taxes. ***HN5***[] Although respondent Commissioner of Taxation and Finance has the authority to waive penalties, petitioner bears the burden of establishing that the failure to pay tax "was due to reasonable cause and not due to willful neglect" (*Tax Law § 1145 [a] [1] [iii]*; *see Matter of Coppola v Tax Appeals Trib. of State of N.Y., 37 AD3d at 904*; *Matter of Cook v Tax Appeals Trib. of State of N.Y., 222 AD2d 962, 964, 635 NYS2d 355 [1995]*; *Matter of MCI Telecom. Corp. v New York State Tax Appeals Trib., 193 AD2d 978, 979, 598 NYS2d 360 [1993]*; *20 NYCRR 536.1 [c]*). Here, petitioner's allegation that Fifth Avenue undercollected sales tax due to a computer programing error was unsupported by any documentary evidence, and petitioner failed to explain the other tax deficiencies that were unrelated to such alleged error. Accordingly, we find substantial evidence in the record to support the Tribunal's determination upholding the penalties and interest. Petitioner's remaining contentions have been considered **[***8]** and found to be without merit.

McCarthy, Rose and Egan Jr., JJ., concur. Adjudged that the determination is confirmed, without costs, and petition dismissed.

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**End of Document**

**A01983 Summary:**

BILL NO A01983

SAME AS No Same As

SPONSOR Farrell

COSPNSR

MLTSPNSR

Amd Tax L, generally

Provides that for the purposes of sales and compensating use tax collection, "persons required to collect tax" and "person required to collect any tax imposed by this article" shall include any member of a limited liability company; provides for the liability for the collection of motor fuel and petroleum business excise taxes by members or managers of business entities; requires further disclosure to the commissioner of taxation and finance of information on the ownership interests of parties within business entities.

**A01983 Memo:**

**NEW YORK STATE ASSEMBLY**
**MEMORANDUM IN SUPPORT OF LEGISLATION**
**submitted in accordance with Assembly Rule III, Sec 1(f)**

**BILL NUMBER:** A1983

**SPONSOR:** Farrell

**TITLE OF BILL**:

An act to amend the tax law, in relation to the personal liability of certain persons required to collect state and local sales and compensating use taxes and excise taxes imposed upon motor fuels and petroleum businesses, and disclosures of information concerning certain officers, managers, members and persons with certain ownership interests

**PURPOSE**:

To amend the New York State Tax Law so that a passive member of a partnership or limited liability company be relieved of personal liability

for any unpaid sales taxes, and to provide for better, more fair administration of the law covering compliance with the law and collection of taxes owed to the State of New York.

**SUMMARY OF PROVISIONS**:

This bill would:

remove the unlimited, strict liability currently imposed on limited partners and LLC members;

make the smallest changes possible to existing law by retaining the current "duty to act" standard and simply extending it to the only two groups of persons currently left out of that standard (limited partners and LLC members);

authorize the Commissioner to require sales tax vendors to provide information regarding persons who play an important role in the entity (by either owning 20% of more of the entity or having been designated to serve as an officer, manager, or as the person responsible for the entity's tax matters);

enable the Department to determine who is under a duty to act; the

providing of this information would not create liability on those persons identified;

provide that there would be no penalty or other punishment for a failure to provide the requested information other than an extension of the collections period that the State would otherwise have to collect unpaid sales tax.

**EXISTING LAW**:

The current law appears on its face to impose absolute liability for unpaid sales taxes on all members of an LLC and on all limited partners of a limited partnership, without regard to whether the member or limited partner had an active role or significant involvement in the financial affairs or management of the business.

**JUSTIFICATION**:

The current law imposes absolute liability for unpaid sales taxes on all members of an LLC and on all limited partners of a limited partnership, without regard to whether the member or limited partner had an active

role or significant involvement in the financial affairs or management of the business. This result is contrary to the "responsible person" concept that has been followed by state and federal taxing authorities for many years under New York State Tax law section 685(g) and federal Internal Revenue Code section 6672, as evidenced by its large body of case law. The absolute liability imposed by current state law is also in direct contrast to other provisions of New York law intended to encourage investment in LLCs and limited partnerships (See Limited Liability Company Law section 609(a) and New York Partnership law section 121-303).

The existing language of the state law that creates personal liability in passive investors is not just grossly unfair, it could deter investment in New York State businesses. This legislation would result in better tax administration and tax compliance. Requesting information as provided under this bill would be an appropriate function of a tax

administrator. The penalty for not complying is mild and is the only aspect of the law that encourages compliance with the information reporting. The collections period extension would not impose a new liability on any person, it would only extend the collections period for a person already obligated to pay the unpaid sales taxes and who was not identified in a timely information filing.

The penalty of an extended limitations period applies only to individuals who are under a duty to act and fail to see to it that the proper sales taxes are collected and paid over and also fail to see to it that they are properly identified to the state (as a 20% owner, officer, manager or tax-responsible person). This would be fair and appropriate in cases where there has been a failure to pay the sales taxes.

This legislation is being introduced at the request of the New York State Bar Association Tax Section.

**LEGISLATIVE HISTORY**:

The law sought to be amended was enacted as part of the creation of New York's Limited Liability Company Law.
A.33 2013 and 2014 Ways and Means

**FISCAL IMPLICATIONS**:

To be determined

**EFFECTIVE DATE**:
This act shall take effect on the first day of the quarterly period, as described in subdivision (b) of section 1136 of the tax law, next commencing at least ninety days after the date this act shall have become a law and shall apply to quarterly periods beginning on or after such date.

**A01983 Text:**

# STATE OF NEW YORK

1983

2015-2016 Regular Sessions

# IN ASSEMBLY

January 13, 2015

Introduced by M. of A. FARRELL -- read once and referred to the Committee on Ways and Means

AN ACT to amend the tax law, in relation to the personal liability of certain persons required to collect state and local sales and compensating use taxes and excise taxes imposed upon motor fuels and petroleum businesses, and disclosures of information concerning certain officers, managers, members and persons with certain ownership interests

**The People of the State of New York, represented in Senate and Assembly, do enact as follows:**

Section 1. Subdivision 5 of section 283 of the tax law, as separately amended by chapters 275 and 276 of the laws of 1986, is amended to read as follows:

5. A registration shall not be cancelled or suspended nor shall an application for registration be refused unless the registrant or applicant has had an opportunity for a hearing, provided, however, that an application for registration may be denied without a prior hearing. Provided, further, a registration may be cancelled or suspended without a prior hearing, for failure to file a return within ten days of the date prescribed for filing a return under this article or article twenty-eight of this chapter with respect to sales and uses of motor fuel, or for nonpayment of any taxes due pursuant to this article or article twenty-eight or twenty-nine of this chapter with respect to sales and uses of motor fuel if the registrant shall have failed to file such return or pay such taxes within ten days after the date the demand therefor is sent by registered or certified mail to the address of the distributor given in his application for registration, or an address substituted therefor as provided in this subdivision. A registration may be cancelled or suspended prior to a hearing for the failure to continue to maintain in full force and effect at all times the required bond or other security filed with the [~~tax commission~~] **commissioner**. Provided,

EXPLANATION--Matter in **italics** (underscored) is new; matter in brackets [~~-~~] is old law to be omitted.

LBD00056-01-5

however, if a surety bond is cancelled prior to expiration, the [~~tax commission~~] **commissioner**, after considering all the relevant circumstances, may make such other arrangements and require the filing of such other bond or other security as [~~it~~] **the commissioner** deems appropriate. Provided, further, a registration may be cancelled or suspended prior to a hearing for the transfer of such registration without the prior written approval of the [~~state tax commission~~] **commissioner**. A distributor shall immediately inform the department, in [~~writing~~] **the manner prescribed by the commissioner**, of any change in its address and, if the distributor is a corporation [~~or~~]**,** partnership **or limited liability company**, the distributor shall immediately inform the department, in [~~writing~~] **the manner prescribed by the commissioner**, of any change in its officers, directors**, members, managers** or partners or their residence addresses as shown in its application for registration **and any change in ownership interest or profit distribution percentage causing any person to have, or no longer have, an ownership interest of twenty percent or more in such distributor (measured in the aggregate, and whether direct or indirect), or profit distribution percentage if different than the ownership percentage and such profit distribution percentage is twenty percent or more**.

§ 2. Subdivision 5 of section 283-a of the tax law, as amended by chapter 560 of the laws of 1993, is amended to read as follows:

5. A license shall not be cancelled or suspended nor shall an application for a license be refused unless the licensee or applicant for a license has had an opportunity for a hearing, provided, however, that an application for a license may be denied without a prior hearing. Provided, further, a license may be cancelled or suspended without a prior hearing, for failure to file a return or report within ten days of the date prescribed for filing under this article or for nonpayment of any sums due pursuant to this article or article twenty-eight or twenty-nine of this chapter with respect to motor fuel if the licensee shall have failed to file such return or report or pay such sums within ten days after the date the demand therefor is sent by registered or certified mail to the address of the transporter given in his application for a license, or an address substituted therefor as in this subdivision. A license may also be cancelled or suspended prior to a hearing for the failure to continue to maintain in full force and effect at all times the bond or other security filed with the commissioner. Provided, however, if a surety bond is cancelled prior to expiration, the commissioner, after considering all the relevant circumstances, may make such other arrangements and require the filing of such other bond or other security as the commissioner deems appropriate. Provided, further, a license may be cancelled or suspended prior to a hearing for the transfer of such license. A transporter shall immediately inform the department, in [~~writing~~] **the manner prescribed by the commissioner**, of any change in its address and, if the transporter is a corporation [~~or~~]**,** partnership **or limited liability company**, the transporter shall immediately inform the department, in [~~writing~~] **the manner prescribed by the commissioner**, of any change in its officers, directors**, managers, members** or partners or their residence addresses as shown in its application for a license **and any change in ownership interest or profit distribution percentage causing any person to have, or no longer have, an ownership interest of twenty percent or more in such transporter (measured in the aggregate, and whether direct or indirect), or profit distribution percentage if different than the ownership percentage and such profit distribution percentage is twenty percent or more**.

§ 3. Subdivision 5 of section 283-b of the tax law, as added by chapter 276 of the laws of 1986, is amended to read as follows:

5. A license shall not be cancelled or suspended nor shall an application for a license be refused unless the licensee or applicant for a license has had an opportunity for a hearing, provided, however, that an application for a license may be denied without a prior hearing. Provided, further, a license may be cancelled or suspended without a prior hearing, for failure to file a return or report within ten days of the date prescribed for filing under this article or nonpayment of any sums due pursuant to this article or article twenty-eight or twenty-nine of this chapter with respect to motor fuel if the licensee shall have failed to file such return or report or pay taxes within ten days after the date the demand therefor is sent by registered or certified mail to the address of the terminal operator given in his application for a license, or an address substituted therefor as in this subdivision. A license may be cancelled or suspended prior to a hearing for the failure to continue to maintain in full force and effect at all times the required bond or other security filed with the [~~tax commission~~] **commissioner**. Provided, however, if a surety bond is cancelled prior to expiration, the [~~tax commission~~] **commissioner**, after considering all the relevant circumstances, may make such other arrangements and require the filing of such other bond or other security as [~~it~~] **the commissioner** deems appropriate. Provided, further, a license may be cancelled or suspended prior to a hearing for the transfer of such license. A terminal operator shall immediately inform the department, in [~~writing~~] **the manner prescribed by the commissioner**, of any change in its address and, if the terminal operator is a corporation [~~or~~]**,** partnership **or limited liability company**, the terminal operator shall immediately inform the department, in [~~writing~~] **the manner prescribed by the commissioner**, of any change in its officers, directors**, managers, members** or partners or their residence addresses as shown in its application for a license **and any change in ownership interest or profit distribution percentage causing any person to have, or no longer have, an ownership interest of twenty percent or more in such terminal operator (measured in the aggregate, and whether direct or indirect), or profit distribution percentage if different than the ownership percentage and such profit distribution percentage is twenty percent or more**.

§ 4. Paragraph (b) of subdivision 1 of section 288 of the tax law, as amended by chapter 44 of the laws of 1985, is amended to read as follows:

(b) The [~~tax commission~~] **commissioner** shall determine the liability for the penalty imposed by subdivision two of section two hundred eighty-nine-b **of this article** of any officer, director, shareholder or employee of a corporation or of a dissolved corporation, member or employee of a partnership **or a limited liability company** or employee of an individual proprietorship. The [~~tax commission~~] **commissioner** shall also determine the amount of such penalty. All of the provisions of this section shall apply to any determination made pursuant to this paragraph and for such purpose the term distributor, as used in subdivisions four, five and six of this section, shall also mean and include such officer, director, shareholder, employee**, partner, manager** or member as the case may be.

§ 5. Subdivisions 2 and 3 of section 288 of the tax law, subdivision 2 as amended and subdivision 3 as added by chapter 44 of the laws of 1985, are amended to read as follows:

2. The [~~state tax commission~~] **commissioner** may determine the amount of tax due at any time if such distributor (i) has not registered as required by this article, (ii) fails to file a return, (iii) files a willfully false or fraudulent return with intent to evade the tax, or (iv) fails to comply with section two hundred eighty-three of this article in not informing the department[~~, in writing,~~] **in the manner prescribed by the commissioner** of any change in its address and, if a corporation**, limited liability company** or partnership, in not informing the department[~~, in writing~~]**, in the manner prescribed by the commissioner**, of any change in its officers, directors**, managers, members** or partners or their residence addresses as shown in its application for registration **and any change in ownership interest or profit distribution percentage causing any person to have, or no longer have, an ownership interest of twenty percent or more in such distributor (measured in the aggregate, and whether direct or indirect), or profit distribution percentage if different than the ownership percentage and such profit distribution percentage is twenty percent or more and whether such person was under a duty to act for such registrant**.

3. If a distributor shall inform the department, in [~~writing~~] **the manner prescribed by the commissioner**, of any change in its address and, if a corporation**, limited liability company** or partnership shall inform the department, in [~~writing~~] **the manner prescribed by the commissioner**, of any change in its officers, directors**, managers, members** or partners or their residence addresses as shown in its application for registration, **and any change in ownership interest or profit distribution percentage causing any person to have, or no longer have, an ownership interest of twenty percent or more in such distributor (measured in the aggregate, and whether direct or indirect), or profit distribution percentage if different than the ownership percentage and such profit distribution percentage is twenty percent or more, and whether such person was under a duty to act for such registrant,** the determination of the amount of tax due may be made at any time within three years after such information is [~~received~~] **filed with the department in the manner prescribed by the commissioner**.

§ 6. Subdivision 2 of section 289-b of the tax law, as amended by chapter 276 of the laws of 1986, is amended to read as follows:

2. Any officer, director, shareholder or employee of a corporation or of a dissolved corporation, [~~any~~] employee of a partnership**, manager, member or employee of a limited liability company,** or [~~any~~] employee of an individual proprietorship, who as such officer, director, shareholder**, manager, member** or employee is under a duty to act for such corporation, partnership**, limited liability company** or proprietorship in complying with any requirement of this article, and any member of a partnership **(but not including a limited partner unless the limited partner is active in the operation of the partnership)**, which fails to pay the taxes imposed by or pursuant to this article, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax not paid, plus penalties and interest computed pursuant to subdivision one of this section as if such person were a distributor. If the [~~tax commission~~] **commissioner** determines that such failure was due to reasonable cause and not due to willful neglect, [~~it~~] **the commissioner** shall remit all or part of such penalty imposed under this subdivision. Such penalty shall be determined, assessed, collected and paid in the same manner as the taxes imposed by this article and shall be disposed of as hereinafter provided with respect to moneys derived from the tax.

§ 7. Subdivision 1 of section 1131 of the tax law, as amended by chapter 576 of the laws of 1994, is amended to read as follows:

(1) "Persons required to collect tax" or "person required to collect any tax imposed by this article" shall include: every vendor of tangible personal property or services; every recipient of amusement charges; and every operator of a hotel. Said terms shall also include any officer, director or employee of a corporation or of a dissolved corporation, any employee of a partnership, any employee [~~or~~]**, member or** manager of a limited liability company, or any employee of an individual proprietorship who as such officer, director, employee**, member** or manager is under a duty to act for such corporation, partnership, limited liability company or individual proprietorship in complying with any requirement of this article; and any member of a partnership [~~or limited liability company~~] **(but not including a limited partner unless the limited partner is active in the operation of the partnership)**. Provided, however, that any person who is a vendor solely by reason of clause (D) or (E) of subparagraph (i) of paragraph [~~(8)~~] **eight** of subdivision (b) of section eleven hundred one **of this article** shall not be a "person required to collect any tax imposed by this article" until twenty days after the date by which such person is required to file a certificate of registration pursuant to section eleven hundred thirty-four **of this part**.

§ 8. Section 1136 of the tax law is amended by adding a new subdivision (j) to read as follows:

**(j) The commissioner may require any person registered or required to be registered with the commissioner under section eleven hundred thirty-four of this part to disclose, on a report, return, application or form (or any combination of these), information including, but not limited to, the following: (1) for any legal entity other than a publicly traded corporation, the name of, and identifying information for, every person with an ownership interest of twenty percent or more (measured in the aggregate, and whether direct or indirect) in such person registered or required to be registered, or profit distribution percentage if different than the ownership percentage and such profit distribution percentage is twenty percent or more; (2) for any legal entity other than a publicly traded corporation, any change in ownership interest causing any person to have, or no longer have, an ownership interest or profit distribution percentage of twenty percent or more in such person registered or required to be registered, and the name of, and identifying information for, any such person having, or no longer having, such an ownership interest or profit distribution percentage; (3) for a corporation, the name of, and identifying information for, any president, vice president, chief financial officer, chief executive officer and secretary or treasurer of such corporation; (4) for a corporation, any change in any of the officers listed in paragraph three of this subdivision and the name of, and identifying information for, any new officer with any such title; (5) for a limited liability company or partnership, the name of, and identifying information for, any person designated as the tax matters partner or partners or treated as such under the United States internal revenue code or otherwise designated by the limited liability company or partnership as the individual or individuals responsible for tax issues; (6) for a limited liability company, the name of, and identifying information for, every person designated as a manager of the limited liability company by operation of law or under the limited liability company's operating agreement; and (7) for a partnership or limited liability company, any change in any persons required to be disclosed for such partnership or limited liability company pursu-**

**ant to paragraph five or six of this subdivision and the name of, and identifying information for, such persons. The commissioner shall prescribe the form of such report, return, application or form and shall indicate when and how it is to be filed. Provided, however, that such disclosure shall not be required to be updated more frequently than quarterly and the commissioner shall allow any person with respect to whom such disclosure is required to be made to make the required disclosure at their own initiative.**

§ 9. Subparagraph (B) of paragraph 3 of subdivision (a) of section 1138 of the tax law, as amended by chapter 456 of the laws of 1998, is amended to read as follows:

(B) The liability, pursuant to subdivision (a) of section eleven hundred thirty-three of this [~~article~~] **part**, of any officer, director or employee of a corporation or of a dissolved corporation, member or employee of a partnership**, member, manager or employee of a limited liability company** or employee of an individual proprietorship who as such officer, director, employee**, manager,** or member is under a duty to act for such corporation, partnership**, limited liability company** or individual proprietorship in complying with any requirement of this article for the tax imposed, collected or required to be collected, or for the tax required to be paid or paid over to the [~~tax commission~~] **commissioner** under this article, and the amount of such tax liability (whether or not a return is filed under this article, whether or not such return when filed is incorrect or insufficient, or where the tax shown to be due on the return filed under this article has not been paid or has not been paid in full) shall be determined by the [~~tax commission~~] **commissioner** in the manner provided for in paragraphs one and two of this subdivision. Such determination shall be an assessment of the tax and liability for the tax with respect to such person unless such person, within ninety days after the giving of notice of such determination, shall apply to the division of tax appeals for a hearing. If such determination is identical to or arises out of a previously issued determination of tax of the corporation, dissolved corporation, partnership**, limited liability company** or individual proprietorship for which such person is under a duty to act, an application filed with the division of tax appeals on behalf of the corporation, dissolved corporation, partnership**, limited liability company** or individual proprietorship shall be deemed to include any and all subsequently issued personal determinations and a separate application to the division of tax appeals for a hearing shall not be required. The [~~tax commission~~] **commissioner** may, nevertheless, of [~~its~~] **the commissioner's** own motion, redetermine such determination of tax or liability for tax. Where the [~~tax commission~~] **commissioner** determines or redetermines that the amount of tax claimed to be due from a vendor of tangible personal property or services, a recipient of amusement charges, or an operator of a hotel is erroneous or excessive in whole or in part, [~~it~~] **the commissioner** shall redetermine the amount of tax properly due from any such person as a person required to collect tax with respect to such vendor, recipient, or operator, and if such amount is less than the amount of tax for which such person would have been liable in the absence of such determination or redetermination, [~~it~~] **the commissioner** shall reduce such liability accordingly. Furthermore, the [~~tax commission~~] **commissioner** may, of [~~its~~] **the commissioner's** own motion, abate on behalf of any such person, any part of the tax determined to be erroneous or excessive whether or not such tax had become finally and irrevocably fixed with respect to such person but no claim for abatement may be filed by any such person.

The provisions of this paragraph shall not be construed to limit in any manner the powers of the attorney general under subdivision (a) of section eleven hundred forty-one **of this part** or the powers of the [~~tax commission~~] **commissioner** to issue a warrant under subdivision (b) of such section **eleven hundred forty-one** against any person whose liability has become finally and irrevocably fixed.

§ 10. Subdivision (b) of section 1147 of the tax law, as amended by chapter 412 of the laws of 1986, is amended to read as follows:

(b) The provisions of the civil practice law and rules or any other law relative to limitations of time for the enforcement of a civil remedy shall not apply to any proceeding or action taken by the state or the [~~tax commission~~] **commissioner** to levy, appraise, assess, determine or enforce the collection of any tax or penalty provided by this article. However, except in the case of a willfully false or fraudulent return with intent to evade the tax no assessment of additional tax shall be made after the expiration of more than three years from the date of the filing of a return; provided, however, that where no return has been filed as provided by law, the tax may be assessed at any time. **Provided, further, that an assessment against any person with respect to whom a disclosure was required to be filed or made pursuant to subdivision (j) of section eleven hundred thirty-six of this part who was under a duty to act for a vendor, recipient of amusement charges, or operator of a hotel as described in subparagraph (B) of paragraph three of subdivision (a) of section eleven hundred thirty-eight of this part may be made within six years from the later of the due date or the filing date of the quarterly return pertaining to the tax liabilities at issue if the required disclosure was not timely filed or made.** Where a purchaser furnishes a vendor with a false or fraudulent certificate of resale or other exemption certificate or other document with intent to evade the tax, the tax may be assessed against such purchaser at any time. For purposes of this subdivision, a return filed before the last day prescribed by law or regulation for the filing thereof or before the last day of any extension of time for the filing thereof shall be deemed to be filed on such last day. [~~Notwithstanding any other provision of this article, if the time to assess additional tax would otherwise have expired on or before December nineteenth, nineteen hundred sixty-nine, the time to assess such additional tax is hereby extended to and including December twentieth, nineteen hundred sixty-nine, except that it may be further extended by a taxpayer's consent in writing as provided in subdivision (c) hereof.~~]

§ 11. This act shall take effect on the first day of the quarterly period, as described in subdivision (b) of section 1136 of the tax law, next commencing at least ninety days after the date this act shall have become a law and shall apply to quarterly periods beginning on or after such date.

Current through 2018 Chapters 1-47, 50-58

***New York Consolidated Laws Service > Tax Law (Arts. 1 — 41) > Article 8 Department of Taxation and Finance; Commissioner of Taxation and Finance (§§ 170 — 179)***

# § *171-v*. Enforcement of delinquent *tax* liabilities through the suspension of drivers' licenses

**(1)**The commissioner shall enter into a written agreement with the commissioner of motor vehicles, which shall set forth the procedures for the two departments to cooperate in a program to improve ***tax*** collection through the suspension of drivers' licenses of taxpayers with past-due ***tax*** liabilities equal to or in excess of ten thousand dollars. For the purposes of this section, the term "***tax*** liabilities" shall mean any ***tax***, surcharge, or fee administered by the commissioner, or any penalty or interest due on these amounts owed by an individual with a New York driver's license, the term "driver's license" means any license issued by the department of motor vehicles, except for a commercial driver's license as defined in section five hundred one-a of the vehicle and traffic ***law***, and the term "past-due ***tax*** liabilities" means any ***tax*** liability or liabilities which have become fixed and final such that the taxpayer no longer has any right to administrative or judicial review.

**(2)**The agreement shall include the following provisions:

> **(a)**the procedures by which the department shall notify the commissioner of motor vehicles of taxpayers with past-due ***tax*** liabilities, including the procedures by which the department and the department of motor vehicles shall share the information necessary to identify individuals with past-due ***tax*** liabilities, which shall include a taxpayer's name, social security number, and any other information necessary to ensure the proper identification of the taxpayer;
>
> **(b)**the procedures by which the commissioner shall notify the department of motor vehicles that a taxpayer has satisfied his or her past-due ***tax*** liabilities, or has entered into an installment payment agreement or has otherwise made payment arrangements satisfactory to the commissioner, so that the suspension of the taxpayer's driver's license may be lifted; and
>
> **(c)**any other matter the department and the department of motor vehicles shall deem necessary to carry out the provisions of this section.

**(3)**The department shall provide notice to the taxpayer of his or her inclusion in the license suspension program no later than sixty days prior to the date the department intends to inform the commissioner of motor vehicles of the taxpayer's inclusion. However, no such notice shall be issued to a taxpayer whose wages are being garnished by the department for the payment of past-due ***tax*** liabilities or past-due child support or combined child and spousal support arrears. Notice shall be provided by first class mail to the taxpayer's last known address as such address appears in the electronic systems or records of the department. Such notice shall include:

> **(a)**a clear statement of the past-due ***tax*** liabilities along with a statement that the department shall provide to the department of motor vehicles the taxpayer's name, social security number and any other identifying information necessary for the purpose of suspending his or her driver's license pursuant to this section and subdivision four-f of section five hundred ten of the vehicle and traffic ***law*** sixty days after the mailing or sending of such notice to the taxpayer;
>
> **(b)**a statement that the taxpayer may avoid suspension of his or her license by fully satisfying the past-due ***tax*** liabilities or by making payment arrangements satisfactory to the commissioner, and

information as to how the taxpayer can pay the past-due ***tax*** liabilities to the department, enter into a payment arrangement or request additional information;

**(c)**a statement that the taxpayer's right to protest the notice is limited to raising issues set forth in subdivision five of this section;

**(d)**a statement that the suspension of the taxpayer's driver's license shall continue until the past-due ***tax*** liabilities are fully paid or the taxpayer makes payment arrangements satisfactory to the commissioner; and

**(e)**any other information that the commissioner deems necessary.

**(4)**After the expiration of the sixty day period, if the taxpayer has not challenged the notice pursuant to subdivision five of this section and the taxpayer has failed to satisfy the past-due ***tax*** liabilities or make payment arrangements satisfactory to the commissioner, the department shall notify the department of motor vehicles, in the manner agreed upon by the two agencies, that the taxpayer's driver's license shall be suspended pursuant to subdivision four-f of section five hundred ten of the vehicle and traffic ***law***; provided, however, in any case where a taxpayer fails to comply with the terms of a current payment arrangement more than once within a twelve month period, the commissioner shall immediately notify the department of motor vehicles that the taxpayer's driver's license shall be suspended.

**(5)**Notwithstanding any other provision of ***law***, and except as specifically provided herein, the taxpayer shall have no right to commence a court action or proceeding or to any other legal recourse against the department or the department of motor vehicles regarding a notice issued by the department pursuant to this section and the referral by the department of any taxpayer with past-due ***tax*** liabilities to the department of motor vehicles pursuant to this section for the purpose of suspending the taxpayer's driver's license. A taxpayer may only challenge such suspension or referral on the grounds that (i) the individual to whom the notice was provided is not the taxpayer at issue; (ii) the past-due ***tax*** liabilities were satisfied; (iii) the taxpayer's wages are being garnished by the department for the payment of the past-due ***tax*** liabilities at issue or for past-due child support or combined child and spousal support arrears; (iv) the taxpayer's wages are being garnished for the payment of past-due child support or combined child and spousal support arrears pursuant to an income execution issued pursuant to section five thousand two hundred forty-one of the civil practice ***law*** and rules; (v) the taxpayer's driver's license is a commercial driver's license as defined in section five hundred one-a of the vehicle and traffic ***law***; or (vi) the department incorrectly found that the taxpayer has failed to comply with the terms of a payment arrangement made with the commissioner more than once within a twelve month period for the purposes of subdivision three of this section.

However, nothing in this subdivision is intended to limit a taxpayer from seeking relief from joint and several liability pursuant to section six hundred fifty-four of this chapter, to the extent that he or she is eligible pursuant to that subdivision, or establishing to the department that the enforcement of the underlying ***tax*** liabilities has been stayed by the filing of a petition pursuant to the Bankruptcy Code of 1978 (Title Eleven of the United States Code).

**(6)**Notwithstanding any provision of this chapter to the contrary, the department may disclose to the department of motor vehicles the information described in this section that, in the discretion of the commissioner, is necessary for the proper identification of a taxpayer referred to the department of motor vehicles for the purpose of suspending the taxpayer's driver's license pursuant to this section and subdivision four-f of section five hundred ten of the vehicle and traffic ***law***. The department of motor vehicles may not redisclose this information to any other entity or person, other than for the purpose of informing the taxpayer that his or her driver's license has been suspended.

**(7)**Except as otherwise provided in this section, the activities to collect past-due ***tax*** liabilities undertaken by the department pursuant to this section shall not in any way limit, restrict or impair the department from exercising any other authority to collect or enforce ***tax*** liabilities under any other applicable provision of ***law***.

## History

Add, *L 2013, ch 59, § 1* (Part P), eff March 28, 2013 (see 2013 note below).

Annotations

## Notes

**Amendment Notes:**

***Laws 2013, ch 59, § 1*** **(Part P),** eff March 28, 2013, provides as follows:

§ 5. This act shall take effect immediately; provided, however, that the department of taxation and finance and the department of motor vehicles shall have up to six months after this act shall have become a ***law*** to execute the written agreement and implement the necessary procedures as described in sections one and two of this act.

## NOTES TO DECISIONS

**1.Statute of limitations.**

**2.License suspension**

**3.Due process**

**1. Statute of limitations.**

***Tax*** preparers' challenge to the Department of Taxation and Finance's (DTF's) suspension of the preparers' driver's licenses for past-due ***tax*** liabilities was time-barred because DTF gave the requisite notice to the preparers in its October 25, 2013 correspondence, the preparers failed to reach an accord with DTF in the ensuing 60 days, and the preparers commenced the instant matter nine months after the statutory period began to run. *Matter of Jimenez v New York State Dept. of Taxation & Fin., 143 A.D.3d 1221, 40 N.Y.S.3d 622, 2016 N.Y. App. Div. LEXIS 6964 (N.Y. App. Div. 3d Dep't 2016)*, app. denied, *28 N.Y.3d 914, 74 N.E.3d 676, 52 N.Y.S.3d 291, 2017 N.Y. LEXIS 123 (N.Y. 2017)*.

**2. License suspension**

***Tax*** Appeals Tribunal did not err by sustaining the notice of proposed driver's license suspension referral imposed under ***Tax Law*** article 8 because the license holder did not assert that its contents failed to comply with the statute, nor did she raise any of the enumerated grounds set forth in the statute, despite that subdivision plainly stating that those were the only grounds upon which a suspension or referral could be challenged. Thus, according to the plain language of the statute, the Tribunal was required to uphold the suspension notice.*Matter of Jacobi v **Tax** Appeals Trib. of The State of New York, 156 A.D.3d 1154, 68 N.Y.S.3d 184, 2017 N.Y. App. Div. LEXIS 8952 (N.Y. App. Div. 3d Dep't 2017)*.

**3. Due process**

There was no due process violation because, as required by the statute, the Division's notice set forth the basis for the driver’s license suspension, was issued 60 days prior to the proposed referral to the Department of Motor

Vehicles for suspension and informed the license holder of ways to avoid suspension (resolving the ***tax*** debt, setting up a payment plan, notifying the Department of Taxation and Finance of eligibility for an exemption or protesting the proposed suspension by filing a request for a conciliation conference or filing a petition with the Division of ***Tax*** Appeals). The license holder took advantage of the processes that were available.*Matter of Jacobi v **Tax** Appeals Trib. of The State of New York, 156 A.D.3d 1154, 68 N.Y.S.3d 184, 2017 N.Y. App. Div. LEXIS 8952 (N.Y. App. Div. 3d Dep't 2017)*.

## State Notes

## Research References & Practice Aids

**Hierarchy Notes:**

*NY CLS **Tax**, Art. 8*



End of Document

# ***NY CLS Tax § 605***

Current through 2018 Chapters 1-47, 50-58

***New York Consolidated Laws Service > Tax Law (Arts. 1 — 41) > Article 22 Personal Income Tax (Pts. I — VI) > Part I General (§§ 601 — 607)***

## § *605*. General provisions and definitions

**(a)**Accounting periods and methods.

**(1)**Accounting periods. A taxpayer's taxable year under this article shall be the same as his taxable year for federal income ***tax*** purposes.

**(*2*)**Change of accounting periods. If a taxpayer's taxable year is changed for federal income ***tax*** purposes, his taxable year for purposes of this article shall be similarly changed. If a taxable year of less than twelve months results from a change of taxable year, the New York standard deduction and the New York exemptions shall be prorated under regulations of the ***tax*** commission.

**(3)**Accounting methods. A taxpayer's method of accounting under this article shall be the same as his method of accounting for federal income ***tax*** purposes. In the absence of any method of accounting for federal income ***tax*** purposes, New York taxable income shall be computed under such method as in the opinion of the ***tax*** commission clearly reflects income.

**(4)**Change of accounting methods.

**(A)**If a taxpayer's method of accounting is changed for federal income ***tax*** purposes, his method of accounting for purposes of this article shall be similarly changed.

**(*B*)**If a taxpayer's method of accounting is changed, other than from an accrual to an installment method, any additional ***tax*** which results from adjustments determined to be necessary solely by reason of the change shall not be greater than if such adjustments were ratably allocated and included for the taxable year of the change and the preceding taxable years, not in excess of two, during which the taxpayer used the method of accounting from which the change is made.

**(C)**If a taxpayer's method of accounting is changed from an accrual to an installment method, any additional ***tax*** for the year of such change of method and for any subsequent year which is attributable to the receipt of installment payments properly accrued in a prior year, shall be reduced by the portion of ***tax*** for any prior taxable year attributable to the accrual of such installment payments, in accordance with regulations of the ***tax*** commission.

**(*b*)**Resident, nonresident and part-year resident defined.

**(1)**Resident individual. A resident individual means an individual:

**(A)**who is domiciled in this state, unless (i) the taxpayer maintains no permanent place of abode in this state, maintains a permanent place of abode elsewhere, and spends in the aggregate not more than thirty days of the taxable year in this state, or (ii) (I) within any period of five hundred forty-eight consecutive days the taxpayer is present in a foreign country or countries for at least four hundred fifty days, and (II) during the period of five hundred forty-eight consecutive days the taxpayer, the taxpayer's spouse (unless the spouse is legally separated) and the taxpayer's minor children are not present in this state for more than ninety days, and (III) during the nonresident portion of the taxable year with or within which the period of five hundred forty-eight consecutive days begins and the nonresident portion of the taxable year with or within which the period ends, the taxpayer is present in this state for a number of days which does not exceed an amount which bears the same ratio to ninety as the number of days contained in that portion of the taxable year bears to five hundred forty-eight, or

**(*B*)**who maintains a permanent place of abode in this state and spends in the aggregate more than one hundred eighty-three days of the taxable year in this state, whether or not domiciled in this state for any portion of the taxable year, unless such individual is in active service in the armed forces of the United States.

**(*2*)**Nonresident individual. A nonresident individual means an individual who is not a resident or a part-year resident.

**(3)**Resident estate or trust. A resident estate or trust means:

**(A)**the estate of a decedent who at his death was domiciled in this state,

**(*B*)**a trust, or a portion of a trust, consisting of property transferred by will of a decedent who at his death was domiciled in this state, or

**(C)**a trust, or portion of a trust, consisting of the property of:

**(i)**a person domiciled in this state at the time such property was transferred to the trust, if such trust or portion of a trust was then irrevocable, or if it was then revocable and has not subsequently become irrevocable; or

**(ii)**a person domiciled in this state at the time such trust, or portion of a trust, became irrevocable, if it was revocable when such property was transferred to the trust but has subsequently become irrevocable.

**(D)**

**(i)**Provided, however, a resident trust is not subject to ***tax*** under this article if all of the following conditions are satisfied:

**(I)**all the trustees are domiciled in a state other than New York;

**(II)**the entire corpus of the trusts, including real and tangible property, is located outside the state of New York; and

**(III)**all income and gains of the trust are derived from or connected with sources outside of the state of New York, determined as if the trust were a non-resident trust.

**(ii)**For purposes of item (II) of clause (i) of this subparagraph, intangible property shall be located in this state if one or more of the trustees are domiciled in the state of New York.

**(iii)**Provided further, that for the purposes of item (I) of clause (i) of this subparagraph, a trustee which is a banking corporation as defined in subsection (a) of section fourteen hundred fifty-two of this chapter, as such section was in effect on December thirty-first, two thousand fourteen, and which is domiciled outside the state of New York at the time it becomes a trustee of the trust shall be deemed to continue to be a trustee domiciled outside the state of New York notwithstanding that it thereafter otherwise becomes a trustee domiciled in the state of New York by virtue of being acquired by, or becoming an office or branch of, a corporate trustee domiciled within the state of New York.

For the purposes of the foregoing, a trust or portion of a trust is revocable if it is subject to a power, exercisable immediately or at any future time, to revest title in the person whose property constitutes such trust or portion of a trust, and a trust or portion of a trust becomes irrevocable when the possibility that such power may be exercised has been terminated.

**(4)**Nonresident estate or trust.

**(A)**A nonresident estate means an estate which is not a resident.

**(*B*)**A nonresident trust means a trust which is not a resident or part-year resident.

**(5)**Part-year resident individual. A part-year resident individual is an individual who is not a resident or nonresident for the entire taxable year.

**(6)**Part-year resident trust. A part-year resident trust is a trust which is not a resident or nonresident for the entire taxable year.

**(c)*Tax*** treatment of charitable contributions for determining domicile. Notwithstanding any other provision of any other ***law*** to the contrary, the making of a financial contribution, gift, bequest, donation or any other financial instrument or pledge in any amount or the donation or loan of any object of any value, or the volunteering, giving or donation of uncompensated time, or any combination of the foregoing, considered a charitable contribution under subsection (c) of section one hundred seventy of the internal revenue code, or to a not-for-profit organization, as defined in subdivision seven of section one hundred seventy-nine-q of the state finance ***law***, shall not be used in any manner to determine where an individual is domiciled.

## History

Add, L 1960, ch 563, § ***2***; amd, L 1969, ch 653, § 1; L 1977, ch 225, § 1; L 1977, ch 675, § 44; L 1978, ch 790, § 3; L 1987, ch 28, § 8 (see 1987 note below); L 1987, ch 333, § 9 (see 1987 note below); *L 1992, ch 760, § 38* (see 1992 note below); *L 1994, ch 607, § 1* (see 1994 note below); *L 2003, ch 658, § 1*, eff Oct 7, 2003 (see 2003 note below); *L 2009, ch 57, § 1* (Part A–1), eff April 7, 2009 (see 2009 note below); *L 2014, ch 59, § 66* (Part A), eff Jan 1, 2015 (see 2014 note below); *L 2018, ch 59, § 1* (Part O), eff April 12, 2018.

Annotations

## Notes

**Editor's Notes:**

***Laws*** **1987, ch 28, § 1,** eff April 20, 1987, provides as follows:

Section 1. Short title. This act shall be known and may be cited as the "***Tax*** Reform and Reduction Act of 1987".

***Laws*** **1987, ch 28, § 107,** eff April 20, 1987, provides, in part, as follows:

§ 107. This act shall take effect immediately, provided that: (a) . . . sections five through eight . . . shall apply to taxable years beginning after nineteen hundred eighty-six; . . . .

***Laws*** **1987, ch 333, § 1,** eff July 20, 1987, provides as follows:

Section 1. Short title. This act shall be known and may be cited as the "***Tax*** Reform Technical Corrections and New York City ***Tax*** Reduction Act of 1987".

***Laws*** **1987, ch 333, § 176,** eff July 20, 1987, provides, in part, as follows:

§ 176. This act shall take effect immediately, provided that:

. . . (***b***) . . . sections six through eleven . . . shall apply to taxable years beginning after nineteen hundred eighty-seven; . . . .

***Laws 1992, ch 760, § 93*****(i),** eff July 31, 1992, provides as follows:

§ 93. This act shall take effect immediately, except that:

(i) sections thirty-eight, forty, forty-one, fifty-four, fifty-five and fifty-six of this act shall apply to taxable years beginning after 1987; provided, however, that these provisions shall not permit the issuance of any assessment or any claim for credit or refund otherwise barred by any provision of the ***tax law***;.

***Laws 1994, ch 607, § 3*****,** eff July 26, 1994, provides as follows:

§ 3. This act shall take effect immediately and shall apply to contributions, gifts, bequests, donations, pledges, loans, volunteering, and other activities covered in this act, made in taxable years beginning on or after January 1, 1994.

***Laws 2003, ch 658, § 3*****,** eff Oct 7, 2003, provides as follows:

§ 3. This act shall take effect immediately and shall apply to ***tax*** years beginning on or after January 1, 1996.

***Laws 2009, ch 57, § 6*** **(Part A-1),** eff April 7, 2009, provides as follows:

§ 6. This act shall take effect immediately and apply to taxable years beginning on or after January 1, 2009.

***Laws 2014, ch 59, § 113*** **(Part A),** eff Jan 1, 2015, provides as follows:

§ 113. This act shall take effect January 1, 2015 and shall apply to taxable years commencing on or after such date; provided that the amendments to *section 25 of the **tax law*** made by section forty-three of this act shall not affect the repeal of such section and shall be deemed repealed therewith; provided, further, that the amendments to the opening paragraph of subdivision (a), subparagraph (C) of paragraph ***2*** of subdivision (e) and subdivision (f) of *section 35 of the **tax law*** made by section fifty of this act shall not affect the repeal of such provisions and shall be deemed repealed therewith; provided, further, that the amendments to clause (xxxii) of subparagraph (***B***) of paragraph 1 of subsection (i) of *section 606 of the **tax law*** made by section sixty-eight of this act shall not affect the repeal of such clause and shall be deemed repealed therewith; provided, further, that the amendments to clause (xxxiii) of subparagraph (***B***) of paragraph 1 of subsection (i) of *section 606 of the **tax law*** made by section sixty-eight of this act shall not affect the repeal of such clause and shall be deemed repealed therewith; and provided, further, that the amendments to clause (ii) of subparagraph (***B***) of paragraph ***2*** of subsection (q), paragraph 3 of subsection (s) and the closing paragraph of paragraph 1 of subsection (t) of *section 1085 of the **tax law*** made by section eighty-one of this act shall not affect the repeal of such provisions and shall be deemed repealed therewith.

**Subsection History:**

Section heading, add, L 1987, ch 28, § 8, eff April 20, 1987 (see 1987 note below).

Former section heading redesignated part of sub (***b***), L 1987, ch 28, § 8, eff April 20, 1987.

Sub (a), formerly substance of § 604, add, L 1987, ch 28, § 8, eff April 20, 1987 (see 1987 note below).

Former sub (a), redesignated sub (***b***), opening par and par (1), L 1987, ch 28, § 8, eff April 20, 1987.

Sub (a), par (***2***), amd, L 1987, ch 333, § 9, eff July 20, 1987 (see 1987 note below).

Sub (***b***), formerly entire § ***605***, redesignated sub (***b***) and amd, L 1987, ch 28, § 8, eff April 20, 1987 (see 1987 note below).

Former sub (***b***), redesignated sub (***b***), par (***2***), L 1987, ch 28, § 8, eff April 20, 1987.

Sub (***b***), opening par, formerly section heading, redesignated sub (***b***), opening par and amd, L 1987, ch 28, § 8, eff April 20, 1987 (see 1987 note below).

Sub (***b***), par (1), subpar (A), formerly sub (a), par (1), amd, L 1977, ch 675, § 44, L 1978, ch 790, § 3; redesignated sub (***b***), par (1), subpar (A) and amd, L 1987, ch 28, § 8 (see 1987 note below); amd, *L 1992, ch 760, § 38*, eff July 31, 1992 (see 1992 note below), *L 2009, ch 57, § 1* (Part A-1), eff April 7, 2009 (see 2009 note below).

Sub (***b***), par (1), subpar (***B***), formerly sub (a), par (***2***), amd, L 1977, ch 225, § 1, redesignated sub (***b***), par (1), subpar (***B***), L 1987, ch 28, § 8, eff April 20, 1987 (see 1987 note below).

Sub (***b***), par (***2***), formerly sub (***b***), redesignated sub (***b***), par (***2***) and amd, L 1987, ch 28, § 8, eff April 20, 1987 (see 1987 note below).

Sub (***b***), par (3), formerly sub (c), opening par, redesignated sub (***b***), par (3), L 1987, ch 28, § 8, eff April 20, 1987 (see 1987 note below).

Sub (***b***), par (3), subpar (A), formerly sub (c), par (1), redesignated sub (***b***), par (3), subpar (A), L 1987, ch 28, § 8, eff April 20, 1987 (see 1987 note below).

Sub (***b***), par (3), subpar (***B***) formerly sub (c), par (***2***), redesignated sub (***b***), par (3), subpar (***B***), L 1987, ch 28, § 8, eff April 20, 1987 (see 1987 note below).

Sub (***b***), par (3), subpar (C), formerly sub (c), par (3), redesignated sub (***b***), par (3), subpar (C), L 1987, ch 28, § 8, eff April 20, 1987 (see 1987 note below).

Sub (***b***), par (3), subpar (D), add, *L 2003, ch 658, § 1*, eff Oct 7, 2003 (see 2003 note below).

Sub (***b***), par (3), subpar (D), cl (iii), amd, *L 2014, ch 59, § 66* (Part A), eff Jan 1, 2015 (see 2014 note below).

Sub (***b***), par (4), heading and subpar (A), formerly sub (d), redesignated sub (***b***), par (4), heading and subpar (A) and amd, L 1987, ch 28, § 8, eff April 20, 1987 (see 1987 note below).

Sub (***b***), par (4), subpar (***B***), add, L 1987, ch 28, § 8, eff April 20, 1987 (see 1987 note below).

Sub (***b***), pars (5) and (6), add, L 1987, ch 28, § 8, eff April 20, 1987 (see 1987 note below).

Sub (c), add, *L 1994, ch 607, § 1*, eff July 26, 1994 (see 1994 note below).

Former sub (c), amd, 1967, ch 792, § 1, L 1969, ch 653, § 1; redesignated sub (***b***), par (3), L 1987, ch 28, § 8, eff April 20, 1987.

Former sub (d), redesignated sub (***b***), par (4), L 1987, ch 28, § 8, eff April 20, 1987.

Former sub (e), deleted, L 1987, ch 28, § 8, eff April 20, 1987 (see 1987 note below).

**Amendment Notes:**

**2014.** Chaper 59, § 66 (Part A) amended:

Sub (***b***), par (3), subpar (D), cl (iii) by adding the matter in italics.

## Notes to Decisions

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### I. In General

### 1. Generally

*CLS **Tax** § **605**(**b**)(1)(**B**)* does not violate dormant Commerce Clause (US Const Art I § 8) because it does not operate to disadvantage of any identifiable interstate market, but rather simply ***taxes*** residents based on their status as residents; fact that ***tax*** may have incidental effects on interstate commerce does not prove violation of dormant Commerce Clause. *Tamagni v **Tax** Appeals Tribunal, 91 N.Y.2d 530, 673 N.Y.S.2d 44, 695 N.E.2d 1125, 1998 N.Y. LEXIS 1071 (N.Y.)*, cert. denied, *525 U.S. 931, 119 S. Ct. 340, 142 L. Ed. 2d 280, 1998 U.S. LEXIS 6508 (U.S. 1998)*.

In an action by a taxpayer against the State ***Tax*** Commission seeking a review of a determination which sustained a personal income ***tax*** assessment, taxpayer's election to report the sale of eight and seven-tenth's shares of stock on his 1972 State resident income ***tax*** return under the installment method was held proper where the sale of eight and seven-tenth's shares of stock to the purchasers of the corporate business in exchange for cash and promissory notes and the subsequent redemption by the corporation of the taxpayer's remaining five and one-tenth's shares of stocks in exchange for the remaining assets of the corporation not wanted by the purchasers were separate and distinct transactions supported by legitimate business purposes, and where the partial sale and partial redemption enabled the purchasers to buy only that portion of the corporation stock representing corporate assets they desired, and enabled the taxpayer to remove his accumulated earnings while receiving capital gains treatment. *Rosen v State **Tax** Comm., 89 A.D.2d 289, 456 N.Y.S.2d 452, 1982 N.Y. App. Div. LEXIS 18377 (N.Y. App. Div. 3d Dep't 1982)*.

Article 78 proceeding was not proper vehicle for challenging constitutionality of *CLS **Tax** § **605**(**b**)(1)(**B**)* and thus court converted portion of petition which alleged that statute violated Commerce Clause into declaratory judgment action. *Tamagni v **Tax** Appeals Tribunal, 230 A.D.2d 417, 659 N.Y.S.2d 515, 1997 N.Y. App. Div. LEXIS 6712 (N.Y. App. Div. 3d Dep't 1997)*, aff'd, *91 N.Y.2d 530, 673 N.Y.S.2d 44, 695 N.E.2d 1125, 1998 N.Y. LEXIS 1071 (N.Y. 1998)*.

Taxpayer on cash basis method of accounting need not pay ***tax*** on increases in inaccessible restricted accounts, used as security for bank loans, until the loans are paid and the funds are released. In re Barvinchak, Op State ***Tax*** Comm, July 7, 1977.

Issue of taxpayer's statutory residency under *CLS **Tax** § **605*** was not clearly raised by Division of Taxation in pre-hearing communications where, at no point prior to hearing before Administrative ***Law*** Judge, were matters of "permanent place of abode," "days in New York," "statutory residency," or *CLS **Tax** § **605*** former (a)(***2***) (present (***b***)(1)(***B***)) mentioned by division or taxpayer; mere use of term "resident" with regard to domicile did not provide sufficient notice by division to taxpayer that he must prove that he was not statutory resident of New York in addition to proving that he was not New York resident based on domicile. NY ***Tax*** Appeals Tribunal TSB-D-94-(9)I, 1992 *N.Y. **Tax** LEXIS 202*.

Division of Taxation failed raise issue of statutory residency during hearing before Administrative ***Law*** Judge (ALJ), despite ALJ's questioning of parties in which he asked "Both of you will be arguing the ***law*** of domicile I expect? How about the problem with permanent place of abode and days in New York and so on? Do either of you have any presentation on that?" and taxpayer's representative answered only "Yes. For his domicile being in New Jersey I have some case ***law*** on that also, your honor"; such response to ALJ was too unclear to allow conclusion that taxpayer was agreeing that statutory residency was in issue, which was reinforced by fact that ALJ stated in his opinion that matter was not issue in case. NY ***Tax*** Appeals Tribunal TSB-D-94-(9)I, 1992 *N.Y. **Tax** LEXIS 202*.

Clear and convincing evidence standard, rather than preponderance of evidence standard, may be properly imposed on taxpayers in New York City statutory residence matters, even though such matters do not involve issues of intent, since courts have applied clear and convincing standard in context of several different ***tax*** matters not involving intent, including sales ***tax*** audit cases, income ***tax*** audit methodology cases, highway use ***tax*** audit methodology cases, and franchise ***tax*** cases where issue was one of statutory interpretation. NY ***Tax*** Appeals Tribunal TSB-D-95-(30)I.

Taxpayers failed to show how their domicile in New Jersey and their statutory residence in New York constituted interstate commerce, and thus they did not meet their burden of proof to show that *CLS **Tax** § **605**(**b**)(1)(**B**)*, as applied to them, was unconstitutional violation of federal commerce clause, where they relied solely on ***law*** review article in asserting that "if a taxpayer lives in one state and travels to work in another state, this travel probably involves interstate commerce". NY ***Tax*** Appeals Tribunal TSB-D-95-(32)I.

Nondomiciliary taxpayers failed to show how their statutory New York residency violated CLS *NY Const Art XVI § 3* with regard to taxation of income generated from intangible assets, despite language providing that situs of intangibles is deemed to be located at domicile of owner, since history of provision indicates that provision was designed to assure nonresidents that they could keep intangibles in New York without fear that established legislative policy of nontaxability would be changed, and that such property would enjoy privilege against taxation until it was used; taxpayers were being ***taxed*** not on ownership of intangible asset but, as residents, on income generated from asset. NY ***Tax*** Appeals Tribunal TSB-D-95-(32)I.

**II. Domicile**

**A. Effect**

**_2_. Generally**

*CLS **Tax** § **605**(**b**)(1)(**B**)* is not discriminatory on basis that it subjects statutory residents of New York to potential double taxation which New York domiciliaries residing solely in New York do not face, as statutory residents domiciled in another state are not similarly situated to New York; statutory residents domiciled in another state enjoy privileges and protections of another state and may therefore be subject to taxation by that state. *Tamagni v*

***Tax** Appeals Tribunal, 91 N.Y.2d 530, 673 N.Y.S.2d 44, 695 N.E.2d 1125, 1998 N.Y. LEXIS 1071 (N.Y.)*, cert. denied, *525 U.S. 931, 119 S. Ct. 340, 142 L. Ed. 2d 280, 1998 U.S. LEXIS 6508 (U.S. 1998)*.

Domicile itself provides a basis for taxation, and presence within the state of a domiciliary is not necessary in order to ***tax*** him. *Starer v Gallman, 50 A.D.2d 28, 377 N.Y.S.2d 645, 1975 N.Y. App. Div. LEXIS 11422 (N.Y. App. Div. 3d Dep't 1975)*.

The evidence to establish the required intention to effect a change in domicile must be clear and convincing. *Bodfish v Gallman, 50 A.D.2d 457, 378 N.Y.S.2d 138, 1976 N.Y. App. Div. LEXIS 10646 (N.Y. App. Div. 3d Dep't 1976)*.

Taxpayers' susceptibility to both New York and New Jersey ***tax*** for income from intangibles pursuant to *CLS **Tax** § **605**(**b**)(1)(**B**)* did not implicate Commerce Clause, as their commuting from New Jersey to work in New York did not produce requisite effect on commerce, and their maintaining residence and spending time in New York (in addition to domicile in New Jersey) did not necessarily involve interstate commerce. *Tamagni v **Tax** Appeals Tribunal, 230 A.D.2d 417, 659 N.Y.S.2d 515, 1997 N.Y. App. Div. LEXIS 6712 (N.Y. App. Div. 3d Dep't 1997)*, aff'd, *91 N.Y.2d 530, 673 N.Y.S.2d 44, 695 N.E.2d 1125, 1998 N.Y. LEXIS 1071 (N.Y. 1998)*.

Taxpayers, who were members of Seneca Indian Nation and residents of Cattarugus Indian Reservation, were properly ***taxed*** by audit division on income earned in California because income in question was not earned by taxpayers on reservation, but was earned beyond boundaries of such reservation. In re Twoguns, Dec St ***Tax*** Comm, TSB-H-87-(187)-I.

Petitioners' susceptibility to both New York and New Jersey income ***tax*** for their income from intangibles did not violate commerce clause. NY ***Tax*** Appeals Tribunal TSB-D-95-(32.1)I.

**B. Adoption of New York Domicile**

**3. Particular circumstances**

Fact that petitioner married on December 30, 1967, and that his wife thereafter lived in New York had absolutely no relevance to the petitioner's domicile in 1967 for state income ***tax*** purposes. *Starer v Gallman, 50 A.D.2d 28, 377 N.Y.S.2d 645, 1975 N.Y. App. Div. LEXIS 11422 (N.Y. App. Div. 3d Dep't 1975)*.

There was a rational basis for the State ***Tax*** Commission's finding that taxpayers were domiciliaries of New York during the years in which they spent three months of the year in this state and at least eight months of the year in St. Maarten, Netherland Antilles, where taxpayers maintained a joint bank account in New York state, possessed New York state driver's licenses, and maintained a post office box in New York, and where one of taxpayers testified that he had no intention of giving up his United States citizenship. *Schulman v Tully, 86 A.D.2d 705, 446 N.Y.S.2d 548, 1982 N.Y. App. Div. LEXIS 15255 (N.Y. App. Div. 3d Dep't)*, app. denied, *56 N.Y.2d 507, 1982 N.Y. LEXIS 5423 (N.Y. 1982)*, app. denied, *56 N.Y.2d 885, 453 N.Y.S.2d 429, 438 N.E.2d 1144, 1982 N.Y. LEXIS 3496 (N.Y. 1982)*.

Determination that a taxpayer was a statutory resident for *N.Y. **Tax Law** § **605**(**b**)(1)(**B**)* purposes was affirmed because the tribunal's findings that the taxpayer, in addition to owning the building at issue, maintained a telephone and the utilities in his own name at the apartment, paid those bills as well as all other expenses for the apartment, retained unfettered access to the apartment, occasionally slept there, failed to establish that he kept the apartment exclusively for his parents, and did not prove that he held the property solely for investment purposes were supported by substantial evidence. *Matter of Gaied v New York State **Tax** Appeals Trib., 101 A.D.3d 1492, 957 N.Y.S.2d 480, 2012 N.Y. App. Div. LEXIS 9098 (N.Y. App. Div. 3d Dep't 2012)*, rev'd, *22 N.Y.3d 592, 983 N.Y.S.2d 757, 6 N.E.3d 1113, 2014 N.Y. LEXIS 173 (N.Y. 2014)*.

Petitioners failed to establish continuation of a California domicile during their New York resident period, where they offered no evidence other than a California marriage certificate. In re Norsig 1983 Dec State ***Tax*** Comm, TSB-H-83(145)I, June 13, 1983.

Petitioners were domiciliaries and residents of New Jersey until March 13, 1975, at which time they changed both domicile and residence to State of New York, where (1) husband accepted employment as hospital administrator in Lake Placid, New York in October 1974, but terms of such employment called for probationary period of 6 months, during which he could have been terminated at any time, (***2***) he lived at motel during his probationary period, first in one room rented on a daily basis and later in a ***2***-room suite rented on a weekly basis, (3) he spent each weekend with his family in New Jersey during his probationary period, and (4) he purchased house in Lake Placid and physically moved there with his family and household possessions on March 13, 1975. In re Harrington, 1983 Dec State ***Tax*** Comm, TSB-H-83(210)I, July 25, 1983.

Marriage to New York domiciliary ordinarily effects immediate change of domicile to New York; female Armed Services member does not automatically become domiciliary of New York upon marriage to New York domiciliary absent evidence of intent to make New York State permanent home. In re Bernhard, Dec State ***Tax*** Comm, TSB-H-83-(331)-I.

Domicile, once established, continues until person in question moves to new location with bona fide intention of making fixed and permanent home there; Canadian citizen employed as professional athlete in New York does not adopt New York domicile where athlete came to New York only to play hockey, retained close ties to family in Canada, continuely returned to Canada, and financially assisted in maintaining Canadian household; fact that taxpayer took full-year lease on Manhattan apartment because he could not find seasonal apartment falls short of demonstrating intent to become domiciliary of New York. In re Steven Vickers, Dec State ***Tax*** Comm, TSB-H-83-(341)-I.

Military officer's stationing in New York and purchase of home away from base does not indicate adoption of New York domicile where officer voluntarily chose New Jersey as domicile, obtained drivers licenses and automobile registrations in New Jersey, and voted in New Jersey by absentee ballot. In re Connor, Dec State ***Tax*** Comm, TSB-H-84-(139)-I.

Taxpayers, citizens of Canada and domiciliaries of Indiana prior to year in question, did not establish domicile in New York by residing in state for duration of temporary job assignment where business and financial connections with Indiana were maintained; disposal of home in Indiana and rental of home in New York does not mandate different result where such action was taken merely to avoid financial burden of commuting from Indiana to job in New York or cost of maintaining two residences. In re Berdusco, Dec State ***Tax*** Comm, September 21, 1979.

No change of domicile results from removal to new location if intent is to remain there only for limited time; petitioners lived in New York only during interim assignment of husband for company for which he worked, petitioners never voted in New York, had Vermont and French driver's licenses, registered their automobile in Vermont, and had personal checking account with bank in Vermont. In re Davis, Dec State ***Tax*** Comm, July 15, 1980.

Taxpayer was not resident of New York state during year he spent seeking employment in New York while staying at friend's apartment where he had no intention of residing in New York on permanent basis until he found employment. In re Myers, 1982 Dec State ***Tax*** Comm, February 18, 1982.

Taxpayer intended to change his domicile to New York as evidenced by purchase of New York City apartment and sale of District of Columbia home, voting in New York, failure to pay any income ***taxes*** to District of Columbia and obtaining of New York drivers license, notwithstanding he retained some ties with District of Columbia and intended to eventually return there. In re Hensel, 1982 Dec State ***Tax*** Comm, Dec. 31, 1982.

Although owning a home and voting in New York State are indications of New York domicile, taxpayers cannot be considered residents of New York where the transient nature of the job which brought them to the state and taxpayers' retained contacts with their home state and their intention to return there in the future indicate that they had no intent to change their domicile to New York. In re Shofner, 1981 Dec St ***Tax*** Com, Dec. 7, 1981.

Taxpayers became domiciled in New York City in certain year, despite their contention that they left their Long Island home without intent to establish new permanent home in New York City, where they did not retain Long Island residence, there was no evidence that they ever intended to again reside in Long Island or that they did so, and association they had with New York City from date of arrival to their change of domicil outside city was permanent one. NY ***Tax*** Appeals Tribunal TSB-D-95-(34)I.

**C. Abandonment of New York Domicile**

**4. Interstate relocations; factors affecting—In general**

For purposes of determining whether petitioner's domicile for ***tax*** purposes changed during the year 1967, the question was not whether petitioner intended to leave New York forever and set upon a seagoing career, but whether he intended to settle down in a city in a different state, to make that city his permanent home with the range of sentiment, feeling and permanent association with it. *Starer v Gallman, 50 A.D.2d 28, 377 N.Y.S.2d 645, 1975 N.Y. App. Div. LEXIS 11422 (N.Y. App. Div. 3d Dep't 1975)*.

Where petitioner who, prior to 1967 was a domiciliary of the state, did not even attempt to show that he acquired a new domicile in 1967, no change in domicile from New York could have been effected. *Oatman v State **Tax** Comm'n, 50 A.D.2d 1015, 377 N.Y.S.2d 659, 1975 N.Y. App. Div. LEXIS 12002 (N.Y. App. Div. 3d Dep't 1975)*, app. denied, *39 N.Y.2d 709, 1976 N.Y. LEXIS 3388 (N.Y. 1976)*, app. dismissed, *429 U.S. 1067, 97 S. Ct. 799, 50 L. Ed. 2d 785, 1977 U.S. LEXIS 486 (U.S. 1977)*.

In an action for redetermination or refund of 1971 state income ***tax*** on the ground that the petitioners were non-residents and non-domiciliaries of the state for that year, the claim for refund was properly denied and the petition for review would be dismissed where they failed to meet the burden of proving a clear and convincing intent to change their domicile in 1970. *Cooper v State **Tax** Com., 82 A.D.2d 950, 441 N.Y.S.2d 30, 1981 N.Y. App. Div. LEXIS 14683 (N.Y. App. Div. 3d Dep't 1981)*.

Couple that moved from New York to Vermont during the taxable year were liable for New York ***taxes*** on all income moved during that year; they failed to meet the 183-day limit where the only substantial evidence indicated that they enrolled their children in school in the fall and their New York State house was not sold until November. *Schibuk v N.Y. State **Tax** Appeals Tribunal, 289 A.D.2d 718, 733 N.Y.S.2d 801, 2001 N.Y. App. Div. LEXIS 12005 (N.Y. App. Div. 3d Dep't 2001)*, app. denied, *98 N.Y.2d 720, 748 N.Y.S.2d 900, 778 N.E.2d 551, 2002 N.Y. LEXIS 2286 (N.Y. 2002)*.

Intention to acquire domicile without actual residence in locality does not result in acquisition of domicile; physical presence without intention to acquire domicile does not result in acquisition of domicile. In re Braka, Dec State ***Tax*** Comm, TSB-H-83-(6)-I.

Under *CLS **Tax** § 689*, taxpayers once domiciled in New York have burden of proving abandonment of New York domicile. In re Sawyer, Dec State ***Tax*** Comm, TSB-H-83-(340)-I.

Presumption against foreign domicile is stronger than general presumption against change in domicile, and less evidence is required to establish change in domicile from one state to another than from one nation to another. In re Brett, Dec State ***Tax*** Comm, TSB-H-84-(136)-I.

Temporary removal from New York state for limited period of time does not change domicile of resident and domicile continues until new one is established. In re Jacobius, Dec State ***Tax*** Comm, No. 15271.

The presumption against a foreign domicile is stronger than the general presumption against a change of domicile, and evidence establishing the required intention to effect a change to a foreign domicile must be clear and convincing. In re Smith, Op State ***Tax*** Comm, August 16, 1977.

Domicile once established continues until person in question moves to new location with bona fide intention of making his fixed and permanent home there; general presumption against foreign domicile is stronger than general presumption against change of domicile. In re Minsky, 1979 Dec. State ***Tax*** Comm., December 14, 1979.

No change of domicile results from a removal to new location if intention is to remain there only for a limited time, and this applies even though individual may have sold or disposed of former home; petitioners spent more than 30 days in New York and did not maintain permanent place of abode outside New York. In re Wall, Dec State ***Tax*** Comm, August 21, 1980.

Evidence to establish the required intention to effect a change in domicile must be clear and convincing. In re Dell, 1981 Dec St ***Tax*** Comm, December 3, 1981.

Fact that person leaves his established domicile with intention of never returning is important but not necessarily conclusive, and such domicile continues until new one is clearly established; in determining individuals intention in this regard, his declarations will be given due weight, but they will not be conclusive if they are contradicted by his conduct. In re Hauser, 1979 Dec State Com., December 20, 1979.

Administrative ***Law*** Judge correctly determined that taxpayers’ New York home constituted permanent place of abode, and thus they did not qualify for treatment as nonresidents with regard to personal income ***tax***, even though they owned Florida house and held Florida driver’s licenses, where they utilized their New York home on their visits to New York from Florida, house was maintained on year-round basis (including cable television and pool service), they also held New York driver’s licenses, they registered vehicles in New York, they utilized services of professionals in New York, and they collected rent from other New York real property owned by them. NY ***Tax*** Appeals Tribunal TSB-D-94-(4)I.

Petitioners failed to establish that they abandoned their New York domicile in favor of Florida when husband retired from his New York business, on ground that they intended to make Florida their domicile, where they made assertions in their brief about their Florida home, their lifestyle change and recreational activities they engaged in at Florida country club, but they did not appear at hearing and did not submit any testimony or documentary evidence. NY ***Tax*** Appeals Tribunal TSB-D-97-(44)I.

**5. —Employment**

The ***Tax*** Commissioner’s determination that a taxpayer was a New York resident was supported by substantial evidence, despite his claim that he had moved his residence to Florida, where he had not abandoned his New York home in that he used it more frequently than he did his Florida residence, and where a very considerable portion of his time was spent in fulfilling his responsibilities as director of two banks located in New York State. *Clute v Chu, 106 A.D.2d 841, 484 N.Y.S.2d 239, 1984 N.Y. App. Div. LEXIS 21745 (N.Y. App. Div. 3d Dep't 1984)*.

Taxpayer maintained New York domicile for purposes of gift ***tax*** where, prior to her husband’s death, husband maintained apartment and corporate headquarters in New York City, there was no evidence that wife’s 3-year stay in Florida prior to husband’s death and 18 month stay in Florida following husband’s death was result of deliberate choice of new domicile, taxpayer spent all of her time in New York City at time of hearing due to severe incapacitation, and where only indication of her intent to become domiciled in Florida were documentary statements made after controversy arose. *Kaskel v New York State **Tax** Com., 111 A.D.2d 431, 488 N.Y.S.2d 322, 1985 N.Y. App. Div. LEXIS 51526 (N.Y. App. Div. 3d Dep't 1985)*.

Petitioner was domiciled in New York for years 1976 and 1977, notwithstanding that he registered to vote, filed a declaration of domicile and citizenship, joined clubs, and changed his will to Florida, where he continued to maintain his house and furniture in New York long after he bought condominium in Florida, he lived in New York for extensive periods during 1976 and 1977 and worked at the same New York corporations as before the move, and he did not transfer residence until after 1977. In re Clute, 1983 Dec State ***Tax*** Comm, TSB-H-83(284)I, October 14, 1983.

Petitioners' conduct does not clearly demonstrate intention to give up New York domicile and take up new domicile, and petitioners were therefore domiciled in New York during 1979, where they continued to maintain their house and furniture in New York after they moved to Florida, they returned to New York for 3 months in 1978 and 4 months in 1979 to allow husband to work at New York plant, and, during these periods, petitioners lived in their New York home; the fact that petitioners registered to vote and filed Declaration of Residence in Florida, while indicative of an intent to change domicile, is not conclusive. In re Zigrossi, 1983 Dec State ***Tax*** Comm, TSB-H-83(181)I, June 20, 1983.

Taxpayer born in New York was domiciliary of New York during years at issue where it was shown that taxpayer lived with parents in New York City until 1973 when he left to attend Yale University in Connecticut, stayed at parents' home for brief periods of time during 7 years he was at Yale, during summer of 1978 and 1979 worked at Chicago ***law*** firm and San Francisco ***law*** firm, upon graduation obtained clerkship in Chicago where it was shown that such position was admittedly of limited duration, and taxpayer voted in New York in fall of 1980. In re David W. & Marilyn A. Rivkin, Dec St ***Tax*** Comm, TSB-H-86(139)-I.

Taxpayer who was domiciliary of New York when he entered United States Public Health Service for ***2*** year tour of duty in Oklahoma did not effect change of domicile since absence from New York state was for particular purpose and for limited period of time; temporary removal from New York state for limited period of time does not change domicile of resident and domicile continues until new one is established. In re Jacobius, Dec State ***Tax*** Comm, No. 15271.

Taxpayer continued to be a domiciliary of New York during period while he resided in Illinois as a union officer, as he had no permanent Illinois residence, intended to return after the fixed term, and retained his New York home, savings account, telephone listing, driver's license, and safe deposit box, even though during the period he had removed all of his personal effects to Illinois, voted in Illinois, and obtained an Illinois driver's license. In re Chancey, Op State ***Tax*** Comm, June 14, 1977.

Taxpayers failed to prove change of domicile, despite their formal declarations of intent to make Florida their new domicile, where several factors indicated that they failed to abandon their New York domicile and sever their ties with New York, including their continued ownership and use of house in New York, their wage and ***tax*** statements showing that New York address, and taxpayer husband's constant supervision and review of his business interests in New York. NY ***Tax*** Appeals Tribunal TSB-D-91-(23)I.

Taxpayer's business ties to New York were significant, and thus he failed to prove by clear and convincing evidence that he and his wife intended to change their domicile from New York to Vermont, where he was actively involved with designing educational materials for company of which he was president, he spent considerable time at company's New York offices, and he was in frequent telephone contact with company. NY ***Tax*** Appeals Tribunal TSB-D-94-(20)I.

Non-New York City taxpayer failed to produce evidence sufficient to prove cogent pattern of travel accounting for his location outside city during 61 days at issue, despite his assertion that he had established "pattern" of never working on Mondays unless there was meeting scheduled, and that he usually worked on Fridays, where record showed that he spent nearly as many Mondays as Fridays in city. NY ***Tax*** Appeals Tribunal TSB-D-95-(30)I.

Witnesses' testimony as to nondomiciliary taxpayer's visits to his New York City office was insufficient to meet his burden of showing on what days he was in city or at home, even though such testimony might have been truthful and competent, where it did not relate to any particular day and it only raised possibility that taxpayer was not in city for any one of 61 days in issue. NY ***Tax*** Appeals Tribunal TSB-D-95-(30)I.

Absence of credit card charge on given day should not, in itself, result in excluding that day from nondomiciliary taxpayer's calculation of days spent within New York City, despite his claim that if he had spent day in city, he would have had to eat meal there, payment for which he would have made on his credit card, where he made frequent trips into city. NY ***Tax*** Appeals Tribunal TSB-D-95-(30)I.

### 6. —Maintenance of state driver's license or registration of motor vehicle in state

Petitioner demonstrated that necessary intent existed at time of his removal from New York to Connecticut to effect change of domicile, notwithstanding that he continued to maintain his New York driver's license, where this was done because it was cheaper than obtaining a Connecticut license. In re Rones, 1983 Dec State ***Tax*** Comm, TSB-H-83(262)I, October 7, 1983.

Petitioner established by clear and convincing proof that he changed his domicile from New York to Florida prior to 1975, where he purchased a home there in March 1973, his employer relocated there in 1974, he had his bank accounts there and his car registered there, and he joined the local Chamber of Commerce and was active on the local United Way and Easter Seal campaigns and had been a member of a country club there since 1974. His wife remained in their New York home and would travel to Florida on a regular but limited basis, since her mother who was aged and ill resided with her in her New York home together with her children, but petitioner sold their home in New York subsequent to the death of wife's mother in 1976. In re Rush, 1983 Dec State ***Tax*** Comm, TSB-H-83(280)I, October 14, 1983.

Taxpayer continued to be a domiciliary of New York during period while he resided in Illinois as a union officer, as he had no permanent Illinois residence, intended to return after the fixed term, and retained his New York home, savings account, telephone listing, driver's license, and safe deposit box, even though during the period he had removed all of his personal effects to Illinois, voted in Illinois, and obtained an Illinois driver's license. In re Chancey, Op State ***Tax*** Comm, June 14, 1977.

Petitioners maintained a permanent place of abode in New York during 1967 regardless of their claim of changing domicile to Connecticut in 1966 where petitioners continued to rent and occupy a New York City apartment in 1967, registered their automobile in New York during that year, were listed in Who's Who at a New York address for 1967 and were registered to vote in New York. In re Farago 1980 Dec St ***Tax*** Comm, Apr 11, 1980.

Petitioners did not sustain burden of proof with respect to change of domicile for year 1970; petitioners owned two cars one of which was registered in New York, maintained New York operators licenses, voted in New York elections in 1972 and 1976, received mail at both New York and Florida residences, and maintained membership with one New York club. In re Campana, Dec State ***Tax*** Comm, Aug 12, 1980.

Affirming the decision of the Administrative ***Law*** Judge that petitioner changed his domicile from New York to Florida, the Tribunal rejected the argument of the ***Tax*** Division that petitioner's formal acts, that is, the filing of a declaration of domicile, registering to vote, and obtaining a driver's license in Florida, were self-serving and should have been accorded little or no weight by the Administrative ***Law*** Judge. The ***Tax*** Division's argument that these kinds of actions should be discounted as self-serving is an argument, in essence, that they are not, and never can be, credible. Carried to its logical end, this argument would have as rule of general application to disregard such actions in determining domicile. Each case must be taken in accord with the facts and circumstances entered. The significance of these formal acts in each case will depend upon other relevant factors in the case and depending upon these factors may take on greater or lesser importance. NY ***Tax*** Appeals Tribunal TSB-D-90 (33) I (1990).

### 7. —Personal property located in state

Petitioner was domiciled in New York for years 1976 and 1977, notwithstanding that he registered to vote, filed a declaration of domicile and citizenship, joined clubs, and changed his will to Florida, where he continued to maintain his house and furniture in New York long after he bought condominium in Florida, he lived in New York for extensive periods during 1976 and 1977 and worked at the same New York corporations as before the move, and he did not transfer residence until after 1977. In re Clute, 1983 Dec State ***Tax*** Comm, TSB-H-83(284)I, October 14, 1983.

Petitioners' conduct does not clearly demonstrate intention to give up New York domicile and take up new domicile, and petitioners were therefore domiciled in New York during 1979, where they continued to maintain their house and furniture in New York after they moved to Florida, they returned to New York for 3 months in 1978 and 4 months in 1979 to allow husband to work at New York plant, and, during these periods, petitioners lived in their New York home; the fact that petitioners registered to vote and filed Declaration of Residence in Florida, while indicative of an intent to change domicile, is not conclusive. In re Zigrossi, 1983 Dec State ***Tax*** Comm, TSB-H-83(181)I, June 20, 1983.

Taxpayer continued to be a domiciliary of New York during period while he resided in Illinois as a union officer, as he had no permanent Illinois residence, intended to return after the fixed term, and retained his New York home, savings account, telephone listing, driver's license, and safe deposit box, even though during the period he had removed all of his personal effects to Illinois, voted in Illinois, and obtained an Illinois driver's license. In re Chancey, Op State ***Tax*** Comm, June 14, 1977.

Taxpayer did not intend to permanently change domicle to Georgia as evidenced by statement in Georgia ***tax*** return that he was not resident of that state, by his spending most of his time in New York with his girlfriend and son, and retention of his New York financial advisors, bank accounts, and his Manhattan apartment. In re Meminger, 1982 Dec State ***Tax*** Comm, Dec. 31, 1982.

**8. —Retention of living quarters or mailing address in state**

The ***Tax*** Commissioner's determination that a taxpayer was a New York resident was supported by substantial evidence, despite his claim that he had moved his residence to Florida, where he had not abandoned his New York home in that he used it more frequently than he did his Florida residence, and where a very considerable portion of his time was spent in fulfilling his responsibilities as director of two banks located in New York State. *Clute v Chu, 106 A.D.2d 841, 484 N.Y.S.2d 239, 1984 N.Y. App. Div. LEXIS 21745 (N.Y. App. Div. 3d Dep't 1984)*.

Taxpayer maintained New York domicile for purposes of gift ***tax*** where, prior to her husband's death, husband maintained apartment and corporate headquarters in New York City, there was no evidence that wife's 3-year stay in Florida prior to husband's death and 18 month stay in Florida following husband's death was result of deliberate choice of new domicile, taxpayer spent all of her time in New York City at time of hearing due to severe incapacitation, and where only indication of her intent to become domiciled in Florida were documentary statements made after controversy arose. *Kaskel v New York State **Tax** Com., 111 A.D.2d 431, 488 N.Y.S.2d 322, 1985 N.Y. App. Div. LEXIS 51526 (N.Y. App. Div. 3d Dep't 1985)*.

Evidence supported determination that petitioner, renowned architect, was domiciled in New York during year in question, even though he subleased his New York City apartment and only spent 56 days in New York during that year, where he did not relinquish his rights to his New York apartment, he retained his name on utility accounts as to apartment, most of his furniture, together with family artwork and other personal possessions, remained in apartment, he thereafter moved back to New York City, filed New York resident income ***tax*** returns for ensuing ***2*** years, and eventually purchased apartment, and in subsequent letter to his attorney, petitioner indicated that he did not own apartment he used in California for year in question and stated that "my home for over 20 years has been my apartment 9B at 525 Park Avenue." *Warnecke v **Tax** Appeals Tribunal, 252 A.D.2d 748, 676 N.Y.S.2d 286, 1998 N.Y. App. Div. LEXIS 8295 (N.Y. App. Div. 3d Dep't 1998)*.

Taxpayer did not prove a change in domicile prior to realizing nearly $***2*** million in capital gains on April 30, 2004, where she extended her lease on the New York apartment until June 2004, actually vacated that apartment in July 2004, maintained duplicate household items in both her Tennessee and New York apartments and did not affect a change in her lifestyle or related business interests until July 2004; the taxpayer did not present any evidence or credible testimony regarding the amount of time she spent in Tennessee versus New York during the relevant time period, and her registration of a vehicle and to vote in Tennessee were not conclusive as they were merely to escape taxation. *Matter of Ingle v **Tax** Appeals Trib. of the Dept. of Taxation & Fin. of the State of N.Y., 110 A.D.3d 1392, 973 N.Y.S.2d 877, 2013 N.Y. App. Div. LEXIS 7084 (N.Y. App. Div. 3d Dep't 2013)*.

Petitioner established by clear and convincing proof that he changed his domicile from New York to Florida prior to 1975, where he purchased a home there in March 1973, his employer relocated there in 1974, he had his bank accounts there and his car registered there, and he joined the local Chamber of Commerce and was active on the local United Way and Easter Seal campaigns and had been a member of a country club there since 1974. His wife remained in their New York home and would travel to Florida on a regular but limited basis, since her mother who was aged and ill resided with her in her New York home together with her children, but petitioner sold their home in New York subsequent to the death of wife's mother in 1976. In re Rush, 1983 Dec State ***Tax*** Comm, TSB-H-83(280)I, October 14, 1983.

Petitioner was domiciled in New York for years 1976 and 1977, notwithstanding that he registered to vote, filed a declaration of domicile and citizenship, joined clubs, and changed his will to Florida, where he continued to maintain his house and furniture in New York long after he bought condominium in Florida, he lived in New York for extensive periods during 1976 and 1977 and worked at the same New York corporations as before the move, and he did not transfer residence until after 1977. In re Clute, 1983 Dec State ***Tax*** Comm, TSB-H-83(284)I, October 14, 1983.

Petitioners' conduct does not clearly demonstrate intention to give up New York domicile and take up new domicile, and petitioners were therefore domiciled in New York during 1979, where they continued to maintain their house and furniture in New York after they moved to Florida, they returned to New York for 3 months in 1978 and 4 months in 1979 to allow husband to work at New York plant, and, during these periods, petitioners lived in their New York home; the fact that petitioners registered to vote and filed Declaration of Residence in Florida, while indicative of an intent to change domicile, is not conclusive. In re Zigrossi, 1983 Dec State ***Tax*** Comm, TSB-H-83(181)I, June 20, 1983.

Petitioner has failed to sustain burden of proof under CLS ***Tax** L § **605**(a)(1)* that he had bona fide intention of establishing fixed and permanent home in Connecticut, despite fact that petitioner accepted permanent employment in Connecticut, that car registration was with Connecticut, that petitioner has Connecticut driver's license and has bank accounts in Connecticut, where petitioner (1) voted in New York during year in question, (***2***) maintained post office box in New York, (3) rented apartment in Connecticut on month-to-month basis and (4) filed amended New York ***tax*** return as resident individual. In re Malcolm Kafka, Dec State ***Tax*** Comm, TSB-H-84-(128)-I.

Taxpayer born in New York was domiciliary of New York during years at issue where it was shown that taxpayer lived with parents in New York City until 1973 when he left to attend Yale University in Connecticut, stayed at parents' home for brief periods of time during 7 years he was at Yale, during summer of 1978 and 1979 worked at Chicago ***law*** firm and San Francisco ***law*** firm, upon graduation obtained clerkship in Chicago where it was shown that such position was admittedly of limited duration, and taxpayer voted in New York in fall of 1980. In re David W. & Marilyn A. Rivkin, Dec St ***Tax*** Comm, TSB-H-86(139)-I.

Taxpayer continued to be a domiciliary of New York during period while he resided in Illinois as a union officer, as he had no permanent Illinois residence, intended to return after the fixed term, and retained his New York home, savings account, telephone listing, driver's license, and safe deposit box, even though during the period he had removed all of his personal effects to Illinois, voted in Illinois, and obtained an Illinois driver's license. In re Chancey, Op State ***Tax*** Comm, June 14, 1977.

Taxpayer who had lived with his parents in New York, but then had accepted several jobs in different states and lived with relatives and also had travelled widely, but used his parents' address on some federal ***tax*** returns and had important mail sent to his parents, remained a New York resident, as he did not sustain his burden of proof that he intended to change domicile, because none of his other residences were intended to be his fixed and permanent home. In re Hamill, Op State ***Tax*** Comm, June 30, 1977.

New York attorney, who had a 3 year employment contract in New Jersey and rented an apartment there during that time, remained a New York resident, as he retained his New York home where his wife lived, continued being a member of the New York bar, and was at his home at least 30 days in each year, notwithstanding that he attempted to find a permanent home in New Jersey, voted in New Jersey, and had a temporary New Jersey driver's license. In re Patterson, Op State ***Tax*** Comm, August 16, 1977.

Despite fact that taxpayer used a New York address on his federal return, taxpayer was not a New York domiciliary, where several years previously he sold his New York home and business, moved to Nevada, obtained Nevada operator's and automobile licenses, voted in Nevada, executed a Nevada will, and only visited New York on occasion and owned a New York passive real estate investment company. In re Wolf, Op State ***Tax*** Comm, October 11, 1977.

Taxpayer who was transferred from job in New York to job in Pennsylvania remained domiciliary of New York for ***tax*** year in question where he maintained home in New York where his wife and children lived, and spent at least 60 days in New York for purpose of visiting his family. In re Kester, Dec State ***Tax*** Comm, Oct. 9, 1979.

Petitioners maintained a permanent place of abode in New York during 1967 regardless of their claim of changing domicile to Connecticut in 1966 where petitioners continued to rent and occupy a New York City apartment in 1967, registered their automobile in New York during that year, were listed in Who's Who at a New York address for 1967 and were registered to vote in New York. In re Farago 1980 Dec St ***Tax*** Comm, Apr 11, 1980.

Where petitioners maintained a permanent place of abode in New York and spent in the aggregate more than 30 days in the state during the taxable year in question, they were domiciliary resident individuals of New York within the meaning of ***Tax Law*** *§* ***605****(a)* since they satisfy the residency requirements and since, although they purchased an apartment in Florida, they never filed a declaration of intent to change domicile with the State of Florida. In re Karnell, 1980 Dec St ***Tax*** Comm, May 16, 1980.

Petitioner, a management consultant for a Connecticut company with its home office in Connecticut, is a domiciliary of New York during the year in question despite the fact that he maintained an abode in Connecticut, worked there, and claimed his permanent residence there for income ***tax*** purposes since petitioner's legal spouse maintained a New York City apartment for her convenience and for business purposes and petitioner contributed to the rental and maintenance payments of the apartment, occasionally stayed there, and failed to introduce any evidence as to the number of days he stayed in New York or to show that the maintenance of a separate abode for his wife was the result of marital difficulties. In re Schweppe, 1980 Dec St ***Tax*** Comm, July 7, 1980.

Petitioners did not sustain burden of proof with respect to change of domicile for year 1970; petitioners owned two cars one of which was registered in New York, maintained New York operators licenses, voted in New York elections in 1972 and 1976, received mail at both New York and Florida residences, and maintained membership with one New York club. In re Campana, Dec State ***Tax*** Comm, Aug 12, 1980.

Petitioners effected change of domicile by selling New York home, moving to Florida to live with brother, opening bank accounts, registering to vote, and obtaining drivers license in Florida; change of domicile was effected although petitioners maintained apartment in New York City, which was small and remained empty most of time. In re Fielding, Dec State ***Tax*** Comm, Aug 22, 1980.

Taxpayer did not intend to permanently change domicle to Georgia as evidenced by statement in Georgia ***tax*** return that he was not resident of that state, by his spending most of his time in New York with his girlfriend and son, and retention of his New York financial advisors, bank accounts, and his Manhattan apartment. In re Meminger, 1982 Dec State ***Tax*** Comm, Dec. 31, 1982.

Facts that petitioner retained an interest in a New York apartment and did not immediately change his will to show a change of domicile are not sufficient to negate a clearly manifested intent to change his domicile from New York to New Jersey. In re Carity, 1981 Dec St ***Tax*** Ct, October 28, 1981.

Taxpayers failed to prove by clear and convincing evidence that they changed their domicile from New York to Florida, even though taxpayers filed declaration of domicile, registered their automobile, obtained driver's licenses, and registered to vote, all in State of Florida, where taxpayers retain their home in New York and returned there for approximately for 3 months each year, as well as fact that taxpayers leased furnished condominium in Florida. In Matter of Zapka, NYS Dept. of ***Tax***. & Fin., ***Tax*** Appeals Tribunal Decision No. TSB-D-89-(16)I.

Although continued ownership of former New York home is often indication that there was no intent to change domicile, such fact is only one factor that needs to be considered; where person has ***2*** homes, his domicile is one which he considers and uses as his permanent home, and length of time spent at each location is important factor in determining intention in this regard. NY ***Tax*** Appeals Tribunal TSB-D-94-(9)I.

Taxpayer's uncontroverted testimony that he never entered his New York residence during 18 months in question, due to separation from his wife and couple's intent to get divorce, diminished importance of his retention of New York home in determination of domicile. NY ***Tax*** Appeals Tribunal TSB-D-94-(9)I.

Fact that taxpayers continued to maintain large New York residence, and did not sell their original New York home, did not indicate that they could not have intended to effectuate change of domicile to Florida since it was significant that taxpayers moved their most personal belongings and memorabilia to Florida, including photographs, china and such. NY ***Tax*** Appeals Tribunal TSB-D-94-(18)I.

Mere assertion by taxpayer that he did not live in his mother's house during his tenure in New York City did not sufficiently establish his lack of permanent place of abode in state and city; moreover, fact that he paid for more than 50 percent of expenses associated with his mother's house contradicted his assertion that he did not maintain permanent place of abode. NY ***Tax*** Appeals Tribunal TSB-D-94-(22)I.

Taxpayers failed to show that they had changed their domicile from New York to Florida, despite purchase of home in Florida, where their pattern of life did not change during years in question, they maintained their New York home and could not support their claim that they had placed it on market, they utilized New York attorneys, accountants and physicians, they continued their membership and activities in New York social, charitable and religious organizations, they used their New York and Florida checking accounts equally, and they were "less than candid" with auditor's requests for information concerning their organization memberships, wills, driver's licenses, vehicle registrations and bank accounts. NY ***Tax*** Appeals Tribunal TSB-D-94-(38)I.

Taxpayer failed to prove that he changed his domicile to New jersey where he stayed at his New Jersey address only 3 or 4 nights per week and returned to New York residence for remainder where his family was still located, he and his wife always intended to move into their "dream home" (second New Jersey address) on its completion and intended their first New Jersey address to be temporary, he did not register to vote or register his vehicle in New Jersey, he did not hold New Jersey driver's license, and he had no New Jersey bank accounts. NY ***Tax*** Appeals Tribunal TSB-D-95-(5)I.

Taxpayers failed to show that they had permanently abandoned their New York home, and thus that they were not statutory New York residents after their move to New Jersey, where they continued to own New York house, furniture remained which did not preclude occasional use, one taxpayer continued to work in New York, and credit card receipts established pattern of purchases in New York. NY ***Tax*** Appeals Tribunal TSB-D-95-(5)I.

Nondomiciliary taxpayers maintained "permanent place of abode" in New York City during 1987 through 1989 for purposes of *CLS **Tax** § **605(b)**(1)(**B**)* where it was undisputed that they owned and maintained apartment in city during such years. NY ***Tax*** Appeals Tribunal TSB-D-95-(32)I.

Taxpayers failed to show that they had changed their domicile from New York City to Long Island during 4-year period in which one taxpayer was preparing for retirement where period was one of "transition" following purchase of his company, winding down of his business affairs and change of status as owner was part of natural process, and during period he maintained much daily contact with New York City, including maintenance of permanent place of abode and use of city for many daily services and professional contacts. NY ***Tax*** Appeals Tribunal TSB-D-95-(34)I.

Petitioners' New York City apartment was dwelling place suitable for full-time occupancy by petitioners, regardless of whether they removed most of their furniture, and thus it was properly determined to be permanent place of abode within meaning of *CLS **Tax** § **605**(**b**)(1)* and *20* NYCRR former § 102.***2***(a)(1) without evidence that petitioners did not or could not have resided therein. NY ***Tax*** Appeals Tribunal TSB-D-97-(22)I.

Fact that petitioner subleased his New York City apartment and spent only 56 days in New York for year in question did not establish change in domicile where he did not relinquish his rights to apartment, he retained his name on utility accounts thereto, most of his furniture, together with family artwork and other personal possessions, remained in apartment, and he moved back to New York City, filed New York resident income ***tax*** returns for subsequent years, and eventually purchased apartment. NY ***Tax*** Appeals Tribunal TSB-D-97(6.1) I.

***Tax*** Appeals Tribunal did not err in sustaining a notice of deficiency of petitioner's personal income ***tax*** for the 2007 and 2008 ***tax*** years, in which he filed nonresident income ***tax*** returns, as he failed to present clear and convincing evidence that, as of 2007, he had abandoned his New York domicile and acquired a new Florida domicile; the Tribunal reasonably deferred to the administrative ***law*** judge's refusal to credit petitioner's testimony that he intended for Florida to be his domicile long before the 2007 sale of his Florida office building since he had misrepresented on both his 2006 and 2007 nonresident and part-year ***tax*** returns that neither he nor his wife had living quarters in New York. *Matter of Campaniello v New York State Div. of **Tax** Appeals Trib., 2018 N.Y. App. Div. LEXIS 3345 (N.Y. App. Div. 3d Dep't 2018)*.

**9. —Returning to state**

Taxpayer maintained New York domicile for purposes of gift ***tax*** where, prior to her husband's death, husband maintained apartment and corporate headquarters in New York City, there was no evidence that wife's 3-year stay in Florida prior to husband's death and 18 month stay in Florida following husband's death was result of deliberate choice of new domicile, taxpayer spent all of her time in New York City at time of hearing due to severe incapacitation, and where only indication of her intent to become domiciled in Florida were documentary statements made after controversy arose. *Kaskel v New York State **Tax** Com., 111 A.D.2d 431, 488 N.Y.S.2d 322, 1985 N.Y. App. Div. LEXIS 51526 (N.Y. App. Div. 3d Dep't 1985)*.

Taxpayer incurred change of domicile from New York to Kansas and was thus taxable as part-year resident individual where it was shown that although taxpayer maintained some contacts with New York after his move to Kansas, he evidenced clear intention to leave New York in 1980 and move to Kansas, and move was permanent commitment rather than move for specified period or purpose, and work and residence in Kansas was ended only by his illness; furthermore, after taxpayer left Kansas taxpayer did not return to New York but instead purchased residence in Florida. In re Wills, Dec St ***Tax*** Comm, TSB-H-86(134)-I.

Petitioners established no clear intention to remain permanently in Florida, where they moved from New York to Florida, back to New York and stayed for more than a year, and moved to Florida a second time. In re Recchia, Dec State ***Tax*** Comm, August 22, 1980.

Petitioner changed his domicile from New York State to California, where (1) he voluntarily interviewed for position in San Francisco, California and his subsequent transfer there did not represent a corporate transfer in which petitioner had little voice, but in fact represented a voluntary act on his part and (***2***) petitioner, who subsequently returned to New York, testified to the effect that he would not have taken any job in New York City just to get back to New York. In re Wall, 1983 Dec State ***Tax*** Comm, TSB-H-83(249)I, August 24, 1983.

Petitioner who lived and worked in New York State until December of 1970 and who thereafter terminated his employment, sold his furniture, vacated his apartment and went to Los Vegas, Nevada did not show necessary intent to establish new domicile where, after beginning employment in his field (personnel) and obtaining divorce, petitioner, in or about October of 1971, decided that he did not want to live in Los Vegas and looked for employment in southwestern part of country, thereafter deciding to return to New York area because of his established reputation in his field of work; since petitioner did not change his domicile during 1971, he is New York State resident for entire year, within meaning and intent of § ***605***(a). In re Hauser, 1979 Dec State Com., December 20, 1979.

Taxpayers were domiciled in, and residents of, state of New York for year in question, notwithstanding that they took many steps towards establishing Florida as their domicile (e.g., filing Declaration of Domicile, automobile registration, driver's licenses, bank accounts, and voting registration), where they retained their New York home, which they returned to for approximately 6 months during relevant year, and taxpayer husband conducted medical consulting and service-oriented work to VA hospital and nursing home in New York. NY ***Tax*** Appeals Tribunal TSB-D-91-(11)I.

Although act of taxpayer in reconciling with his wife in New York after moving to New Jersey could be significant in showing "range of sentiment, feeling and permanent association" that he felt for his purported new domicile, such act was not conclusive, and thus his later return to New York did not automatically preclude him from having had sincere intention in remaining permanently in New Jersey at time when he moved there. NY ***Tax*** Appeals Tribunal TSB-D-94-(9)I.

**10. —Spouse/children remaining in state**

Petitioner established by clear and convincing proof that he changed his domicile from New York to Florida prior to 1975, where he purchased a home there in March 1973, his employer relocated there in 1974, he had his bank accounts there and his car registered there, and he joined the local Chamber of Commerce and was active on the local United Way and Easter Seal campaigns and had been a member of a country club there since 1974. His wife remained in their New York home and would travel to Florida on a regular but limited basis, since her mother who was aged and ill resided with her in her New York home together with her children, but petitioner sold their home in New York subsequent to the death of wife's mother in 1976. In re Rush, 1983 Dec State ***Tax*** Comm, TSB-H-83(280)I, October 14, 1983.

New York attorney, who had a 3 year employment contract in New Jersey and rented an apartment there during that time, remained a New York resident, as he retained his New York home where his wife lived, continued being a member of the New York bar, and was at his home at least 30 days in each year, notwithstanding that he attempted to find a permanent home in New Jersey, voted in New Jersey, and had a temporary New Jersey driver's license. In re Patterson, Op State ***Tax*** Comm, August 16, 1977.

Taxpayer who was transferred from job in New York to job in Pennsylvania remained domiciliary of New York for ***tax*** year in question where he maintained home in New York where his wife and children lived, and spent at least 60 days in New York for purpose of visiting his family. In re Kester, Dec State ***Tax*** Comm, Oct. 9, 1979.

Petitioner, a management consultant for a Connecticut company with its home office in Connecticut, is a domiciliary of New York during the year in question despite the fact that he maintained an abode in Connecticut, worked there, and claimed his permanent residence there for income ***tax*** purposes since petitioner's legal spouse maintained a New York City apartment for her convenience and for business purposes and petitioner contributed to the rental and maintenance payments of the apartment, occasionally stayed there, and failed to introduce any evidence as to the number of days he stayed in New York or to show that the maintenance of a separate abode for his wife was the result of marital difficulties. In re Schweppe, 1980 Dec St ***Tax*** Comm, July 7, 1980.

Taxpayer was properly found not to be New York domiciliary where he moved out of his New York marital home and into New Jersey condominium which he had purchased during previous year, and there was evidence that taxpayer's separation from his wife was not intended to be temporary when he moved out, and that couple intended to get divorced. NY ***Tax*** Appeals Tribunal TSB-D-94-(9)I.

Taxpayer did not maintain New York City apartment as permanent place of abode, even though his wife resided there, he often spent one night per week there and couple sought to maintain "viable familial relationship" despite informal separation, where he maintained Connecticut residence, he had no property right in apartment (i.e., he did not own, lease or rent it, but rather his wife rented it), there was no connection between couple's agreement to pay money to wife and his utilization of apartment, and he did not have free and continuous access to apartment under their agreement. NY ***Tax*** Appeals Tribunal TSB-D-95-(3)I.

Fact that taxpayer and his wife sought to maintain “viable familial relationship” did not make any less serious their marital separation “in fact,” and thus taxpayer’s occasional visits to wife’s New York City apartment were insufficient to establish permanent place of abode in New York, where couple had agreed to informal separation that, inter alia, placed restrictions on his access to apartment. NY ***Tax*** Appeals Tribunal TSB-D-95-(3)I.

### 11. —Voting rights

Petitioner has failed to sustain burden of proof under CLS *Tax L § 605(a)(1)* that he had bona fide intention of establishing fixed and permanent home in Connecticut, despite fact that petitioner accepted permanent employment in Connecticut, that car registration was with Connecticut, that petitioner has Connecticut driver’s license and has bank accounts in Connecticut, where petitioner (1) voted in New York during year in question, (***2***) maintained post office box in New York, (3) rented apartment in Connecticut on month-to-month basis and (4) filed amended New York ***tax*** return as resident individual. In re Malcolm Kafka, Dec State ***Tax*** Comm, TSB-H-84-(128)-I.

Taxpayer born in New York was domiciliary of New York during years at issue where it was shown that taxpayer lived with parents in New York City until 1973 when he left to attend Yale University in Connecticut, stayed at parents’ home for brief periods of time during 7 years he was at Yale, during summer of 1978 and 1979 worked at Chicago ***law*** firm and San Francisco ***law*** firm, upon graduation obtained clerkship in Chicago where it was shown that such position was admittedly of limited duration, and taxpayer voted in New York in fall of 1980. In re David W. & Marilyn A. Rivkin, Dec St ***Tax*** Comm, TSB-H-86(139)-I.

Taxpayer continued to be a domiciliary of New York during period while he resided in Illinois as a union officer, as he had no permanent Illinois residence, intended to return after the fixed term, and retained his New York home, savings account, telephone listing, driver’s license, and safe deposit box, even though during the period he had removed all of his personal effects to Illinois, voted in Illinois, and obtained an Illinois driver’s license. In re Chancey, Op State ***Tax*** Comm, June 14, 1977.

Petitioners maintained a permanent place of abode in New York during 1967 regardless of their claim of changing domicile to Connecticut in 1966 where petitioners continued to rent and occupy a New York City apartment in 1967, registered their automobile in New York during that year, were listed in Who’s Who at a New York address for 1967 and were registered to vote in New York. In re Farago 1980 Dec St ***Tax*** Comm, Apr 11, 1980.

Petitioners did not sustain burden of proof with respect to change of domicile for year 1970; petitioners owned two cars one of which was registered in New York, maintained New York operators licenses, voted in New York elections in 1972 and 1976, received mail at both New York and Florida residences, and maintained membership with one New York club. In re Campana, Dec State ***Tax*** Comm, Aug 12, 1980.

### 12. —Miscellaneous

Evidence indicating that husband and wife retained their New York domicile until husband’s primary business interest had ben sold provided substantial evidence for concluding that they had not abandoned their New York domicile. *Gray v Tax Appeals Tribunal, 235 A.D.2d 641, 651 N.Y.S.2d 740, 1997 N.Y. App. Div. LEXIS 97 (N.Y. App. Div. 3d Dep't 1997)*.

Petitioners failed to establish that they intended to make New Jersey their fixed and permanent home, where husband’s testimony was that he did not anticipate living in New Jersey “forever,” and petitioners held only a month-to-month leasehold on their New Jersey apartment. In re Press, 1983 Dec State ***Tax*** Comm, TSB-H-83(235)I, July 29, 1983.

Taxpayer was not taxable as full year resident individual of New York State because taxpayer was not domiciliary of New York State or New York City who either maintained permanent place of abode in New York, spent more than 30 days in New York or did not maintain permanent place of abode outside state and city; taxpayer has sustained her burden of proof to show that she changed her domicil from New York to Washington, D.C. and therefore taxpayer is taxable as nonresident of state and city of New York. In re Michel, Dec St ***Tax*** Comm, TSB-H-87-(176)-I.

Taxpayer is not resident individual of New York State where he evinced clear intention to abandon New York as domicil by not only physically moving to Florida, but also increasing his business activities in Florida and executing new will in Florida. In re Rosenthal, Dec St ***Tax*** Comm, TSB-H-87-(181)-I.

Taxpayer who was domiciled in New York until May of year in question did not acquire new domicile by acts of taking employment and boarding with friend in New Jersey; although taxpayer did not maintain permanent place of abode in New York State during latter part of year in question, he is still considered resident of New York during year because he was domiciled in state, spent more than 30 days in state, and did not maintain permanent place of abode outside state during entire period. In re Cook, Dec State ***Tax*** Comm, August 8, 1979.

Petitioners' removal from New York State to Illinois solely as the result of a military assignment coupled with petitioners' search, while in Illinois, for a location to setup a medical practice, leads to the strong inference that petitioners had no intent to remain permanently in Illinois and therefore, petitioners were domiciled in New York State during the taxable year in question. In re Schanzer, 1980 Dec St ***Tax*** Comm, May 23, 1980.

Taxpayers changed their domicile from New York to Florida, even though they maintained substantial ties to New York, including purchase of a condominium, maintenance of bank accounts, contributions to New York political campaigns, and reception of mail at New York address, where working taxpayer substantially reduced his participation in New York businesses and charities, both taxpayers were active in decision to purchase Florida condominium and to design improvements thereto, and they showed intent to retire from their many New York business, social and charitable activities by engaging in such activities in Florida. NY ***Tax*** Appeals Tribunal TSB-D-94-(7)I.

Taxpayer's continued business contacts with New York may be important factor in determining intent to change domicile, but it is just one factor to be considered within totality of circumstances. NY ***Tax*** Appeals Tribunal TSB-D-94-(9)I.

Taxpayer's continuing business activities in New York did not provide adequate basis for disturbing determination of Administrative ***Law*** Judge as to intent to change domicile from New York to New Jersey where, as commodities broker, he ceased being active in his New York firm and hired other floor brokers to be responsible for customers there, he operated commodities clearing firm and dealt only with other brokers rather than outside customers, and he derived most of his income from other sources, including profits from trading in property for his own account and number of investments in partnerships and "S corporations" with no specific geographic sources of income. NY ***Tax*** Appeals Tribunal TSB-D-94-(9)I.

Administrative ***Law*** Judge properly determined that taxpayer failed to prove by clear and convincing evidence that he changed his domicile from New York to Connecticut where taxpayer did not have permanent place of abode after selling his New York residence and he was staying with others, his proof of voting registration in Connecticut related to time after year in issue, and his proof of executing will in Connecticut consisted only of photocopy of letter by witnesses stating that they witnessed such execution at taxpayer's Connecticut residence. NY ***Tax*** Appeals Tribunal TSB-D-94-(11)I.

Administrative ***Law*** Judge properly determined that taxpayers did not abandon their New York domicile until 1988, despite earlier Florida voter registration and homestead exemption, where one taxpayer's diary entry was made in that year and stated their intent to abandon their New York domicile, and their actions included involvement in New York real estate business in 1987, reception of mail at post office box in New York, employment of secretary in New York, maintenance of telephone line, retention of New York driver's licenses and car and trailer registrations, and retention of New York attorney and bank accounts. NY ***Tax*** Appeals Tribunal TSB-D-94-(14)I.

It was not unreasonable to accept taxpayer's explanation that telephone calls and office visits made to New York from Florida related primarily to personal, rather than business, matters, and thus such explanation supported taxpayer's testimony that he had changed his domiciliary to Florida on retiring from his New York business, where he had managed substantial rental operation before retirement, and overall amount of telephone contact (some 24 hours over 3 years) and limited number of office visits were not sufficient to constitute active involvement, or to foster efficiency. NY ***Tax*** Appeals Tribunal TSB-D-94-(18)I.

**13. Foreign relocations; factors affecting—In general**

A determination of the State ***Tax*** Commission that the petitioner is liable for ***taxes*** on income from the sale of securities abroad prior to July, 1971 on the ground that petitioner was a resident of the State for ***tax*** purposes for the year 1971 is reinstated; petitioner's conduct during a stay of over 15 years in England does not conclusively establish a change of domicile from New York State to England. *Shapiro v State **Tax** Com., 50 N.Y.2d 822, 430 N.Y.S.2d 33, 407 N.E.2d 1330, 1980 N.Y. LEXIS 2405 (N.Y. 1980)*.

Presumption against a foreign domicile is stronger than general presumption against a change of domicile for income ***tax*** purposes. *Klein v State **Tax** Com., 55 A.D.2d 982, 390 N.Y.S.2d 686, 1977 N.Y. App. Div. LEXIS 10302 (N.Y. App. Div. 3d Dep't)*, aff'd, *43 N.Y.2d 812, 402 N.Y.S.2d 396, 373 N.E.2d 290, 1977 N.Y. LEXIS 2587 (N.Y. 1977)*.

In order to establish domicile outside of New York, it is not necessary for petitioners to prove that they had intention of remaining there for rest of their lives; it is sufficient to establish foreign domicile that there is no proof that when petitioners took up residence in foreign country they had existing intention to leave foreign country and to take up residence at some other definite location at particular time. *McKone v State **Tax** Com., 111 A.D.2d 1051, 490 N.Y.S.2d 628, 1985 N.Y. App. Div. LEXIS 50288 (N.Y. App. Div. 3d Dep't 1985)*, aff'd, *68 N.Y.2d 638, 505 N.Y.S.2d 71, 496 N.E.2d 230, 1986 N.Y. LEXIS 19029 (N.Y. 1986)*.

United States citizen will not ordinarily be deemed to have changed domicile by going to foreign country unless it is clearly shown that he intends to remain permanently; presumption against foreign domicile is stronger than general presumption against change in domicile, and less evidence is required to establish change in domicile from one state to another than from one nation to another. In re Brett, Dec State ***Tax*** Comm, TSB-H-84-(136)-I.

Taxpayers who left New York for ***2*** year employment assignment in Australia did not establish new domicile there because no change of domicile results from removal to new location if intention is to remain there only for limited time and presumption against foreign domicile is stronger than general presumption against change of domicile; United States citizen will not ordinarily be deemed to have changed his domicile by going to foreign country unless it is clearly shown that he intends to remain there permanently. In re Luse, Dec State ***Tax*** Comm, Sept. 28, 1979.

The presumption against a foreign domicile is stronger than the general presumption against a change of domicile and much less evidence is required to establish a change of domicile from one state to another than from one nation to another. In re Solomon, 1981 Dec St ***Tax*** Com, Dec. 31, 1981.

Affirming the decision of the Administrative ***Law*** Judge that petitioner changed his domicile from New York to Florida, the Tribunal rejected the argument of the ***Tax*** Division that petitioner's formal acts, that is, the filing of a declaration of domicile, registering to vote, and obtaining a driver's license in Florida, were self-serving and should have been accorded little or no weight by the Administrative ***Law*** Judge. The ***Tax*** Division's argument that these kinds of actions should be discounted as self-serving is an argument, in essence, that they are not, and never can be, credible. Carried to its logical end, this argument would have as rule of general application to disregard such actions in determining domicile. Each case must be taken in accord with the facts and circumstances entered. The significance of these formal acts in each case will depend upon other relevant factors in the case and depending upon these factors may take on greater or lesser importance. NY ***Tax*** Appeals Tribunal TSB-D-90 (33) I (1990).

**14. —Employment**

The State ***Tax*** Commission properly determined that a taxpayers's actions were merely preparatory to establishing a Canadian domicile but did not actually establish a change of domicile, where, although the evidence indicated that the taxpayer changed his domicile to Canada for seven months by accepting employment with a Canadian firm, that he sought to purchase a home there, and that he opened an account with a Canadian bank, registered his automobile with the Province of Ontario, filed and paid ***taxes*** to the Canadian government and inquired of the Canadian Consulate as to procedures for becoming a landed immigrant, the taxpayer's family remained in New York in a residence owned by him which he attempted unsuccessfully to sell, he visited his family occasionally on weekends, and continued to contribute the family's support. *Kennedy v New York State Income **Tax** Bureau, 85 A.D.2d 837, 446 N.Y.S.2d 429, 1981 N.Y. App. Div. LEXIS 16662 (N.Y. App. Div. 3d Dep't 1981)*.

In an Article 78 proceeding to review a personal income ***tax*** assessment, the ***tax*** was properly assessed on a man who was domiciled in New York where the man lived abroad only under the terms of a year-to-year contract with his employer, absent any effort on his part to attain foreign citizenship. *Mercer v State **Tax** Com., 92 A.D.2d 636, 459 N.Y.S.2d 938, 1983 N.Y. App. Div. LEXIS 16906 (N.Y. App. Div. 3d Dep't 1983)*.

Petitioner did not establish domicile in Saudi Arabia for purposes of ***Tax*** § ***605***, where, inter alia, he accepted job there with understanding that he would be there for minimum of 5 years, he opened a savings account in New York when he found out he was going overseas and planned to have his wages deposited into this account and then draw on these funds as needed while in Saudi Arabia, he sold one of his ***2*** horses prior to leaving New York, but retained other horse so that his daughter would have it available for riding, he obtained permanent visa 4 or 5 months after arriving in Saudi Arabia, and he resided with other associates in a villa leased by his employer. In re Davison, 1983 Dec State ***Tax*** Comm, TSB-H-83(111)I, June 13, 1983.

Taxpayer's intent was not to remain abroad permanently, but only so long as job assignment was in effect, where taxpayer moved to England in June 1976 because of his job assignment, but returned to New York in December 1976 when such assignment ended, rather than seek other employment in England; accordingly, taxpayer remained New York domiciliary during entire taxable year 1976. In re Stavrides, 1983 Dec State ***Tax*** Comm, TSB-H-83(135)I, June 13, 1983.

Petitioners failed to clearly show that their move to Canada was of such a permanent nature as to effect a change of domicile, where husband's transfer to Canada was at the request of his employer and within the realm of his duties as a corporate officer, notwithstanding that petitioners entered Canada on a permanent resident visa, thereby becoming landed immigrants, and paid income ***taxes*** to the Canadian government for years 1973 through 1976. In re McKone, 1983 Dec State ***Tax*** Comm, TSB-H-83(242)I, July 28, 1983.

Officer of company who was moved to company's London office, partly at his request to leave his estranged wife, and who formed attachments in England, did not meet burden of proof that he intended to change his domicile, as he did not establish that his association with the company was not his key factor in staying in England, and he moved back to New York when the company made him president. In re Shapiro, Op State ***Tax*** Comm, August 16, 1977.

Since petitioner stated, in a letter to the Income ***Tax*** Bureau, that his intention at the time of his removal from New York was to return to the United States and that his removal to Canada was for a limited time and that his employer could transfer him back to the United States, petitioner's domicile continues to be New York since he has failed to meet the burden of proof of establishing his move to Canada was with the bona fide intention of making that country his fixed and permanent home. In re Bryant, 1980 Dec St ***Tax*** Comm, Nov 16, 1979.

Petitioner established by a preponderance of the evidence that they changed their domicile from New York to Switzerland in the year in question where petitioner accepted a position in Switzerland which was of indefinite duration, sold their home in New York and purchased one in Switzerland and received a residence permit from a Swiss population office. In re Mestre 1980 Dec St ***Tax*** Comm, Apr 11, 1980.

Petitioner remained a New York domiciliary despite his move to Peru on a foreign assignment for a definite two to four year period where petitioner's previous foreign assignments invariably led to his return to New York, petitioner lacked any other abode or asserted domicile, he failed to establish an intent to change his domicile and he spent more than 30 days in New York during the year in question. In re Freeborn, 1980 Dec St ***Tax*** Comm, April 11, 1980.

Petitioners failed to present clear and convincing evidence showing intent to change domicile, and therefore are subject to New York personal income ***tax***; although petitioner accepted position of hotel manager in England he merely leased premises there, registered as voter with United States embassy, and employed real estate firm to manage and lease New York home. In re Starke, Dec State ***Tax*** Comm, August 28, 1980.

Although petitioners moved to Bahama Island with the intent to work there, obtained the necessary approvals from the Bahamian officials and became residents of the Bahamas due to petitioner's employment, petitioner did not change his New York domicile by going to the Bahamas when he remained there only 7 months; such stay was not sufficient to sustain the burden of proof where petitioner intended to remain there permanently. In re Healey, 1980 St ***Tax*** Comm, Feb. 15, 1980.

Taxpayer did not change his domicile from New York to Mexico during the ***tax*** year where evidence shows that his marriage to a Mexican national and his purchase of a home in Mexico occurred after close of ***tax*** year in question and that he continued to use a New York checking account, retained his United States citizenship, continued his membership in a New York professional society, did not pay any income ***tax*** to Mexico, and that his move to Mexico was connected with his employment. In re Trucios, 1982 Dec State ***Tax*** Comm, Dec. 24, 1982.

**15. —Immigration status**

In proceeding to review determination of State ***Tax*** Commission which denied petitioner's application for redetermination of deficiency of personal income ***tax*** for year 1970 on theory that income earned in Pakistan was not includable, evidence, including fact that petitioners had entered Pakistan not on an immigration visa, but on a "four year multiple entry" visa, did not present a clear and convincing showing of intent to change domicile. *Bodfish v Gallman, 50 A.D.2d 457, 378 N.Y.S.2d 138, 1976 N.Y. App. Div. LEXIS 10646 (N.Y. App. Div. 3d Dep't 1976)*.

In an Article 78 proceeding to review a determination of the State ***Tax*** Commission that sutained a deficiency against a husband and wife and denied their application for a redetermination of personal income ***tax***, there was sufficient evidence to rationally conclude that the husband and wife did not change their domicile to Canada where the husband retained viable New York City business interests, which he tended to during several trips during the period at issue, where he continued to maintain a checking account in a New York City bank and was unable to state with any certainty that he had not voted in New York in elections during the period at issue, where he testified that neither he nor his wife at the time they went to Canada was ready to give up United States citizenship, and where, despite the fact that they applied for "landed immigrant" status in Canada, they were required to do so as a condition precedent to engaging in a business enterprise. *Minsky v Tully, 78 A.D.2d 955, 433 N.Y.S.2d 276, 1979 N.Y. App. Div. LEXIS 14840 (N.Y. App. Div. 3d Dep't 1979)*.

In an Article 78 proceeding to review a personal income ***tax*** assessment, the ***tax*** was properly assessed on a man who was domiciled in New York where the man lived abroad only under the terms of a year-to-year contract with his employer, absent any effort on his part to attain foreign citizenship. *Mercer v State **Tax** Com., 92 A.D.2d 636, 459 N.Y.S.2d 938, 1983 N.Y. App. Div. LEXIS 16906 (N.Y. App. Div. 3d Dep't 1983)*.

In a proceeding to review a determination of the State ***Tax*** Commission as to an individual's personal income ***tax*** assessment, a determination of the commission that the taxpayer was a New York resident for the entire year of 1972 would be modified to the extent that the determination was based on the conclusion that the taxpayer had failed to establish a change of domicile, since the factors relied upon by the commission for reaching its conclusion did not provide the necessary rational basis therefor where it appeared that the taxpayer had moved to New York in the fall of 1971 and that in May, 1972, the taxpayer and his children left New York and went to France where they resided in Paris with a French woman to whom the taxpayer become married after his divorce became final and that the taxpayer had not lived in New York or in the United States since moving to France; there was no support for the finding that the taxpayer had failed to follow the normal procedure for a person who intended to live and work in France and the taxpayer's failure to apply for French nationality after residing in France for five years could not be construed to mean that he maintained a New York domicile. *Bernbach v State **Tax** Com., 98 A.D.2d 559, 471 N.Y.S.2d 903, 1984 N.Y. App. Div. LEXIS 16504 (N.Y. App. Div. 3d Dep't 1984)*.

Petitioner did not establish domicile in Saudi Arabia for purposes of ***Tax*** § ***605***, where, inter alia, he accepted job there with understanding that he would be there for minimum of 5 years, he opened a savings account in New York when he found out he was going overseas and planned to have his wages deposited into this account and then draw on these funds as needed while in Saudi Arabia, he sold one of his ***2*** horses prior to leaving New York, but retained other horse so that his daughter would have it available for riding, he obtained permanent visa 4 or 5 months after arriving in Saudi Arabia, and he resided with other associates in a villa leased by his employer. In re Davison, 1983 Dec State ***Tax*** Comm, TSB-H-83(111)I, June 13, 1983.

Petitioners failed to clearly show that their move to Canada was of such a permanent nature as to effect a change of domicile, where husband's transfer to Canada was at the request of his employer and within the realm of his duties as a corporate officer, notwithstanding that petitioners entered Canada on a permanent resident visa, thereby becoming landed immigrants, and paid income ***taxes*** to the Canadian government for years 1973 through 1976. In re McKone, 1983 Dec State ***Tax*** Comm, TSB-H-83(242)I, July 28, 1983.

Taxpayers who had moved to Israel, applied for immigrant aid, obtained new jobs in Israel, sold their home and sold or moved their personal goods, and exercised the rights of Israeli immigrants had changed their domicile for the purposes of New York income ***tax***. In re Leiter, Op State ***Tax*** Comm, August 16, 1977.

Taxpayer who spent 53 days in New York during 1974 is resident within meaning of ***Tax Law § 605****(a)(1)* where, although her only place of abode during 1974 was in Spain, she did not renounce her United States citizenship nor take positive steps to obtain Spanish citizenship, where she traveled on United States passport, and where she conceded that she was New York domiciliary through 1973. In re Elbert, 1980 Dec State ***Tax*** Comm, Jan 11, 1980.

Petitioner established by a preponderance of the evidence that they changed their domicile from New York to Switzerland in the year in question where petitioner accepted a position in Switzerland which was of indefinite duration, sold their home in New York and purchased one in Switzerland and received a residence permit from a Swiss population office. In re Mestre 1980 Dec St ***Tax*** Comm, Apr 11, 1980.

Although petitioners moved to Bahama Island with the intent to work there, obtained the necessary approvals from the Bahamian officials and became residents of the Bahamas due to petitioner's employment, petitioner did not change his New York domicile by going to the Bahamas when he remained there only 7 months; such stay was not sufficient to sustain the burden of proof where petitioner intended to remain there permanently. In re Healey, 1980 St ***Tax*** Comm, Feb. 15, 1980.

Taxpayer did not change his domicile from New York to Mexico during the ***tax*** year where evidence shows that his marriage to a Mexican national and his purchase of a home in Mexico occurred after close of ***tax*** year in question and that he continued to use a New York checking account, retained his United States citizenship, continued his membership in a New York professional society, did not pay any income ***tax*** to Mexico, and that his move to Mexico was connected with his employment. In re Trucios, 1982 Dec State ***Tax*** Comm, Dec. 24, 1982.

**16. —Marriage to foreign national**

In a proceeding to review a determination of the State ***Tax*** Commission as to an individual's personal income ***tax*** assessment, a determination of the commission that the taxpayer was a New York resident for the entire year of 1972 would be modified to the extent that the determination was based on the conclusion that the taxpayer had failed to establish a change of domicile, since the factors relied upon by the commission for reaching its conclusion did not provide the necessary rational basis therefor where it appeared that the taxpayer had moved to New York in the fall of 1971 and that in May, 1972, the taxpayer and his children left New York and went to France where they resided in Paris with a French woman to whom the taxpayer become married after his divorce became final and that the taxpayer had not lived in New York or in the United States since moving to France; there was no support for the finding that the taxpayer had failed to follow the normal procedure for a person who intended to live and work in France and the taxpayer's failure to apply for French nationality after residing in France for five years could not be construed to mean that he maintained a New York domicile. *Bernbach v State **Tax** Com., 98 A.D.2d 559, 471 N.Y.S.2d 903, 1984 N.Y. App. Div. LEXIS 16504 (N.Y. App. Div. 3d Dep't 1984)*.

Taxpayer did not change his domicile from New York to Mexico during the ***tax*** year where evidence shows that his marriage to a Mexican national and his purchase of a home in Mexico occurred after close of ***tax*** year in question and that he continued to use a New York checking account, retained his United States citizenship, continued his membership in a New York professional society, did not pay any income ***tax*** to Mexico, and that his move to Mexico was connected with his employment. In re Trucios, 1982 Dec State ***Tax*** Comm, Dec. 24, 1982.

**17. —Personal property located in state**

In an Article 78 proceeding to review a determination of the State ***Tax*** Commission that sutained a deficiency against a husband and wife and denied their application for a redetermination of personal income ***tax***, there was sufficient evidence to rationally conclude that the husband and wife did not change their domicile to Canada where the husband retained viable New York City business interests, which he tended to during several trips during the period at issue, where he continued to maintain a checking account in a New York City bank and was unable to state with any certainty that he had not voted in New York in elections during the period at issue, where he testified that neither he nor his wife at the time they went to Canada was ready to give up United States citizenship, and where, despite the fact that they applied for "landed immigrant" status in Canada, they were required to do so as a condition precedent to engaging in a business enterprise. *Minsky v Tully, 78 A.D.2d 955, 433 N.Y.S.2d 276, 1979 N.Y. App. Div. LEXIS 14840 (N.Y. App. Div. 3d Dep't 1979)*.

Petitioner did not establish domicile in Saudi Arabia for purposes of ***Tax*** § ***605***, where, inter alia, he accepted job there with understanding that he would be there for minimum of 5 years, he opened a savings account in New York when he found out he was going overseas and planned to have his wages deposited into this account and then draw on these funds as needed while in Saudi Arabia, he sold one of his ***2*** horses prior to leaving New York, but retained other horse so that his daughter would have it available for riding, he obtained permanent visa 4 or 5 months after arriving in Saudi Arabia, and he resided with other associates in a villa leased by his employer. In re Davison, 1983 Dec State ***Tax*** Comm, TSB-H-83(111)I, June 13, 1983.

Petitioners failed to show that on May 1, 1974 they intended to relinguish their New York domicile, where they maintained and made use of their Manhattan apartment during the entire period May 1, 1974 through December 31, 1975, husband retained his New York voter registration and operator's license, and both kept their New York bank accounts. In re Press, 1983 Dec State ***Tax*** Comm, TSB-H-83(235)I, July 29, 1983.

Taxpayers who left New York in January and bought sizable estate in Jamaica did not show sufficient intent to establish new and permanent domicile with appropriate sentiment where they put house in New York up for sale but did not sell it, moved only portion of their belongings to Jamaica, husband returned to New York on numerous business trips during year, and taxpayers returned to residence in New York State in mid-December for health reasons. In re Reeves, 1978 Op State ***Tax*** Comm, September 1, 1978.

Taxpayers, former residents and domiciliaries of New York state who went to Hong Kong pursuant to employment assignment remained domiciliaries of New York because they maintained their furnished New York City apartment during absence, on ground that landlord refused to break lease, although they rented and later purchased quarters in Hong Kong and became members of various organizations there; because taxpayers were domiciled in New York they were residents of state during years in question in accordance with meaning and intent of ***Tax Law** § **605**(a)(1)*. In re House, Dec State ***Tax*** Comm, Sept. 28, 1979.

Although petitioner obtained apartment in Portugal, he was domiciled in and resident of New York during year in question where he maintained post office box, telephone, bank accounts and home in New York State. In re Shevlin, Dec State ***Tax*** Comm, Aug 19, 1980.

**18. —Retention of living quarters in state**

Petitioners sustained their burden of proof to show that they changed their domicile to Belgium, notwithstanding that they retained a ***2*** ½ room apartment in New York City which was on same landing as duplex which they sold, but which faced back of the building and had no view, where apartment was retained because (1) husband needed place to stay on his business trips to New York and had determined that the maintenance fees on the apartment were lower than the rates at a suitable hotel and (***2***) the real estate market was soft at the time petitioners moved from New York and sale of the apartment was consequently impeded. In re Landau, 1983 Dec State ***Tax*** Comm, TSB-H-83(250)I, October 1, 1983.

Petitioners, citizens of Iran, were domiciliaries of New York for entire year of 1976, notwithstanding their testimony that they intended to remain permanently in Iran when they returned there in December 1973, where, inter alia, 3 of their 4 children continued to reside in their home in New York State, they returned to New York for a short time in 1975 to meet with immigration authorities for the purpose of extending husband's re-entry permit, and they returned to New York in June 1976 because their son would not have been allowed to graduate from high school there without a legal guardian present. In re Nabavi, 1983 Dec State ***Tax*** Comm, TSB-H-83(200)I, July 15, 1983.

Petitioners failed to show that on May 1, 1974 they intended to relinguish their New York domicile, where they maintained and made use of their Manhattan apartment during the entire period May 1, 1974 through December 31, 1975, husband retained his New York voter registration and operator's license, and both kept their New York bank accounts. In re Press, 1983 Dec State ***Tax*** Comm, TSB-H-83(235)I, July 29, 1983.

Taxpayers, because they were domiciled in New York and either maintained permanent place of abode in New York, maintained no permanent place of abode elsewhere, or spent time in aggregate more than 30 days in New York, were properly considered to be resident individuals under ***tax law***. In re Castagna, Dec St ***Tax*** Comm, TSB-H-87-(189)-I.

Taxpayers who left New York in January and bought sizable estate in Jamaica did not show sufficient intent to establish new and permanent domicile with appropriate sentiment where they put house in New York up for sale but did not sell it, moved only portion of their belongings to Jamaica, husband returned to New York on numerous business trips during year, and taxpayers returned to residence in New York State in mid-December for health reasons. In re Reeves, 1978 Op State ***Tax*** Comm, September 1, 1978.

Despite strong indications of taxpayers' intent to make London their permanent place of abode, they are resident individuals of New York State within meaning of ***Tax Law*** *§* ***605****(a)(1)* where they maintain apartment in New York for use by their son who was attending school in New York, and they spent over 30 days visiting New York. In re Cooper, Dec State ***Tax*** Comm, August 17, 1979.

Taxpayers, former residents and domiciliaries of New York state who went to Hong Kong pursuant to employment assignment remained domiciliaries of New York because they maintained their furnished New York City apartment during absence, on ground that landlord refused to break lease, although they rented and later purchased quarters in Hong Kong and became members of various organizations there; because taxpayers were domiciled in New York they were residents of state during years in question in accordance with meaning and intent of ***Tax Law*** *§* ***605****(a)(1)*. In re House, Dec State ***Tax*** Comm, Sept. 28, 1979.

Petitioners failed to establish that they had effected a change of domicile from New York to Israel despite purchasing an apartment in Israel and residing there 10 months out of the year where petitioner also maintained an apartment in New York and spent more than 30 days in the state. In re Katz, 1980 Dec St ***Tax*** Comm, Apr. 4, 1980.

Although petitioner obtained apartment in Portugal, he was domiciled in and resident of New York during year in question where he maintained post office box, telephone, bank accounts and home in New York State. In re Shevlin, Dec State ***Tax*** Comm, Aug 19, 1980.

Petitioners failed to present clear and convincing evidence showing intent to change domicile, and therefore are subject to New York personal income ***tax***; although petitioner accepted position of hotel manager in England he merely leased premises there, registered as voter with United States embassy, and employed real estate firm to manage and lease New York home. In re Starke, Dec State ***Tax*** Comm, August 28, 1980.

Although petitioners may have left New York in 1970 with the veritable intention of not returning, they failed to sustain the burden of proof that they established a new domicile in France where petitioner maintained a co-operative apartment in New York, spent 30 days in the state in the year in question and returned permanently to New York in June, 1972. In re Greenstan Dec. St. ***Tax*** Comm., Oct. 17, 1980.

**19. —Spouse/children remaining in state**

The State ***Tax*** Commission properly determined that a taxpayers's actions were merely preparatory to establishing a Canadian domicile but did not actually establish a change of domicile, where, although the evidence indicated that the taxpayer changed his domicile to Canada for seven months by accepting employment with a Canadian firm, that he sought to purchase a home there, and that he opened an account with a Canadian bank, registered his automobile with the Province of Ontario, filed and paid ***taxes*** to the Canadian government and inquired of the Canadian Consulate as to procedures for becoming a landed immigrant, the taxpayer's family remained in New York in a residence owned by him which he attempted unsuccessfully to sell, he visited his family occasionally on weekends, and continued to contribute the family's support. *Kennedy v New York State Income* ***Tax*** *Bureau, 85 A.D.2d 837, 446 N.Y.S.2d 429, 1981 N.Y. App. Div. LEXIS 16662 (N.Y. App. Div. 3d Dep't 1981)*.

Petitioners, citizens of Iran, were domiciliaries of New York for entire year of 1976, notwithstanding their testimony that they intended to remain permanently in Iran when they returned there in December 1973, where, inter alia, 3 of their 4 children continued to reside in their home in New York State, they returned to New York for a short time in 1975 to meet with immigration authorities for the purpose of extending husband's re-entry permit, and they returned to New York in June 1976 because their son would not have been allowed to graduate from high school there without a legal guardian present. In re Nabavi, 1983 Dec State ***Tax*** Comm, TSB-H-83(200)I, July 15, 1983.

Despite strong indications of taxpayers' intent to make London their permanent place of abode, they are resident individuals of New York State within meaning of ***Tax Law*** *§* ***605****(a)(1)* where they maintain apartment in New York for use by their son who was attending school in New York, and they spent over 30 days visiting New York. In re Cooper, Dec State ***Tax*** Comm, August 17, 1979.

**20. —Voting rights**

In an Article 78 proceeding to review a determination of the State ***Tax*** Commission that sutained a deficiency against a husband and wife and denied their application for a redetermination of personal income ***tax***, there was sufficient evidence to rationally conclude that the husband and wife did not change their domicile to Canada where the husband retained viable New York City business interests, which he tended to during several trips during the period at issue, where he continued to maintain a checking account in a New York City bank and was unable to state with any certainty that he had not voted in New York in elections during the period at issue, where he testified that neither he nor his wife at the time they went to Canada was ready to give up United States citizenship, and where, despite the fact that they applied for "landed immigrant" status in Canada, they were required to do so as a condition precedent to engaging in a business enterprise. *Minsky v Tully, 78 A.D.2d 955, 433 N.Y.S.2d 276, 1979 N.Y. App. Div. LEXIS 14840 (N.Y. App. Div. 3d Dep't 1979)*.

Petitioners failed to show that on May 1, 1974 they intended to relinguish their New York domicile, where they maintained and made use of their Manhattan apartment during the entire period May 1, 1974 through December 31, 1975, husband retained his New York voter registration and operator's license, and both kept their New York bank accounts. In re Press, 1983 Dec State ***Tax*** Comm, TSB-H-83(235)I, July 29, 1983.

Petitioners, medical student and wife who maintained no place of abode in New York during period from end of June, 1968 until July 1969, during which time husband interned at San Francisco hospital, and who testified that they returned to New York only because wife had been accepted at medical school there, but who voted by absentee ballot for State of New York in 1968 election, failed to sustain burden of proof of intention to abandon New York domicile and make California permanent home. In re Stone (File No. 13731) Op State ***Tax*** Comm, April 24, 1978.

Petitioners failed to present clear and convincing evidence showing intent to change domicile, and therefore are subject to New York personal income ***tax***; although petitioner accepted position of hotel manager in England he merely leased premises there, registered as voter with United States embassy, and employed real estate firm to manage and lease New York home. In re Starke, Dec State ***Tax*** Comm, August 28, 1980.

Petitioner who moved to foreign country halfway through taxable year was taxable as a resident of New York under ***Tax Law*** *§* ***605****(a)(1)* where petitioner's evidence, inter alia, that his New York voter registration was canceled and that he intended to return to Indiana after tour in foreign country, failed to establish his intent to establish permanent residence in location other than New York State. Petition of Haumann, No. 12108 State ***Tax*** Com., August 25, 1978.

Affirming the decision of the Administrative ***Law*** Judge that petitioner changed his domicile from New York to Florida, the Tribunal rejected the argument of the ***Tax*** Division that petitioner's formal acts, that is, the filing of a declaration of domicile, registering to vote, and obtaining a driver's license in Florida, were self-serving and should have been accorded little or no weight by the Administrative ***Law*** Judge. The ***Tax*** Division's argument that these kinds of actions should be discounted as self-serving is an argument, in essence, that they are not, and never can be, credible. Carried to its logical end, this argument would have as rule of general application to disregard such actions in determining domicile. Each case must be taken in accord with the facts and circumstances entered. The significance of these formal acts in each case will depend upon other relevant factors in the case and depending upon these factors may take on greater or lesser importance. NY ***Tax*** Appeals Tribunal TSB-D-90 (33) I (1990).

**21. —Business trips to state**

In an Article 78 proceeding to review a determination of the State ***Tax*** Commission that sutained a deficiency against a husband and wife and denied their application for a redetermination of personal income ***tax***, there was sufficient evidence to rationally conclude that the husband and wife did not change their domicile to Canada where the husband retained viable New York City business interests, which he tended to during several trips during the period at issue, where he continued to maintain a checking account in a New York City bank and was unable to state with any certainty that he had not voted in New York in elections during the period at issue, where he testified that neither he nor his wife at the time they went to Canada was ready to give up United States citizenship, and where, despite the fact that they applied for "landed immigrant" status in Canada, they were required to do so as a condition precedent to engaging in a business enterprise. *Minsky v Tully, 78 A.D.2d 955, 433 N.Y.S.2d 276, 1979 N.Y. App. Div. LEXIS 14840 (N.Y. App. Div. 3d Dep't 1979)*.

Petitioners sustained their burden of proof to show that they changed their domicile to Belgium, notwithstanding that they retained a ***2*** ½ room apartment in New York City which was on same landing as duplex which they sold, but which faced back of the building and had no view, where apartment was retained because (1) husband needed place to stay on his business trips to New York and had determined that the maintenance fees on the apartment were lower than the rates at a suitable hotel and (***2***) the real estate market was soft at the time petitioners moved from New York and sale of the apartment was consequently impeded. In re Landau, 1983 Dec State ***Tax*** Comm, TSB-H-83(250)I, October 1, 1983.

Taxpayers who left New York in January and bought sizable estate in Jamaica did not show sufficient intent to establish new and permanent domicile with appropriate sentiment where they put house in New York up for sale but did not sell it, moved only portion of their belongings to Jamaica, husband returned to New York on numerous business trips during year, and taxpayers returned to residence in New York State in mid-December for health reasons. In re Reeves, 1978 Op State ***Tax*** Comm, September 1, 1978.

**22. —Miscellaneous**

Where taxpayer failed to prove bona fide intention of making his fixed and permanent home in Puerto Rico, his New York domicile continued throughout year in question; accordingly, taxpayer was resident individual of New York State and is subject to New York State ***tax*** on that basis. In re Roache, Dec St ***Tax*** Comm, TSB-H-87-(180)-I.

Taxpayer who moved from New York to the Bahamas during second half of 1968 remained New York resident, within meaning and intent of ***Tax Law*** *§* ***605****(a)(1)*, for entire year since move to Bahamas did not change his domicile. In re Kaplan, Op State ***Tax*** Comm, April 14, 1977.

Taxpayer who permanently moved to California and worked there was entitled to refund of New York withholding ***tax*** deducted by employer which had home office in New York. In re Myers, Op State ***Tax*** Comm, August 26, 1977.

Professor at State University of New York who took leave of absence from teaching position in June, 1973, resided at apartment in Florida for 3 weeks, moved to Brussels, Belgium, for about ***2*** years, and returned to his teaching position in August, 1975, in the same status and under same conditions as existed prior to leave of absence, was domiciled in New York State during all of 1973 for income ***tax*** purposes. In re Zionts, Op State ***Tax*** Comm, November 3, 1978.

Taxpayer, employee of New York based corporation, who was assigned to Europe on or about July 1, 1971, for purpose of investigating potential market there remained New York domiciliary for all of 1971 where record was devoid of any information concerning where he resided for 3-month period commencing with his arrival in Europe, where record revealed that from October 1, 1971 through September 30, 1972, taxpayer leased furnished apartment in Brussels, Belgium; taxpayer’s contention that wife’s closing all charge accounts prior to joining him in December of 1971 establishes his intention at time of his removal from New York to remain permanently in Brussels, Belgium is insufficient to sustain burden of proof imposed by § 689(e) which requires taxpayer to show that he changed his domicile from New York to Belgium during 1971. In re Shorin, 1979 Dec. State ***Tax*** Comm., December 14, 1979.

Petitioner, a journalist with the National Broadcasting Company, did not establish that he intended to remain abroad permanently and therefore was domiciled in New York for the entire taxable year in question since petitioner moved to various foreign locations at the discretion of his employer for indefinite durations of time, the amount of which was directly and solely related to his employment. In re Steinman, 1980 Dec St ***Tax*** Comm, Jan 11, 1980.

Petitioner was domiciled in, and a resident of, New York State for 1972 despite the fact that petitioner was inducted into the armed forces in 1967 and, after a short visit to New York upon his discharge in 1969, remained overseas in Austria or Germany until August 1, 1972 since petitioner did not indicate intent to change domicile regardless of the fact that he rented an apartment, purchased furniture, opened bank accounts, purchased an automobile, and practiced ***law*** in Germany. In re Siegel, 1980 Dec St ***Tax*** Comm, Feb. 15, 1980.

Taxpayers who moved to Bahamas in 1976, declared their intent to retire in Florida following completion of assignment in Bahamas, registered to vote in Florida, obtained Florida drivers license and sold their New York home were nonetheless New York residents for 1976 ***tax*** year in view of their failure to move to Florida. In re Wilbur, 1982 Dec State ***Tax*** Comm, Dec. 24, 1982.

Taxpayer’s move to California was temporary and was made primarily because California was where he could best resolve his financial problems; thus, he did not change his domicile from New York to California for year at issue. NY ***Tax*** Appeals Tribunal TSB-D-97(6)I.

**23. Declaration of intent to change domicile**

Petitioners acquired foreign domicile in Brazil where their taking up of residence in their rented home there confirmed their stated intention to make Brazil their domicile, where they completely abandoned their New York domicile by selling their home and moving, where husband expected his employment in Brazil to continue indefinitely, and where petitioners are registered and pay ***taxes*** in Brazil as permanent residents. In re Wightman, 1983 Dec State ***Tax*** Comm, TSB-H-83(244)I, July 28, 1983.

Where taxpayer filed a retroactive Florida declaration of domicile because he was not certain on the retroactive date that he intended to change his domicile, he did not change his domicile on the retroactive date for purposes of the New York income ***tax***. In re Toplitz, Op State ***Tax*** Comm, August 16, 1977.

Taxpayer is resident of state during 1974 within meaning of § ***605***(a) of ***Tax Law***, where, prior to 1974, taxpayer was resident of state and frequently visited home owned by her father in Florida, taxpayer submitted notarized statement on which she contended that in August, 1974 she decided to become resident of Florida and in same month started to attend college in Florida, but taxpayer failed to submit any evidence supporting her notarized statement or her contentions. In re Usdan, Dec State ***Tax*** Comm, Oct 3, 1980.

**24. Miscellaneous**

Taxpayer, who entered into separation agreement with wife which recited that he lived in New York City, had an apartment in New York City, and provided no proof that the apartment was leased for business purposes only, but listed his address on his federal income ***tax*** return as the wife's Pennsylvania address, was a New York resident. In re Koles, Op State ***Tax*** Comm, June 30, 1977.

Petitioners were domiciliaries of New York during the years in question since they spent more than 30 days in New York, owned a summer cottage in New York, possessed a New York driver's license and, although they spent 8 months out of the year in St. Maarten, N. A., continued to list their New York address on their passports. In re Schulman, 1980 Dec St ***Tax*** Comm, Feb 22, 1980.

Petitioners were domiciled in State of New York; they did not maintain permanent place of abode outside New York State, although they only spent approximately 18 days in New York State. In re Duff, Dec State ***Tax*** Comm, August 12, 1980.

Where petitioners moved into yacht located in Florida and leased slip for yacht, they did not evidence intent to take up new residence required to establish new domicile, even though they may have evidenced intent to abandon New York domicile. In re Allan, Dec State ***Tax*** Comm, Aug 28, 1980.

Petitioner will be deemed domiciled in New York despite the fact that he lives in Florida, filed a Florida state ***tax*** return, has a Florida driver's license and executed a Florida will where petitioner spent more than 30 days in New York in each of the years in question on business associated with a New York based brokerage firm. In re Richman, 1980 Dec St ***Tax*** Comm, Feb 15, 1980.

Taxpayers who moved to Bahamas in 1976, declared their intent to retire in Florida following completion of assignment in Bahamas, registered to vote in Florida, obtained Florida drivers license and sold their New York home were nonetheless New York residents for 1976 ***tax*** year in view of their failure to move to Florida. In re Wilbur, 1982 Dec State ***Tax*** Comm, Dec. 24, 1982.

Field audit guidelines for personal income ***tax*** investigation do not indicate that statement as to residence signed by petitioners, and corroborating testimony of petitioners and their accountant, would be acceptable proof of time spent outside state. NY ***Tax*** Appeals Tribunal TSB-D-94-(4)I.

Petitioners' did not prove that they intended to abandon their New York City domicile and acquire new domicile in Westchester County, where they did not appear at hearing to offer testimony no furnish affidavits containing their intent, and there was no evidence regarding Westchester County residence which demonstrated their actual dates of residence there; administrative ***law*** judge properly relied on case ***law*** relating to New York state residence, as *NYC Admin Code § 11-1705(**b**)(1)* contains identical language as that of *CLS **Tax** § **605**(**b**)(1)*. NY ***Tax*** Appeals Tribunal TSB-D-97-(22)I.

### III. Residence for ***Tax*** Purposes

### A. Domiciliaries

### 25. 30 days or abode in New York; generally

Since taxpayer was domiciled in New York and did not maintain permanent place of abode elsewhere, she was subject to ***tax*** as resident of New York. In re Sultan, Dec St ***Tax*** Comm, TSB-H-87-(164)-I.

Taxpayers, because they were domiciled in New York and either maintained permanent place of abode in New York, maintained no permanent place of abode elsewhere, or spent time in aggregate more than 30 days in New York, were properly considered to be resident individuals under ***tax law***. In re Castagna, Dec St ***Tax*** Comm, TSB-H-87-(189)-I.

Where taxpayers successfully showed that they left New York State with no intention of returning, but failed to sustain burden of proof required to show that they established new domicile outside New York State, taxpayers continued to be domiciled in New York State within meaning and intent of ***tax law***; in such circumstances taxpayers were domiciled in New York State for all of year in question, maintained permanent place of abode in state for part of year, spent more than 30 days in state and, therefore, were residents of state for entire year. In re De Witt, Dec State ***Tax*** Comm, August 17, 1979.

All income earned by petitioners in year in question is taxable as New York income since (1) they maintain a permanent place of abode in New York, (***2***) they did not maintain a permanent place of abode outside of New York for the entire taxable year and (3) they spent more than 30 days in New York during the year in question. In re Drachenberg, 1980 Dec St ***Tax*** Comm, Nov. 26, 1979.

Where taxpayer was registered voter in New York, served on jury duty, maintained bank accounts in New York throughout entire period in issue, listed New York City address as address of residence on federal income ***tax*** returns, owned home in New York State throughout period in issue, and he spent more than 30 days in New York State in each of years in issue, he was resident of New York State pursuant to § ***605***(a)(1) and all income for years at issue was includible in New York adjusted gross income and was subject to taxation. In re Hofmann, 1979 Op State ***Tax*** Comm, January 24, 1979.

Taxpayer was resident of New York where he moved to New York from Chicago to take advancement with company, spent 6 months in New York, was assigned ***2***-year position in Australia, terminated employment with company, and returned to Chicago, and where he failed to establish by preponderance of evidence that he changed his domicile from New York and did not spend at least 30 days in New York. In re Young, 1980 Dec State ***Tax*** Comm, Jan ***2***, 1980.

Taxpayers were resident individuals within meaning and intent of § ***605***(a)(1) where they were domiciliaries of New York State and spent more than 30 days in New York State during 1973, did not have permanent place of abode outside New York State for entire year, and did have permanent place of abode in New York State for part of said year. In re Noaks, 1980 Dec. State ***Tax*** Comm, February 1, 1980.

Taxpayer is not a New York resident for ***tax*** purposes despite the fact that his family remained in their New York home while he lived in a hotel room and searched for suitable housing at his new job location. In re Quinn, 1981 Dec St ***Tax*** Comm, December 3, 1981.

Any person domiciled in New York is resident for income ***tax*** purposes for specific taxable year unless for that year (1) he maintains no permanent place of abode in New York, (***2***) he maintains permanent place of abode elsewhere during entire year, and (3) he spends in aggregate not more than 30 days of taxable year in New York. In re Christ, 1982 Dec State ***Tax*** Comm, March 5, 1982.

Petitioners were resident individuals of New York within the meaning of ***Tax Law*** *§* ***605****(a)* from January 1, 1971 through August 31, 1971 since they maintained a permanent place of abode in New York and spent more than 30 days in New York; although ***Tax Law*** *§* ***605*** does not provide for the collation of income that was done by the Income ***Tax*** Bureau for petitioners' 1971 ***taxes***, petitioners did not show that the figures as computed by the Bureau were incorrect and therefore their petition will be denied. In re Restler, 1980 Dec St ***Tax*** Com, Apr 11, 1980.

Taxpayers were subject to ***tax*** as resident individuals of New York State during year in question, even though they spent less than 30 days in New York during relevant year, and even assuming that their 34-foot motor home on its lot in Florida constituted permanent place of abode, since taxpayer admittedly owned home in New York at time in question, and there was no showing that it was rented out or even that it was up for sale. NY ***Tax*** Appeals Tribunal TSB-D-92-(19)I.

**26. —Other home in another state**

Income ***tax*** imposed on worldwide income of statutory residents of New York who are New Jersey domiciliaries does not substantially affect interstate commerce, as neither commuting from New Jersey to New York to work nor maintaining permanent residence in New York produces requisite effect on commerce; thus, protections of dormant Commerce Clause (US Const Art I § 8) do not apply. *Tamagni v* ***Tax*** *Appeals Tribunal, 91 N.Y.2d 530, 673 N.Y.S.2d 44, 695 N.E.2d 1125, 1998 N.Y. LEXIS 1071 (N.Y.)*, cert. denied, *525 U.S. 931, 119 S. Ct. 340, 142 L. Ed. 2d 280, 1998 U.S. LEXIS 6508 (U.S. 1998)*.

When a taxpayer who had an apartment in Manhattan showed that he bought and furnished a house in New Jersey, the conclusory affidavits he and his father submitted averring that the taxpayer and his wife lived in New Jersey and the taxpayer's father and brother lived in the apartment in Manhattan were not clear and convincing evidence that the taxpayer had established a new domicile in New Jersey, so, under *N.Y.* ***Tax Law*** *§* ***605****(****b****)(1)(A)*, he was a New York resident, for ***tax*** purposes because he did not show he had terminated his lease on the Manhattan apartment or that someone else paid the rent and/or utilities there. *Matter of El-Tersli v Commissioner of Taxation & Fin., 14 A.D.3d 808, 787 N.Y.S.2d 526, 2005 N.Y. App. Div. LEXIS 248 (N.Y. App. Div. 3d Dep't 2005)*.

When a taxpayer who had an apartment in Manhattan showed that he bought and furnished a house in New Jersey, he did not show he was not a statutory resident of New York, for ***tax*** purposes, under *N.Y.* ***Tax Law*** *§* ***605****(****b****)(1)(****B****)* because he did not show he had terminated his lease on the Manhattan apartment or that he did not otherwise contribute to the household living there, nor did he show that he did not spend more than 183 days in New York during the periods at issue. *Matter of El-Tersli v Commissioner of Taxation & Fin., 14 A.D.3d 808, 787 N.Y.S.2d 526, 2005 N.Y. App. Div. LEXIS 248 (N.Y. App. Div. 3d Dep't 2005)*.

Taxpayer fails to meet her burden of proof that she was not New York resident during taxable years in question where (1) she contended that she operated her business out of apartment in New York City which was leased in name of business, that she used apartment as an occasional place to stay overnight while in New York, and that she spent less than 4 months there in each of the ***tax*** years in question, (***2***) she contended that she was a resident of Connecticut during years in issue and put in evidence to leases which named her as co-tenant of premises in Connecticut, (3) she filed an application for enrollment as a voting elector in Connecticut in October of second ***tax*** year in question, (4) she reported that her home address was in Connecticut on her federal income ***tax*** returns for years in question, but (5) she offered no cancelled rental payment checks, no local business bills, nor any other evidence indicative of Connecticut residency during ***tax*** years in issue. In re Rosenberg, 1983 Dec State ***Tax*** Comm, TSB-H-83(171)I, June 20, 1983.

Petitioner was resident of New York in 1977 under ***Tax*** § ***605***(a)(1), notwithstanding that he purchased house in Florida on June 23 of that year, and he and his wife moved to that house, and notwithstanding that he offered his house in New York for sale at the same time, where his New York house did not sell for ***2*** years, during which time petitioner's son lived in it. In re Thomas, 1983 Dec State ***Tax*** Comm, TSB-H-83(177)I, June 20, 1983.

Petitioner was not taxable as New York State resident individual in 1972 within meaning and intent of ***Tax*** § ***605***, notwithstanding that he maintained some contacts with New York and permanent place of abode there after his move to Ohio, where he went to Ohio to operate business he viewed as his own, as opposed to going there to work for particular employer, and where his residence in Ohio was ended by events over which he had no control. In re Cromwell, 1983 Dec State ***Tax*** Comm, TSB-H-83(205)I, July 25, 1983.

Petitioners were residents of New York State for personal income ***tax*** purposes, notwithstanding their assertion that they were domicilliaries of Washington, D. C. where they did not demonstrate that they acted in accordance with this assertion for District of Columbia income ***tax*** purposes, since, if they were domiciled in Washington during year in question, they should have filed ***tax*** return with and paid income ***tax*** to District of Columbia. In re Vaughn, 1983 Dec State ***Tax*** Comm, TSB-H-83(217)I, July 25, 1983.

Wife was not taxable as resident individual until July 9, 1979, when she moved to New York to join her husband, despite fact that husband acquired New York domicile on January 8, 1979, date he left other state for permanent employment in New York. In re Brenda M. Keegan, Dec State ***Tax*** Comm, TSB-H-84-(178)-I.

Taxpayer born in New York was domiciliary of New York during years at issue where it was shown that taxpayer lived with parents in New York City until 1973 when he left to attend Yale University in Connecticut, stayed at parents' home for brief periods of time during 7 years he was at Yale, during summer of 1978 and 1979 worked at Chicago ***law*** firm and San Francisco ***law*** firm, upon graduation obtained clerkship in Chicago where it was shown that such position was admittedly of limited duration, and taxpayer voted in New York in fall of 1980. In re David W. & Marilyn A. Rivkin, Dec St ***Tax*** Comm, TSB-H-86(139)-I.

Taxpayer was not taxable as full year resident individual of New York State because taxpayer was not domiciliary of New York State or New York City who either maintained permanent place of abode in New York, spent more than 30 days in New York or did not maintain permanent place of abode outside state and city; taxpayer has sustained her burden of proof to show that she changed her domicil from New York to Washington, D.C. and therefore taxpayer is taxable as nonresident of state and city of New York. In re Michel, Dec St ***Tax*** Comm, TSB-H-87-(176)-I.

Taxpayers who were living in Florida at time of receipt of single-sum distribution of pension account were New York domiciliaries and residents within meaning of ***Tax Law*** § ***605***(a)(1) where, inter alia, they had lived in New York for first two months of year and maintained furnished apartment in New York for two more years. In re Tegen, Op State ***Tax*** Comm, April 14, 1977.

Taxpayers who maintained apartments in New York and Florida, had bank accounts in both states, and were registered to vote in Florida, with husband taxpayer dividing his working time between Florida and New York, maintaining his New York driver's license, and filing Florida property ***tax*** returns, were New York domiciliaries and residents within meaning of ***Tax Law*** § ***605***(a)(1) since they maintained permanent place of abode in New York and spent more than 30 days a year in New York during years in question. In re Butensky, Op State ***Tax*** Comm, April 14, 1977.

Taxpayer, who had lived in New York, moved to Georgia and Florida, but did not sell house and would visit house on occasion, and moved back to house and became domiciliary of New York in 1972, and lived in New York for at least 30 days during 1972 was a New York resident in 1972 under ***Tax*** L § ***605***(a)(1). In re Zinn, Op State ***Tax*** Comm, June 14, 1977.

Site manager and spouse who maintained mailing address within New York State, who went wherever manager's jobs took them within and without New York State where they rented cottages by the week and opened bank accounts, and who offered no substantial evidence that they did not spend at least 30 days per year within New York State, were domiciled in New York State and were subject to the New York personal income ***tax*** as resident individuals on all their income, including income earned outside of New York State. In re Gillert, Op State ***Tax*** Comm, September 29, 1977.

Petitioner was a resident of New York during year in question pursuant to ***Tax Law § 605*** where petitioner failed to show that the home he jointly owned with his wife located in New York did not constitute his permanent place of abode since, while petitioner worked in Indiana and did not spend more than 30 days in New York during the year in question, petitioner only maintained an apartment in Indiana and returned to his home in New York where his wife and children resided throughout the year in question. In re Martin, 1980 Dec St ***Tax*** Comm, Feb 15, 1980.

Petitioner were residents of New York State for income ***tax*** purposes for the first 7 months of 1972 where they owned several co-operative apartments in New York and spent more than 30 days there; however, petitioners were not residents for the remainder of the year when petitioners decided to abandon New York as a domicile, notified their bank of a change of address to Connecticut, advised their brokers of the same change, allowed their New York State drivers licenses to expire, reregistered their automobile in Connecticut and registered and voted in Connecticut in 1972. In re Silver, Dec St ***Tax*** Comm, October 3, 1980.

Taxpayer who moved out of New York State to work as a personal secretary to her employer who had been appointed Secretary of the Navy, remains a New York State resident during her 3 ½ year stay in Washington, D.C. since her removal to that area was solely for the limited period of her employer's appointment and she continued to maintain her New York apartment. In re Fisher, 1981 Dec St ***Tax*** Comm, December 3, 1981.

Petitioners were residents of New York for income ***tax*** purposes where, inter alia, their children attended school in New York City during relevant period when they were allegedly domiciled in New Jersey and Virgin Islands, petitioners spent at least twice as much time in New York City than they did in either Virgin Islands or New Jersey, they claimed business deductions from their activities in New York City, and they continuously held themselves out as New York City residents on various administrative and legal documents, including, but not limited to, their marriage license, children's birth certificates, real property transfer ***tax*** return, and maintenance of checking and mortgage accounts in New York City. NY ***Tax*** Appeals Tribunal TSB-D-98-(18)I.

**27. —Other home in foreign country**

Petitioners are deemed resident individuals of State and City of New York for ***tax*** purposes, since allegations that wife was bona fide resident of Puerto Rico and that husband maintained Brooklyn apartment only as matter of convenience, are insufficient to invoke exceptions provided in § ***605***[a][1] of ***Tax Law***. In re Juan Rodriguez & Ana Rodriguez, Dec St ***Tax*** Comm, TSB-H-86-[22]-I.

Petitioner was New York resident in accordance with meaning and intent of ***Tax Law § 605****(a)(1)*, where he was New York domiciliary during year in question, he worked at N.Y. office of employer for first part of year, and used parents' N.Y. address for mail and on ***tax*** withholding statements and spent more than 30 days in New York that year, notwithstanding fact that on April 15 of year he was assigned to South African office of employer and shared apartment in Connecticut with friend. IN re Tulley, Op State ***Tax*** Comm, February 28, 1977.

Petitioners remained New York residents for 1968 and 1969, despite facts that in April of 1968 they and their children moved to France as result of employment there by French firm, vacating their leased New York apartment, their visa classified them as provisional French residents, and they did not return to New York until October of 1969, where they maintained permanent place of abode in New York during years in question and spent more than 30 days per year in New York during said years. In re Lasry, Op State ***Tax*** Comm, March 7, 1977.

Taxpayers who moved from New York to Guam in middle of year pursuant to husband's two-year assignment as air traffic controller, remained New York residents within meaning and intent of ***Tax Law § 605****(a)(1)*, where they admittedly spent more than 6 months of year in which they moved in New York, during that time they had no permanent place of abode outside of New York, and they failed to establish by preponderance of evidence their intention to have established new permanent home in Guam at time of move, despite, inter alia, their having sold their New York home, having closed their New York bank account, and having acquired Guam drivers' licenses. In re Schehr, Op State ***Tax*** Comm, April 14, 1977.

Taxpayer who was domiciliary of New York when he left to spend 10 years in Italy was New York resident within meaning and intent of ***Tax Law** § **605**(a)(1)* during year following his departure for Italy, for which year he told Italian authorities he was not resident of Italy, where he failed to prove that he spent not more than 30 days in New York during that year. In re Gabbe, Op State ***Tax*** Comm, April 14, 1977.

Taxpayers who maintained permanent places of abode in Tokyo, Milan, and New York, continued to be New York domiciliaries and residents within intent and meaning of ***Tax Law** § **605**(a)(1)* during two-year period in which they did not spend more than 30 days in New York. In re Estate of Bernstein, Op State ***Tax*** Comm, April 14, 1977.

Where former New York residents, residing overseas, maintained summer residence in New York for entire time of absence from state, and returned to that residence in September of year in question they were domiciliaries of New York during year and since they spent more than 30 days in state during year they were individuals within meaning and intent of CLS ***Tax Law** § **605***. In re Evans, 1978 Op State ***Tax*** Comm, September 13, 1978.

Taxpayers were domiciliaries of New York State and spent more than 30 days in New York State during 1972, even though taxpayer had accepted employment in West Germany for indefinite duration and during 1972 his house in Germany was rented on renewable long-term lease. In re Clark, 1979 Op State ***Tax*** Comm, February 14, 1979.

Taxpayer, native New Yorker, would be considered New York resident where he was resident of New York until 1966 at which time he was assigned overseas by employer, where his stays at each foreign location were for indefinite durations at discretion of employer and were directly and solely related to his employment, and where taxpayer returned to and took up residence in New York in July of the year in question. In re Steinman, 1980 Dec State ***Tax*** Comm, Jan 11, 1980.

Where petitioners maintained a permanent place of abode in New York during part of the year in question, spent more than 30 days in New York and failed to show that they intended to abandon their New York domicile and establish a new domicile in Canada, where petitioners had taken a ***2*** year assignment with the U. S. Customs Service, petitioners will be considered to be domiciled in New York and taxable as residents in accordance with ***Tax Law** § **605***. In re Jablonski, 1980 Dec St ***Tax*** Comm, Jan. 11, 1980.

Petitioners would be considered New York residents by maintaining a permanent abode in New York state, not maintaining a permanent abode outside New York state for entire taxable year and spending, in aggregate, more than 30 days in New York state, where petitioners were residents of New York from January to June, husband accepted assignment from his employer in Canada which was to last for one year with option for ***2*** year extension, and where petitioners resided in leased house in Canada with option to renew said lease on annual basis, even though petitioners contended they had no real property in New York state after June and had no intention of returning to New York. In re Jablonski, 1980 Dec State ***Tax*** Comm, January 11, 1980.

Petitioners failed to establish that they had effected a change of domicile from New York to Israel despite purchasing an apartment in Israel and residing there 10 months out of the year where petitioner also maintained an apartment in New York and spent more than 30 days in the state. In re Katz, 1980 Dec St ***Tax*** Comm, Apr. 4, 1980.

Petitioner, flight engineer on airline flights originating and terminating at Kennedy airport, who moved from home in New York to Bahamas, leasing apartment there and renting out New York home, and who made practice of coming to New York on day before or day of scheduled flight, and returning to Bahamas as soon as possible after flight, failed to clearly sustain burden of proof that he intended to remain in Bahamas permanently, and therefore was considered New York domiciliary, as well as failing to sustain burden of proof that he did not spend more than 30 days in New York State, and therefore was considered resident for income ***tax*** purposes. In re Ramey, Op State ***Tax*** Comm, April 17, 1978.

**28. No abode in state, abode elsewhere, and not present 30 days in state**

New York domiciliaries who maintain no permanent place of abode in state and aggregate not more than 30 days of taxable year in state are taxable as nonresidents; rental of taxpayers' home in New York State during time of residence abroad constitutes lack of permanent place of abode in New York. In re Cunningham, Dec State ***Tax*** Comm, TSB-H-83-(14)-I.

Income earned by taxpayer, while in military service, was subject to New York State personal income ***tax*** since taxpayer did not maintain permanent place of abode outside of New York State for entire year in issue. In re Quadrini, Dec St ***Tax*** Comm, TSB-H-86(152)-I.

Taxpayers, who lived in Japan, which was their permanent place of abode, until October of 1968 at which time they moved to New Jersey and ceased being New York domiciliaries were not New York state residents within meaning and intent of ***Tax Law § 605****(a)(1)* and § ***605***(***b***), where they had no permanent place of abode in New York during 1968 and did not spend more than 30 days in New York during that year. In re Martinuzzi, Op State ***Tax*** Comm, April 14, 1977.

Although taxpayers who moved to a foreign country remained domiciliaries in New York, since they did not maintain a permanent place of abode in New York, maintained a permanent place of abode elsewhere, and spent less than 30 days in New York, they were not residents for ***tax*** purposes. In re Smith, Op State ***Tax*** Comm, August 16, 1977.

Taxpayer who resided and worked outside New York during year in question and who considered New York State his home, retained New York State driver's license and license plates but did not maintain permanent place of abode in New York or visit state more than 30 days during year in question was not resident of state or subject to New York State personal income ***tax*** during year. In re Coppola, Dec State ***Tax*** Comm, September 21, 1979.

Taxpayer is not resident individual within meaning and intent of ***Tax Law § 605****(a)* where he had formerly established domicile in New York but did not maintain permanent place of abode in New York during year in question, did maintain permanent place of abode elsewhere, and was not present in New York for more than 30 days of taxable year; taxpayer's wife would be resident individual of New York State where during same year she spent more than 30 days within state. In re Whealy, Dec State ***Tax*** Comm, October 5, 1979.

Where New York taxpayer and his wife are separated by consent and wife resides in New Jersey where she is registered voter and where she maintains permanent place of abode, employment and bank accounts and wife neither came into New York during year in question nor had permanent place of abode in state, New York taxpayer need not include wife's income on his state income ***tax*** return. In re Burr, 1979 Op St ***Tax*** Comm, April 6, 1979.

Petitioner, as minor, was domiciled with mother who had legal custody; petitioner had permanent place of abode outside New York State, had no permanent place of abode in state and spent less than 30 days in state, and is therefore considered nonresident and not subject to state income ***tax***. In re Wei, Dec State ***Tax*** Comm, Aug 28, 1980.

Taxpayers who vacated their apartment in New York in August 1965, lived in Japan until August 1971, and then moved to Connecticut were domiciliaries of New York until 1971, despite their alleged intent not to return to New York after they left for Japan, but were not residents of New York for purposes of the ***tax law*** after 1965, as while they were in Japan they maintained no permanent place of abode in New York, maintained a permanent place of abode elsewhere, and did not spend 30 days in New York. In re Marsh, Op State ***Tax*** Comm, August 22, 1977.

Taxpayer who purchases sailboat upon which he and his family will live, which boat will never be present in New York State, and taxpayer will not maintain permanent place of abode in New York State nor spend more than 30 days in New York State will continue to be residents of New York State for taxable years they continue to live aboard sailboat, as although evidencing intent to abandon New York domicile, taxpayer will not have evidenced intent to take up new residence to which he is attached full range of sentiment, feeling and permanent association required to establish new domicile, and living aboard sailboat will not constitute maintenance of permanent place of abode. NYS Dept. of ***Tax***. & Fin., Commissioner of Taxation & Finance, Advisory Op. No. TSB-A-89(7)I.

**29. Military personnel—Maintenance of contacts with state**

Petitioner failed to remove himself from resident classification for personal income ***tax*** purposes, notwithstanding that he entered military service and left state during ***tax*** year in question, where he maintained a permanent abode and spent more than 30 days in state during such year. *Lane v Gallman, 49 A.D.2d 963, 373 N.Y.S.2d 700, 1975 N.Y. App. Div. LEXIS 11267 (N.Y. App. Div. 3d Dep't 1975)*, app. dismissed, *42 N.Y.2d 823, 1977 N.Y. LEXIS 3941 (N.Y. 1977)*, app. dismissed, *434 U.S. 1055, 98 S. Ct. 1222, 55 L. Ed. 2d 755, 1978 U.S. LEXIS 633 (U.S. 1978)*.

Air force officer who was stationed in Korea during 1970, who was domiciled in New York upon entering into service, who effected no change of domicile prior to 1970, and whose wife and family resided in New York, was subject to New York State personal income ***tax*** for that year. In re Bortle, Op State ***Tax*** Comm. April 13, 1976.

Taxpayer, who was resident of New York State at time he entered military service was domiciled in New York during year when he was stationed in Germany although he did not maintain permanent place of abode in New York where he did not maintain permanent place of abode outside New York and did maintain bank account at bank located in New York State. In re Tighe, Dec State ***Tax*** Comm, August 8, 1979.

**30. —No permanent place of abode outside of state**

Adoption of new permanent abode requires dwelling place of fixed character, and abodes which are transitory in nature and which cannot be considered permanent do not constitute permanent place of abode outside of New York; military officer who resided in several apartments during year of departure from New York does not maintain permanent place of abode outside of New York for entire year. In re Revett, Dec State ***Tax*** Comm, TSB-H-84-(91)-I.

Interstate relocation as result of military assignment does not result in change of domicile in absence of factors to indicate that taxpayer has definite plan for remaining permanently at place of reassignment. In re Gatchell, Dec State ***Tax*** Comm, TSB-H-84-(95)-I.

Determination of whether a serviceman maintains a permanent place of abode outside New York State is not dependent merely upon whether serviceman lives on or off a military base; other factors include type and location of quarters occupied by taxpayer and how and by whom such quarters are maintained, and further, the maintenance of place of abode by serviceman outside New York State generally will not be considered permanent if it is maintained only briefly during a duty assignment of temporary nature. In re Johnson, Dec St ***Tax*** Comm, TSB-H-85-(120)-I.

Income earned by taxpayer, while in military service, was subject to New York State personal income ***tax*** since taxpayer did not maintain permanent place of abode outside of New York State for entire year in issue. In re Quadrini, Dec St ***Tax*** Comm, TSB-H-86(152)-I.

Petitioner, who was domiciliary of New York at time he entered military service, was not subject to New York income ***tax*** for 1969, during which year, while in flight training, he lived in off-base housing as permanent place of abode outside New York, but was subject to ***tax*** in 1970 during which year he served in Vietnam and did not maintain permanent place of abode outside New York. In re Polanco, Op State ***Tax*** Comm, May 18, 1976.

Taxpayer, career naval officer, who was New York domiciliary prior to entry into Navy, and who has not resided in New York, been stationed in New York, maintained permanent place of abode in New York or spent more than 30 days in New York for ***tax*** years in question is resident individual where temporary or indefinite nature of his duty assignments from Navy prevented him from establishing permanent abode elsewhere. In re Lynch, Dec State ***Tax*** Comm, File #00514.

Taxpayer, who was resident of New York State at time he entered military service was domiciled in New York during year when he was stationed in Germany although he did not maintain permanent place of abode in New York where he did not maintain permanent place of abode outside New York and did maintain bank account at bank located in New York State. In re Tighe, Dec State ***Tax*** Comm, August 8, 1979.

### 31. —Military base quarters as permanent place of abode

Residence in bachelor officers quarters provided by military may constitute permanent place of abode outside of New York where quarters are maintained over sufficiently significant period of time to create well-settled physical connection with geographical area; taxpayer may establish permanent nature of quarters by submission of telephone bill and credit card evidencing private phone maintained by taxpayer in his quarters, automobile insurance policy issued at naval address, out-of-state medical license issued to taxpayer, evidence of checking account maintained out-of-state by taxpayer, and evidence of charitable services rendered out of state. In re Brazin, Dec State ***Tax*** Comm, TSB-H-83-(342)-I.

Residence in bachelor officers' quarters does not constitute maintenance of permanent place of abode unless such quarters are comparable to off-base housing, and New York domiciliary who resided in such quarters for more than ***2*** months did not maintain permanent place of abode outside New York State for ***tax*** year. In re Mannle, Dec State ***Tax*** Comm, TSB-H-84-(59)-I.

In absence of special factors, commission presumes that residence in military base domitory does not constitute permanent residence; accordingly, residence of New York domiciliary in base dormitory at Air Force base does not constitute maintenance of permanent place of abode outside of New York State. In re Ogrodnik, Dec State ***Tax*** Comm, TSB-H-84-(68)-I.

In absence of indicia of permanency, accommodations in military barracks do not constitute dwelling place permanently maintained by taxpayer; residence in military barracks is presumed to be temporary in nature unless presumption is rebutted by presence of significant factors tending to indicate that accommodations are permanent or that taxpayer reasonably regards such accommodations as permanent. In re Gatchell, Dec State ***Tax*** Comm, TSB-H-84-(95)-I.

Determination of whether a serviceman maintains a permanent place of abode outside New York State is not dependent merely upon whether serviceman lives on or off a military base; other factors include type and location of quarters occupied by taxpayer and how and by whom such quarters are maintained, and further, the maintenance of place of abode by serviceman outside New York State generally will not be considered permanent if it is maintained only briefly during a duty assignment of temporary nature. In re Johnson, Dec St ***Tax*** Comm, TSB-H-85-(120)-I.

### 32. —Ship quarters as permanent place of abode

Record, in proceeding to determine petitioner's income ***tax*** liability, contained substantial evidence to support the finding of the State ***Tax*** Commission that petitioner's domicile did not change from New York State in the year 1967, even though from the time of his graduation from the U. S. Merchant Marine Academy in New York on February 10, 1967, petitioner lived on board ship for remainder of year, even when the ship was in port, and even though he joined a union, rented a post office box and opened a bank account in New Jersey. *Starer v Gallman, 50 A.D.2d 28, 377 N.Y.S.2d 645, 1975 N.Y. App. Div. LEXIS 11422 (N.Y. App. Div. 3d Dep't 1975)*.

Evidence was sufficient to support State ***Tax*** Commission's determination which denied an application for a redetermination of a deficiency for New York personal income ***tax*** for the year 1967, which was filed by a seaman in the merchant marine who was assigned to a ship which sailed to and from New York City during the year 1967. *Oatman v State **Tax** Comm'n, 50 A.D.2d 1015, 377 N.Y.S.2d 659, 1975 N.Y. App. Div. LEXIS 12002 (N.Y. App.*

*Div. 3d Dep't 1975)*, app. denied, *39 N.Y.2d 709, 1976 N.Y. LEXIS 3388 (N.Y. 1976)*, app. dismissed, *429 U.S. 1067, 97 S. Ct. 799, 50 L. Ed. 2d 785, 1977 U.S. LEXIS 486 (U.S. 1977)*.

Determination of whether a serviceman maintains a permanent place of abode outside New York State is not dependent merely upon whether serviceman lives on or off a military base; other factors include type and location of quarters occupied by taxpayer and how and by whom such quarters are maintained, and quarters assigned on vessels generally do not qualify as permanent places of abode maintained by serviceman, absent proof of significant special indicia of permanency; further, the maintenance of place of abode by serviceman outside New York State generally will not be considered permanent if it is maintained only briefly during a duty assignment of temporary nature. In re Johnson, Dec St ***Tax*** Comm, TSB-H-85-(120)-I.

### 33. —Returning to state after service

Petitioner, who was domiciliary of New York at time he entered military service, was not subject to New York income ***tax*** for 1969, during which year, while in flight training, he lived in off-base housing as permanent place of abode outside New York, but was subject to ***tax*** in 1970 during which year he served in Vietnam and did not maintain permanent place of abode outside New York. In re Polanco, Op State ***Tax*** Comm, May 18, 1976.

Taxpayer who was resident and domiciliary of New York until enrollment in United States Naval Academy, and who thereafter lived in various states and countries, was a resident of New York State during 1967 in accordance with ***Tax Law** § **605**(a)(1)* and 20 NYCRR 102.***2*** where, upon discharge from service in June, 1967, taxpayer obtained employment in New York and from October 29, 1967, his employer paid motel and living expenses in New York until taxpayer acquired his own home, even though taxpayer contended that he had purchased land in North Carolina where he ultimately intended to live. In re Missailidis, 1980 Dec State ***Tax*** Comm, Jan 11, 1980.

Taxpayer who has resided in New York since retiring from military must include his military retirement pay on his New York state ***tax*** return despite fact that he was resident of Indiana when he entered military service and never lived or was stationed in New York before or during his active duty. In re Deane, 1982 Dec of State ***Tax*** Comm, April 26, 1982.

### 34. —Miscellaneous

Taxpayers, who lived in Japan, which was their permanent place of abode, until October of 1968 at which time they moved to New Jersey and ceased being New York domiciliaries were not New York state residents within meaning and intent of ***Tax Law** § **605**(a)(1)* and § ***605***(***b***), where they had no permanent place of abode in New York during 1968 and did not spend more than 30 days in New York during that year. In re Martinuzzi, Op State ***Tax*** Comm, April 14, 1977.

### ***B***. Nondomiciliaries

### 35. Living in New York more than 183 days

When a nondomiciliary seeks treatment in New York for a serious illness, the time spent in a medical facility for the treatment of that illness should not be counted in determining whether such a nondomiciliary was a resident of the State for income ***tax*** purposes during such confinement; accordingly, decedent, a nondomiciliary who maintained a New York apartment for her occasional visits to New York, and who, during 1973, was confined in a New York hospital for 148 days and spent 67 days in her New York apartment, was not subject to New York State income ***tax*** for 1973, despite the facts that decedent's apartment was a permanent place of abode within the State and that she spent more than 183 days in the State in 1973. *Stranahan v New York State **Tax** Com., 68 A.D.2d 250, 416 N.Y.S.2d 836, 1979 N.Y. App. Div. LEXIS 10545 (N.Y. App. Div. 3d Dep't 1979)*.

***Tax*** Commission properly determined that taxpayer was New York resident under *CLS **Tax** § **605*** although he was domiciled in Connecticut, where he worked 5 days per week in New York for 6 hours per day, for more than 183 days, and he maintained apartment in New York which qualified as permanent place of abode, since regulation defining "day" for purpose of 183-day requirement as "presence within New York for any part of a calendar day" was not irrational or unreasonable; thus, it was error for court, in Article 78 proceeding, to annul personal ***tax*** assessments imposed under CLS ***Tax*** Art 22 on ground that commission lacked power to define term "day" as period of time less than 24 hours. *Leach v Chu, 150 A.D.2d 842, 540 N.Y.S.2d 596, 1989 N.Y. App. Div. LEXIS 5448 (N.Y. App. Div. 3d Dep't)*, app. dismissed, app. denied, *74 N.Y.2d 839, 546 N.Y.S.2d 344, 545 N.E.2d 634, 1989 N.Y. LEXIS 2939 (N.Y. 1989)*.

Judgment which annulled determination of State ***Tax*** Commission sustaining personal income ***tax*** assessments reversed–Department of Taxation and Finance issued two notices of deficiency to decedent for three ***tax*** years; issues were whether decedent was New York resident for years in question and, if so, whether he was eligible for resident credit for ***taxes*** paid to another jurisdiction on income derived from other jurisdiction (***Tax Law*** *§ 620 [a]*)–***Tax Law*** *§* ***605*** *(**b**) (1) (**B**)* includes as resident one who is not domiciled in this State but maintains permanent place of abode in this State and spends in aggregate more than 183 days of taxable year in this State; regulations define day as presence within State for any part of calendar day (20 NYCRR 102.***2*** [c]); decedent had worked five days per week in New York from 10:00 A.M. to 4:00 P.M.; while he was domiciled in Connecticut and usually returned to his home there after workday; he also maintained apartment in New York and used it approximately one night per week except in summer; on his ***tax*** returns, decedent stated that he worked 200, 192 and 192 days in New York for subject years–***Tax*** Commission properly defined day as "any part" of day; decedent was, accordingly, resident under ***Tax Law*** *§* ***605*** *(**b**) (1) (**B**)*–credit of ***Tax Law*** *§ 620 (a)* on its face does not apply to decedent, given that he was resident under ***Tax Law*** *§* ***605*** *(**b**) (1) (**B**)* and since income at issue, dividends and capital gains from sale of securities, was not derived from Connecticut; imposition of ***tax*** does not violate Privileges and Immunities Clause; decedent was not being denied any benefits granted to New York residents; there is also no equal protection violation since decedent is considered resident and was treated no less favorably than other residents. *Leach v Chu, 150 A.D.2d 842, 540 N.Y.S.2d 596, 1989 N.Y. App. Div. LEXIS 5448 (N.Y. App. Div. 3d Dep't)*, app. dismissed, app. denied, *74 N.Y.2d 839, 546 N.Y.S.2d 344, 545 N.E.2d 634, 1989 N.Y. LEXIS 2939 (N.Y. 1989)*.

Imposition of personal income ***tax*** on income from intangibles pursuant to *CLS **Tax** § **605**(**b**)(1)(**B**)* does not violate CLS *NY Const Art XVI § 3*; taxpayers are not ***taxed*** on ownership located in New York nor are their intangibles ***taxed*** on ad valorem basis, but rather they are ***taxed*** based on income generated by those intangibles. *Tamagni v **Tax** Appeals Tribunal, 230 A.D.2d 417, 659 N.Y.S.2d 515, 1997 N.Y. App. Div. LEXIS 6712 (N.Y. App. Div. 3d Dep't 1997)*, aff'd, *91 N.Y.2d 530, 673 N.Y.S.2d 44, 695 N.E.2d 1125, 1998 N.Y. LEXIS 1071 (N.Y. 1998)*.

Taxpayers' daily diary did not sustain their burden of establishing that they spent fewer than 184 days in state during year where each review of diary had yielded different total number of days, and taxpayers offered no documentary evidence to support their contention that "blank" days in diary represented days spent in Connecticut. *Wachsman v New York State Comm'r of Taxation & Fin., 241 A.D.2d 708, 660 N.Y.S.2d 462, 1997 N.Y. App. Div. LEXIS 7444 (N.Y. App. Div. 3d Dep't 1997)*.

Petitioners were statutory residents of New York within meaning and intent of ***Tax Law*** *§* ***605****(a)(**2**)*, where, although they were domiciliaries of Connecticut, they maintained permanent place of abode within New York, spent more than 183 days in New York in each year in question. In re Hodge, Op State ***Tax*** Comm, March 7, 1977.

Taxpayers who were domiciled in Michigan were residents of New York pursuant to ***Tax Law*** *§* ***605****(a)(**2**)*, thus making all income taxable to New York, where husband was executive of company, worked in New York office, spent excess of 183 days in New York in each year at issue, and sublet apartment in New York which was permanent place of abode for taxpayers. In re Foley, Op State ***Tax*** Comm, April 14, 1977.

Although taxpayers changed their domicile in July, they were New York residents for the entire taxable year, because they did not sell their New York home until the next year, thereby having spent more than 183 days in New York and maintained a permanent place of abode for the entire year in New York. In re Smith, Op State ***Tax*** Comm, June 24, 1977.

Taxpayer who had a vacation apartment in New York, and who was involuntarily in New York for 183 days in year because she was confined to a New York hospital, was a resident of New York for ***tax*** purposes. In re Holmyard, Op State ***Tax*** Comm, July 6, 1977.

Taxpayer who maintained apartment in state for storage of furniture and for use during frequent business trips to state is resident individual of state within meaning and intent of ***Tax Law** § **605**(a)(**2**)* where taxpayer failed to keep and have available for examination by ***Tax*** Commission, adequate records to substantiate claim that he did not spend more than 183 days within state. In re Peralta-Ramos, Dec State ***Tax*** Comm, September 21, 1979.

Petitioner maintained permanent place of abode in New York State, since his stay was for unspecified duration and he spent more than 183 days in state; therefore he was resident and subject to income ***tax***. In re Covington, Dec State ***Tax*** Comm, August 12, 1980.

A taxpayer who is not domiciled in New York but maintains a permanent place of abode in New York and spent in the aggregate more than 183 days in New York during ***tax*** year is a resident of New York State for income ***tax*** purposes pursuant to ***Tax Law** § **605**(a)(**2**)*. In re Melvin, 1981 Dec St ***Tax*** Comm, December 3, 1981.

Where individual is domiciled outside New York State for entire taxable year, maintains permanent place of abode in New York State for only portion of taxable year and spends in aggregate more than 183 days in New York State during taxable year, individual is not considered New York State resident individual, pursuant to CLS ***Tax** L § **605**(**b**)(1)(**B**)*, for such taxable year. 1988 New York State Dept. of Taxation & Finance ***Tax*** Advisory Opinion, TSB-A-88-(16)-I (Income ***Tax***).

Nondomiciliary taxpayers failed to sustain their burden to prove that they were in New York less than 184 days in particular year where neither one testified as to their whereabouts on specific days, one could not remember where he was on specific days, sole documentary evidence offered by them with respect to their daily activities were inconsistent summary schedules, and they did not offer specific testimony from individual or individuals who prepared summary schedules to explain how they were prepared. NY ***Tax*** Appeals Tribunal TSB-D-95-(31)I.

Neither *CLS **Tax** § **605**(**b**)(1)* nor § 1305(a) violated Commerce Clause of United States Constitution or CLS *NY Const Art XVI § 3* as applied to nondomiciliary taxpayers, who maintained permanent place of abode in New York City and who spent in excess of 183 days in New York City during years at issue. NY ***Tax*** Appeals Tribunal TSB-D-97(5)I.

Taxpayer did not show that she had not spent more than 183 days in New York State and New York City during years in issue solely by her testimony as to the general pattern of activity. NY ***Tax*** Appeals Tribunal TSB-D-97(9)I.

**36. Living in New York for 183 or fewer days**

Petitioners who moved out of New York State in July of 1967 could not qualify as residents for the entire year under definition contained in ***Tax Law** § **605***, subd a(***2***). *Kritzik v Gallman, 41 A.D.2d 994, 344 N.Y.S.2d 107, 1973 N.Y. App. Div. LEXIS 4369 (N.Y. App. Div. 3d Dep't 1973)*.

Taxpayers who moved from state in July of 1967 and did not maintain a residence in the state after that time clearly fell within the provisions of ***Tax Law** § 654* rather than ***Tax Law** § **605***, subd a(***2***). *Kritzik v Gallman, 41 A.D.2d 994, 344 N.Y.S.2d 107, 1973 N.Y. App. Div. LEXIS 4369 (N.Y. App. Div. 3d Dep't 1973)*.

Petitioner was nonresident of New York State for entire taxable year 1975, where, inter alia, (1) he had leased an apartment in Florida beginning in 1969, (***2***) he and his wife moved most of their furniture to Florida, but gave remaining furniture to their daughter who continued to reside in an apartment in New York State which the family had occupied for many years, (3) he executed a will in 1967 in which he characterized himself as Florida resident, (4) he registered to vote in Flordia on July 1, 1975, (5) he and his wife filed joint ***tax*** returns with Florida Department of Revenue for 1975, 1976, and 1977, stating on each return that they had moved to Florida in November, 1974, and (6) he and his wife stated that they spent approximately 22 days in New York State during 1975 and that during these visits they stayed at their summer house which was otherwise used during summer season by their son and daughter. In re Leibman, 1983 Dec State ***Tax*** Comm, TSB-H-83(120)I, June 13, 1983.

Professional hockey player who has place of abode in New York state which is maintained only during tempporary stay during hockey season is not deemed to be state resident since place of abode is not permanent; New York place of abode is not permanent where taxpayer maintains checking accounts and home in foreign country and does not obtain New York driver's license, does not vote in New York, and has not applied for or received United States citizenship. In re MacMillan, Dec State ***Tax*** Comm, TSB-H-84-(67)-I.

Domiciliary of another state will not become resident of New York for purposes of personal income ***tax*** by virtue of purchase of vacation home in New York if vacation home constitutes mere camp or cottage which is suitable and used only for vacations; if home is more substantial in nature and does constitute permanent place of abode, its purchase does not by itself render taxpayer resident for purposes of income ***tax*** unless such taxpayer in addition spends more than 183 days of taxable year in New York. In re Nimmannit, Op State ***Tax*** Comm, January 19, 1981 (Advisory Opinion No. 1801030 ***B***).

Maine domiciliary who had an apartment in New York used only for business and recreational purposes, and who spent less than 183 days in New York was not a New York resident. In re Combemale, Op State ***Tax*** Comm, July 29, 1977.

Sixty-eight year old bachelor who worked 110 of 240 working days within New York state, who applied for and was granted permanent residence status in Switzerland, and who resided while in Switzerland at a hotel which always held a suite available for him was not a resident of New York state for ***tax*** purposes. In re Heymans, Op State ***Tax*** Comm, September 29, 1977.

Taxpayers, husband and wife, who filed joint New York State income ***tax*** resident return for 1970, on which they listed their period of New York residence as "from January 1, through January 5, 1970" and who spent less than 183 days within New York State during taxable year at issue were not "resident individuals" of New York State within meaning and intent of § ***605*** subsequent to January 5, 1970 where husband left New York for Montreal, Canada to commence his duties as president of corporation despite fact that wife remained in New York until June of 1970 for express purpose of allowing children to complete school year since ordinarily wife's domicile follows that of her husband. In re Mulholland, 1979 Dec. State ***Tax*** Comm, December 14, 1979.

Petitioner, retired chiropodist and owner of various casinos and nightclubs in Las Vegas, is not a resident of New York in the years in question where petitioner resided in Nevada and derived all of his income from Nevada sources, and where his only contact with New York was an apartment which he rented year round but visited only a few weeks a year and a bank account which he kept in a New York City bank. In re Lewis, 1980 Dec St ***Tax*** Comm, Jan. ***2***, 1980.

Petitioner was not resident of New York where he had previously been resident of Connecticut, sold house in Connecticut, moved to Zambia for business purposes only, and used company furnished apartment in New York as United States address. In re Vuillequez, Dec State ***Tax*** Comm, Aug 25, 1980.

Although petitioner maintained permanent abode in New York, and spent more than 30 days and less than 183 days in state she was nonresident; petitioner's domicile was that of her husband who was not citizen of United States and did not evince an intention to make New York his home. In re Iervolino, Dec State ***Tax*** Comm, July 21, 1980.

Taxpayer, employee of international oil company who spent nearly 40 years working throughout world on various employment assignments, did not become resident of New York when he was assigned to state temporarily awaiting another overseas assignment nor did such subsequent overseas assignment amount to merely temporary removal from state for limited period of employment where taxpayer, upon leaving state, intended to spend remainder of his natural life elsewhere, he did not own property in state nor did he rent, lease or own any apartment in state and he had never voted in state in any city, state or federal elections and during year in question taxpayer spent total of 135 days in state. In re Walstow, 1979 Op ***Tax*** St Comm, March 15, 1979.

Affirming the decision of the Administrative ***Law*** Judge that petitioner changed his domicile from New York to Florida, the Tribunal rejected the ***Tax*** Division's argument that petitioner failed to keep sufficient records to show that he was not present in New York for greater than 183 days for each of the ***tax*** years at issue. The testimony of petitioner was that he was in New York "certainly less than 100 days per year" and more likely visited New York no more than 60 to 75 days per year. Telephone bills in petitioner's name revealed that outgoing calls were placed from petitioner's Florida condominium on 164 different days over a period of 11 months in 1981 and on 187 different days over a period of 10 ½ months in 1982. The bills corroborate petitioner's testimony as to his time spent in Florida and together with his testimony formed a sufficient basis to conclude that petitioner was not present in New York for greater than 183 days for each of the ***tax*** years at issue. NY ***Tax*** Appeals Tribunal TSB-D-90 (34) I (1990).

Taxpayers adequately substantiated their claim that they did not spend more than 183 days at their permanent place of abode in New York, despite absence of diaries or detailed records of their day-to-day whereabouts, where their accountant analyzed checks, utility and telephone bills, bank statements, travel itineraries and credit card statements, and prepared summaries outlining petitioners' whereabouts for each day during years at issue. NY ***Tax*** Appeals Tribunal TSB-D-94-(7)I.

Taxpayer failed to show that he had spent fewer than 183 days in New York, despite occupying residence in New Jersey, where business address of his employer and partnerships with which he was associated were in New York, he received wage income from New York employer and made no attempt to explain his relationship with business, and he offered little proof that he was not present in New York on at least 183 days other than his own testimony, which was not credible. NY ***Tax*** Appeals Tribunal TSB-D-95-(5)I.

Computer printout submitted by taxpayers entitled "NYS Diary of Days In & Out of NYS" was not, in fact, diary in support of showing actual days in and out of New York since there was no indication as to when document was prepared, and taxpayer admitted that it was merely "the best of my recollection, just an attempt at it." NY ***Tax*** Appeals Tribunal TSB-D-99-(1)I.

Absent corroborating documentary evidence, testimony of taxpayer, his business associates, and his wife's cousin, standing alone, was insufficient to show that taxpayers spent fewer than 183 days in New York for year in question. NY ***Tax*** Appeals Tribunal TSB-D-99-(1)I.

**C. Estates and Trusts**

**37. Generally**

Request to transfer situs of two trusts to Delaware was denied where the testator and the grantor had expressed an intent that the trusts be New York trusts, and the trustees' goal of avoiding New York income ***tax*** was achieved by *N.Y. **Tax Law** § **605(b**)(3)(D)*, by which a New York resident trust was treated as a non-resident trust for ***tax*** purposes. *In re Bush, 774 N.Y.S.2d 298, **2** Misc. 3d 744, 2003 N.Y. Misc. LEXIS 1640 (N.Y. Sur. Ct. 2003)*.

Trust executed in Connecticut by New York State domiciliary, which by its terms is to be administered under Connecticut ***law***, may properly be ***taxed*** by New York State as a resident trust, because a substantial portion of the trust property is located in New York State and because a majority of the trustees reside within New York State. In re John Frankel Trust, Dec State ***Tax*** Comm, September 5, 1980.

The residence of an irrevocable inter vivos trust may not change; thus, such a trust established in New York State is a resident trust for ***tax*** purposes notwithstanding that the trust corpus, beneficiaries and trustees have all removed from New York State. In re Cole Trust L. ***2***, 1982, Dec State ***Tax*** Comm, Nov. 24, 1982.

## Opinion Notes

**Agency Opinions**

**I. In General**

**1. Generally**

Intent of *CLS **Tax** § **605**(c)*—to assure that donations of money, objects of value or time to not-for-profit organization may not be used by Department of Taxation and Finance in determining resident status—is consistent with longstanding departmental policy that charitable donations are not considered in determining domicile for New York state personal income ***tax*** purposes. NY Adv Op Comm T & F TSB-A-95(***2***)I.

Activities of nonresident individual in donating objects of value, as well as additional funds, to not-for-profit organization in order to establish private museum, may not be considered in making any determination regarding individual's domicile where organization qualified as ***tax***-exempt organization under *Internal Revenue Code § 501(c)(3)*; moreover, contributions of additional funds by individual to trust which is sole shareholder of organization, and concomitant contribution of capital by trust to organization, as well as individual's donation of uncompensated time on behalf of both entities as liaison with organization, may not be considered in such context since, under trust agreement, organization will be ultimate beneficiary of such gifts and activities. NY Adv Op Comm T & F TSB-A-95(***2***)I.

**II. Domicile**

**A. Adoption of New York Domicile**

***2***. **Particular circumstances**

When individual (who is not domiciled in New York) purchases cooperative apartment in New York, apartment will be permanent place of abode under *20 NYCRR § 105.20(e)*, even if it will be vacant portion of taxable year, and thus individual will be considered resident of New York under *CLS **Tax** § **605**(**b**)* and *20 NYCRR § 105.20(a)*, and will be subject to personal income ***tax***, for any taxable year he maintains permanent place of abode for substantially all of taxable year, and spends aggregate more than 183 days of taxable year in state. NY Adv Op Comm T & F TSB-A-94(14)I.

Residency audit guidelines of Department of Taxation and Finance note that residence maintained by one individual but used exclusively by another should not be deemed permanent place of abode for individual who maintains it. NY Adv Op Comm T & F TSB-A-95(3)I.

***B***. **Abandonment of New York Domicile**

**3. Interstate relocations; factors affecting—In general**

**4. —Miscellaneous**

Taxpayer's abode in New Jersey from August 1998 to May 1999 was not considered permanent place of abode because he was on temporary assignment for particular purpose, and, likewise, his assignment in Washington D.C. from June 1999 to August 1999 was temporary assignment for particular purpose; thus, for portion of 1998 and 1999 at issue, when taxpayer was not considered nonresident of New York State under 548 day rule under *CLS **Tax** § **605**(a)(A)(ii)*, he did not meet condition of *CLS **Tax** § **605**(**b**)(1)(A)(i)* that he maintain permanent place of abode outside New York State. NY Adv Op Comm T & F TSB-A-01-(4)I.

Petitioners did not maintain permanent place of abode in New York state for substantially all of taxable year, and thus were part-year residents up to date they changed their domicile to Florida, where, inter alia, they moved all of their household furnishings, clothing and other tangible personal effects to their new home in Florida on August 17 and, after that date, their New York house and all its contents were listed for sale. NY Adv Op Comm T & F TSB-A-97-(3)I.

**III. Residence for *Tax* Purposes**

**A. Domiciliaries**

**5. No abode in state, abode elsewhere, and not present 30 days in state**

As long as individual who is domiciled in New York State continues to meet requirements of either paragraph (1) or paragraph (***2***) of Income ***Tax*** Regulations § 102.***2***(***b***), he or she will be considered nonresident for income ***tax*** purposes; where individual domiciled in New York State claims to be nonresident for any taxable year, such individual has burden to show that during that year he or she satisfied aforementioned requirements. NY Adv Op Comm T & F TSB-A-90-(4)I.

Burden is on taxpayer to prove number of days he was present in foreign country for purposes of "548 day rule" under *CLS **Tax** § **605**(**b**)(1)(ii)*; hotel receipts, airline ticket receipts, and military orders would be type of proof that would be relevant. NY Adv Op Comm T & F TSB-A-90-(11)I.

**6. Military personnel—Maintenance of contacts with state**

**7. —Ship quarters as permanent place of abode**

Petitioner was nonresident of New York State for personal income ***tax*** purposes where he had sold his New York home and began living on boat situated in Maine, whereupon he and his family sailed from United States and had not returned, and he had not maintained permanent place of abode in New York for any taxable year, had not spent more than 30 days of any year in New York State, and had maintained permanent place of abode outside New York State. NY Adv Op Comm T & F TSB-A-98-(1)I.

Determination of whether serviceman maintains permanent place of abode is not dependent merely upon whether serviceman lives on or off military base, and other factors include type and location of quarters occupied by individual and individual's immediate family, and how and by whom such quarters are maintained; further, maintenance of place of abode by serviceman will not be considered permanent if it is maintained only during duty assignment of limited or temporary nature. NY Adv Op Comm T & F TSB-A-90-(4)I.

***B*. Nondomiciliaries**

**8. Living in New York more than 183 days**

Individual was not New York domiciliary and would be nonresident of New York State for taxable years during which her presence in New York State was maintained in nursing home since individual's presence in New York State was not result of her own intent and decision but due to physical or mental incapacity. NY Adv Op Comm T & F TSB-A-91-(10)I.

Taxpayer would be nonresident individual of New York state for duration of his 4-year employment contract, even though he would spend more than 183 days of each taxable year in New York, where he would keep his home in Nebraska where his wife would continue to live, he would file federal income ***tax*** return with his Nebraska address, he would vote in Nebraska and maintain his Nebraska driver's licence, he would retain all significant bank accounts and his safety deposit box in Nebraska, he would retain his Nebraska address for all other personal items such as credit card billings and his passport address, he would be given use of company apartment in New York, and on expiration of contract in 4 years or less, he would retire, resign his employment, and return to Nebraska. NY Adv Op Comm T & F TSB-A-94(3)I.

Petitioners would be subject to ***tax*** for taxable year 1989 as statutory residents of New York state under *CLS **Tax** § **605**(**b**)(1)*, regardless of change of domicile to another state during year, where they maintained permanent place of abode in state for entire year and they spent in aggregate more than 183 days of year in state. NY Adv Op Comm T & F TSB-A-94(9)I.

Taxpayer would be nonresident individual of New York State for duration of his 4-year employment contract, even though he might spend more than 183 days of each taxable year in New York, where he would keep his home outside state, he would maintain another office outside state, and he would have use of furnished apartment in New York provided by his New York employer. NY Adv Op Comm T & F TSB-A-94(15)I.

Taxpayer domiciled in Tennessee, who was present in New York solely to care for her 14-year-old son during school year when he attended orthodox religious high school in New York, would not be deemed to be statutory resident of New York under CLS **Tax** § **605(b)**(1)(**B**) even though she would spend more than 183 days per year in New York, but would continue to be considered nonresident and file nonresident return. NY Adv Op Comm T & F TSB-A-97-(8)I.

Employees of multinational bank would be deemed residents of New York State under CLS **Tax** § **605(b)** for duration of employees' temporary assignment to work in New York State if employees maintained permanent place of abode in New Yoork State for substantially all of taxable year and they spent in aggregate more than 183 days of taxable year in New York. NY Adv Op Comm T&F TSB-A-98(10) I.

**9. Living in New York for 183 or fewer days**

Admittance of petitioner's wife to nursing home in New York would not cause her to be considered resident of New York for personal income ***tax*** purposes, even though she and her husband owned and occasionally used apartment in New York, since any day spent in such facility would not count for purposes of 183-day rule under CLS **Tax** § **605(b)**(1) and 20 NYCRR § 105.20(a). NY Adv Op Comm T & F TSB-A-06-(6)I.

**C. Estates and Trusts**

**10. Generally**

Complex inter vivos trust was resident trust of New York under CLS **Tax** § **605(b)**(3)(C) and 20 NYCRR § 105.23 where it consisted of property of person domiciled in New York state when such property was transferred to trust, and trust was irrevocable. NY Adv Op Comm T & F TSB-A-94(7)I.

Fact that trust is deemed resident trust of New York under CLS **Tax** § **605(b)**(3)(C) and 20 NYCRR § 105.23 does not ipso facto mean that it is subject to New York state personal income ***tax*** under CLS ***Tax*** Art 22. NY Adv Op Comm T & F TSB-A-94(7)I.

Three conditions contained in 20 NYCRR § 105.23(c) were met, and thus no New York state personal income ***tax*** would be imposed on complex inter vivos trust for years 1990, 1991, and 1992, despite fact that trust would be deemed New York resident, where (1) petitioner was sole trustee of trust, he sold his New York home in 1985 and became domiciled in Connecticut, and he changed his domicile to Colorado in 1991, (***2***) corpus of trust consisted solely of intangibles, and such cash, securities and federal government obligations were held by trust company in New York, and (3) no assets were employed in business carried on in New York, and all income and gains were derived from sources outside state, determined as if trust were nonresident. NY Adv Op Comm T & F TSB-A-94(7)I.

Situs of intangible assets of trust are deemed to be at domicile of trustee, even if such assets are held by trust company located in New York. NY Adv Op Comm T & F TSB-A-94(7)I.

No New York city personal income ***tax*** authorized under CLS ***Tax*** Art 30 would be imposed on complex inter vivos trust for years 1990, 1991, and 1992, despite fact that trust would be deemed New York resident, where trust met 3 conditions contained in 20 NYCRR § 105.23(c) and no state personal income ***tax*** would be imposed. NY Adv Op Comm T & F TSB-A-94(7)I.

Trust was resident trust under CLS **Tax** § **605(b)**(3)(c) where it consisted of property of person domiciled in New York State at time such property was transferred to trust, and when trust became irrevocable. NY Adv Op Comm T & F TSB-A-96(4)I.

No New York State personal income ***tax*** would be imposed on resident trust for those years in which all trustees were domiciled outside New York State, corpus of trust consisted of intangible assets, none of assets of trust were employed in business carried on in New York State, and all income and gains of trust were derived from sources outside New York State, determined as if trust were nonresident. NY Adv Op Comm T & F TSB-A-94(4)I.

Testamentary trust created under last will and testament of Florida domiciliary and resident, to be funded primarily with Florida assets, is nonresident trust under *CLS **Tax** § **605**(**b**)(4)*, even though its principal place of business and location of trust records was to be in New York state. NY Adv Op Comm T & F TSB-A-96-(***2***)I.

Trust, consisting of property of individual who was domiciled in New York State at time such property was transferred to trust, and when trust became irrevocable, was resident trust of New York under *CLS **Tax** § **605**(**b**)(3)(c)*; however, no New York State personal income ***tax*** would be imposed on such trust for years when trustee was domiciled outside New York State, corpus of trust consisted of intangible assets, situs of which were deemed to be at trustee's domicile, and none of trust assets were employed in business carried on in New York State and all income and gains of trust were derived from sources outside New York State, determined as if trust were nonresident. NY Adv Op Comm T & F TSB-A-00-(***2***)I.

## Research References & Practice Aids

**Cross References:**

This section referred to in §§ 639, 657.

**Codes, Rules and Regulations:**

Accounting periods and methods and resident defined. *20 NYCRR §§ 105.1* et seq.

**Federal Aspects:**

***Tax*** on nonresident aliens, *26 USCS §§ 871* et seq.

**Jurisprudences:**

100 NY Jur 2d Taxation and Assessment §§ 1203, 1204.

71 Am Jur 2d, State and Local Taxation §§ 512 et seq.

**Matthew Bender's New York Civil Practice:**

1 Cox, Arenson, Medina, New York Civil Practice: SCPA ¶¶ 102.01, 103.18; 4 Cox, Arenson, Medina, *New York Civil Practice: SCPA ¶1610.03*.

***2*** Rohan, New York Civil Practice: EPTL ¶¶ 3-4.6, 3-5.1.

**Matthew Bender's New York Practice Guides:**

1 *New York Practice Guide: Business and Commercial § 1.09*.

## State Notes

## Research References & Practice Aids

**Hierarchy Notes:**

*NY CLS* ***Tax****, Art. 22*

*NY CLS* ***Tax****, Art. 22, Pt. I*



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| In the Matter of the Petition<br><br>of<br><br>**DAVID AND KAREN SOBOTKA**<br><br>for Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law and the New York City Administrative Code for the Year 2008. | : | ORDER<br>DTA NO. 826286 |

Petitioners, David and Karen Sobotka, filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law and the New York City Administrative Code for the year 2008.

On April 24, 2015, petitioners, appearing by Hodgson Russ LLP (Timothy P. Noonan, Esq., of counsel), filed a motion seeking summary determination in their favor pursuant to 20 NYCRR 3000.5 and 3000.9(b). Accompanying the motion was the affidavit of Timothy P. Noonan, Esq., dated March 27, 2015, and annexed exhibits in support of the motion. On May 24, 2015, the Division of Taxation, appearing by Amanda Hiller, Esq. (Michelle M. Helm, Esq., of counsel), filed a responding brief in opposition to the petitioners' motion. Petitioners requested and received permission, pursuant to 20 NYCRR 3000.5(b), to submit a reply to the Division's response, and did so on June 2, 2015, which date commenced the 90-day period for issuance of this order. After due consideration of the affidavit and documents submitted in support of the motion, the response thereto, the reply to the response, and all pleadings filed in this matter, Dennis M. Galliher, Administrative Law Judge, renders the following order.

## *ISSUE*

Whether, because petitioners were domiciliaries of New York State and New York City and were thus taxable as residents thereof for a portion of the year 2008, the Division of Taxation (Division) is precluded pursuant to the terms of Tax Law § 605(b)(1)(B) from holding petitioners subject to taxation as "statutory" residents of New York State and New York City for the remaining portion of the year 2008.

## *FINDINGS OF FACT*[1]

1. For the year 2008, petitioners, David and Karen Sobotka, jointly filed a New York State and New York City Nonresident and Part-Year Resident Income Tax Return (Form IT-203). Thereafter, they filed an Amended Nonresident and Part-Year Resident Income Tax Return (Form IT-203-X) for such year. On such returns petitioners reported a change of domicile to New York State and City as of August 18, 2008.

2. On March 20, 2014, the Division issued to petitioners a Notice of Deficiency (L-040851299) asserting additional New York State and New York City personal income tax in the amount of $1,063,803.00 for the year 2008, plus interest.

3. The foregoing Notice of Deficiency was issued under the assertion that petitioner David Sobotka became domiciled in New York State and New York City beginning in October of 2007, and was both a statutory resident and a domiciliary of New York State and New York City for the year 2008.

[1] Petitioner Karen Sobotka's name appears herein by virtue of the fact that she filed a joint part-year resident personal income tax return with her husband, petitioner David Sobotka, for the year 2008. While both Mr. and Mrs. Sobotka are petitioners herein, the Division has taken the position that only petitioner David Sobotka was subject to tax as a full-year resident for the year 2008. Unless otherwise specified or made necessary by context, references to petitioner or to petitioners herein shall mean petitioner David Sobotka.

4. The Division has since concluded and the parties agree that petitioner was only domiciled in New York State and New York City from August 18, 2008 to December 31, 2008, as reported on his returns. As a consequence, the deficiency is now based solely on the Division's assertion that petitioner was also subject to tax as a statutory resident of New York State and New York City during the 2008 calendar year.

5. Petitioners filed a timely petition, challenging the foregoing notice and alleging that David Sobotka cannot be subjected to tax as a "statutory" resident because:

> a) he did not maintain a "permanent" place of abode in New York State or New York City, i.e., that his relationship to a hotel room maintained by his employer while he was assigned to New York on a temporary basis was impermanent by its very nature and lacked the "permanence" required under the Tax Law, and
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> b) the "statutory" resident provision in the Tax Law (Tax Law § 605[b][1][B]) only applies to taxpayers who are "not domiciled in New York," and since it is undisputed that Mr. Sobotka was domiciled in New York during 2008, one of the three requirements of the statutory resident test is not met.

6. Petitioners acknowledge that the first argument set forth above, at Finding of Fact 5(a), is not part of the subject motion for summary determination, given the factual questions inherent in such argument. Thus, petitioners' motion pertains only to the second argument set forth above, at Finding of Fact 5(b), with respect to which there are no facts in dispute.

## *CONCLUSIONS OF LAW*

A. Tax Law § 605(b) defines the terms "resident," "nonresident," and "part-year resident."[2] Pursuant to Tax Law § 605(b), a resident individual is defined as follows:

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[2] The noted terms are defined in identical manner for both New York State and New York City purposes, save for the substitution of the term "City" for "State" in each case (***compare*** Tax Law § 605[b]; Administrative Code of City of New York § 11-1705[b]). Unless otherwise specified or required by context, statutory citations for New York State purposes herein shall also include New York City (without reference or parallel citation to the New

> "(1) Resident individual. A resident individual means an individual:
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> (A) who is domiciled in this state, unless (i) he maintains no permanent place of abode in this state, maintains a permanent place of abode elsewhere, and spends in the aggregate not more than thirty days of the taxable year in this state, or . . .
>
> (B) who is not domiciled in this state but maintains a permanent place of abode in this state and spends in the aggregate more than one hundred eighty-three days of the taxable year in this state, unless such individual is in the active service in the armed forces of the United States."

The latter portion of the foregoing statutory language, Tax Law § 605(b)(1)(B), is commonly referred to as the "statutory resident" provision.

B. A nonresident individual is defined as an individual who is not a resident or a part-year resident (Tax Law § 605[b][2]).

C. A part-year resident is defined as individual who is not a resident or a nonresident for the entire taxable year (Tax Law § 605[b][5]).[3]

D. Petitioner's filing position is that he was a resident for only a part of 2008, and specifically that he was taxable as such only for the portion of 2008 commencing when he established his domicile in New York (August 18, 2008) and continuing through the end of 2008 (hereinafter "the later period"). In turn, and by his filings, petitioner claims he was a nonresident for the preceding portion of 2008 (from January 1, 2008 through August 17, 2008), upon the position that he did not meet all three of the criteria for being a statutory resident for such period (hereinafter "the earlier period"). The Division agrees that petitioner was properly taxable as a

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York City Administrative Code).

[3] The classification of resident versus nonresident is significant, since nonresidents are taxed only on their New York State or City (as relevant) source income, whereas residents are taxed on their income from all sources (***see Matter of Tamagni v. Tax Appeals Tribunal of State***, 91 NY2d 530 [1998], ***cert denied*** 525 US 931; ***Matter of Robertson***, Tax Appeals Tribunal, September 23, 2010).

resident on the basis of his New York domicile for the later period. However, the Division challenges petitioner's claim of nonresident status for the earlier period, maintaining that petitioner was subject to tax as a "statutory resident" pursuant to Tax Law § 605(b)(1)(B). If correct, the Division's position negates petitioner's claim of being a part-year resident, and results in petitioner being a resident, for tax purposes, for the entire year 2008, albeit on two differing bases, i.e., statutory resident basis (for the earlier period) and domicile basis (for the later period).

E. Petitioner's position on this motion is succinct. Petitioner maintains that: a) because a statutory resident is directly defined as an individual who is *not* domiciled in New York, and b) because the Division has agreed that he *was* domiciled in New York for a portion of the year 2008, then the Division is precluded from subjecting him to taxation as a statutory resident for that same year (and thereby taxing him as a resident for the entire year). Thus, according to petitioner, even if the evidence were to show that he spent more than 183 days in New York and maintained a permanent place of abode in New York in 2008, he still may not be subjected to New York tax as a statutory resident for any part of that year because the first of the three criteria for statutory resident status (that the taxpayer is *not* a domicilliary of New York) has not been met.

F. Tax Law § 605(b)(5) anticipates circumstances where a taxpayer may be taxable as a resident for only a portion of a given year, i.e., a "part-year resident," and defines a part-year resident to be an individual who is not a resident or a nonresident for the entire year. Petitioner claims this status. The question, as framed on this motion, is whether an individual who files and claims part-year resident status may nonetheless be held taxable as a resident for each of two separate periods during a single year, and thus be subject to tax as a resident for that entire year.

G. To answer the foregoing question, one must determine the propriety of a taxpayer's claimed split status as a part-year resident and as a part-year nonresident by reviewing the particular facts for each of the discrete periods during which such differing status is claimed. Here, the parties agree that petitioner is subject to tax as a resident, on the basis of domicile, for the later period. For the earlier period, however, the parties disagree over whether petitioner met each of the *three* statutory criteria for being subjected to taxation as a statutory resident during such period. Since there is no claim by either party that petitioner was a domiciliary of New York during the earlier period, it follows that petitioner may indeed, as a nondomiciliary for such discrete period, be subjected to tax as a resident *if* the evidence adduced at hearing shows that he maintained a permanent place of abode in New York and was present in New York for the requisite number of days during such discrete period. As a consequence, petitioner would be taxable as a resident for the entire year, notwithstanding his filing claim to the contrary. That is, for each of the discrete claimed periods involved, petitioner would meet the defined status of "resident" under Tax Law § 605(b)(1)(A) and (B), respectively. As a result, he would not meet the definition of "nonresident" (Tax Law § 605[b][2] ["an individual who is not a resident or a part-year resident"]). Further, having met the criteria for being a "resident" for each of the two discrete periods (comprising together the entire year), he would not meet the definition of "part-year resident" (Tax Law § 605[b][5] ["an individual who is not a resident or a nonresident for the entire year"]). While the statutory definition of "resident" is phrased in the disjunctive (i.e., either a domicile-based resident [Tax Law § 605(b)(1)(A)] *or* a "statutory" based resident [Tax Law § 605(b)(1)(B)],) such definition does not result in mutual exclusion in the context of analyzing taxable status where a taxpayer claims a different taxable status for each of two separate and discrete portions of the same year, as is the case here. Instead, and as outlined above, the statutory definitions are to be applied separately to each of such claimed discrete portions within the year. In sum, if the evidence shows that petitioner met the criteria for being a statutory resident for the earlier portion of 2008, then under the statutory framework and by process of elimination, he will be taxable as a resident for the entire year.

H. As noted, for 2008 petitioner admittedly meets the literal definition of a resident individual under Tax Law § 605(b)(1)(A), i.e., one who is domiciled in this state, though only for the latter period beginning as of August 18, 2008. Under prior law, petitioner would have simply been subject to tax as a resident for the entire year because he resided in New York during the last six months of the calendar year (***see*** Tax Law former § 350[7]). Deeming this result "too drastic," the Legislature amended the Tax Law in 1922, effectively providing for "part-year resident" status (***see*** Tax Law former 357-a [L 1922, ch 425]). Under this amendment, and in cases such as the present where a taxpayer became domiciled in New York and thus became subject to tax as a resident partway through the year, he could file two tax returns so as to be taxable as a resident only for the part of the year after he took up his New York domicile (***see*** Recommendation of Approval, Bill Jacket, L 1922, ch 425, at 5).[4] The purpose of the foregoing amendment was to "make it possible to adjust equitably and ratably the tax upon persons changing their residence, allowing them to be taxed as residents for the time they actually were residents, and as nonresidents, for the time they were nonresidents" (Assembly Mem In Support, Bill Jacket, L 1922, ch 425, at 3). After such amendment, a taxpayer could (and here does) claim the status of a nonresident and thus be taxable only to the extent allowed under such status for the non-New York-domiciled balance of the year (here the earlier period). Such a *claim* of nonresident status for part of a year is clearly not immune to challenge by the Division, however, and the challenge question here devolves to whether, *for such claimed nonresident period*, the taxpayer (despite his

[4] This manner of filing would likewise be available in instances where a taxpayer leaves New York, abandons his New York domicile and establishes a new domicile in another state partway through the year.

claim to the contrary) fulfills the three criteria upon which he would be properly subject to taxation as a statutory resident for such nondomiciled period.

I. The foregoing conclusion is consistent with Tax Law § 605(b)(1)(A) and (B), and its "either/or" disjunctive definition of "resident," as well as with the Legislative aim and intent to enable "equitable" (or ratable) taxation based upon a person's "actual" connection with New York. Under the reasoning advanced by petitioner herein, one could effectively eliminate the Division's right to challenge a claimed nonresident filing status for a portion of a year. A taxpayer could, for example, frustrate the Legislature's aim and intent by the simple expedient of changing domicile to New York late in the year (or out of New York early in the year), thereby relegating the balance of the same year beyond scrutiny due to the simple fact that the taxpayer had been domiciled in New York for some portion of the year. Petitioner's premise that being a domicile-based resident for any portion of a year precludes one from being a "statutory" resident for any other portion of the same year is thus rejected as inconsistent with the concept of being entitled to claim part-year resident and part-year nonresident status. That is, the preclusion part of petitioner's claim is based on a "full-year" view and, as such, effectively ignores the separate and discrete periods of his claimed filing status. Correctly viewed, petitioner's taxable status turns on a review of his claimed two part status, such that he may be, for tax purposes, a resident for the entire year and taxable as such, albeit as a statutory resident for the earlier period (if the evidence adduced at hearing supports such status) and as a domiciliary for the later period (as here admitted). At the same time, and based on the evidence, it may be that petitioner did *not* maintain a permanent place of abode and/or did *not* spend more than 183 days in New York during the earlier period, and would thus be taxable as a resident only for the later period during which he was domiciled in New York. That determination, as noted, will turn on the facts adduced at hearing.

J. Petitioner finds support for his position in ***Marks v. Commissioner of Revenue*** (2014 Minn Tax LEXIS 71 [Minn. Tax Ct Oct. 23, 2014]). The ***Marks*** case is similar to the matter at issue, both with respect to the statutory language by which a taxpayer's resident, nonresident or part-year resident income tax status is determined (***see*** Minn Stat § 290.01[7]), and with respect to the facts (taxpayers maintained a place of abode in Minnesota and spent in the aggregate more than 183 days in Minnesota during the year in issue [2007], but were domiciled outside of Minnesota [in Florida] until they moved back to Minnesota and became domiciled there in 2007). Of critical importance, however, is that the taxpayers in ***Marks*** had *not* been physically present in Minnesota for 183 or more days *at the point in time when they moved back into Minnesota and became Minnesota domiciliaries*. The Minnesota Tax Court granted petitioners' motion for partial summary determination, concluding that petitioners were part-year domicile-based residents of Minnesota, but were not statutory residents. In so doing, the Court held that in applying the day count for statutory residence purposes, the only days that may be counted are those spent in state while the taxpayers are domiciled *outside* of the state.[5] The ***Marks*** case thus supports the specific conclusion that one cannot count days spent in the state during a period when a taxpayer is domiciled in the state, for purposes of determining whether that taxpayer meets the physical presence test for statutory resident status. Contrary to petitioner's claim here, the ***Marks*** case does not stand for the broader proposition that a taxpayer who is domiciled in a

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[5] As noted, the petitioners had not been physically present in Minnesota for 183 or more days, as required for statutory resident purposes, when they became domiciled in Minnesota, and hence did not (and could not) meet the day count requirement for statutory resident status. The Court noted that the phrase "in the aggregate" within the context of the statutory residence day count means nothing more than that the days spent in-state need not be *consecutive* days. The Court remanded the matter for an evidentiary hearing on the question of precisely when the petitioners became Minnesota (part-year domicile based) residents, presumably for purposes of apportionment and allocation of petitioners' income as such part-year residents.

state, even if for only part of the year, simply cannot be a statutory resident. Rather, under the facts of the case, the Court held that Mr. and Mrs. Marks could not be held taxable as statutory residents because they lacked the requisite number of days (physical presence) during the period of claimed statutory residence (i.e., during their non-domiciled period). In contrast to ***Marks***, and noting that 2008 was a leap year, there were a total of 230 days during the earlier period in this case (January 1, 2008 through August 17, 2008), and thus it is clearly possible that petitioner herein may meet the physical presence requisite for being subjected to tax as a "statutory" resident for such period.

K. The parties discuss at some length in their motion papers the Division's perceived ambiguity in the interplay of the resident, nonresident and part-year resident provisions of the Tax Law. Review of such provisions leaves no such ambiguity apparent. The Tax Law provides definitions for an individual's status as: 1) a full-year resident (based on either domicile in New York or on stated statutory requirements [not domiciled in New York but maintaining an abode plus physical presence]); 2) a full-year a nonresident; or 3) a part-year resident. Under the third such possible status, the Tax Law and relevant regulations anticipate and address the required filing of separate returns for each of the claimed part-year periods (***see*** Tax Law § 651[a][3]; 20 NYCRR 154.1, 151.6), and provide extensive guidance and rules concerning the apportionment and allocation of items between the two periods (***see generally*** 20 NYCRR 112, 132).[6] This statutory (and regulatory) framework is fully consistent with the legislative aim of achieving equitably ratable taxation where factually appropriate, and avoiding or curtailing the actual or

[6] Though the Tax Law previously called for "separate" filings (***see*** Tax Law former § 654[a]), the same is now accomplished on a single return, Form IT-203 with appropriate required attachments (***see*** Tax Law § 651[a][3]).

perceived inappropriate manipulation of an individual's tax status (***see*** Assembly Mem In Support, Bill Jacket, L 1922, ch 425, at 3). Such statutory framework points clearly to discrete periods where one's claimed taxable status for each of such periods will rise or fall on the basis of the defined criteria (domicile-based or statutory-based resident status, nonresident status or part-year resident status) for each of the claimed separate periods, a result consistent with the legislative aim of taxing those individuals as residents for the period of time during which they "actually were residents" as defined. By contrast, adopting petitioner's "all or nothing" argument runs afoul of the part-year statutory language, requires ignoring the concept of two separate taxable periods with separate filings resulting therefrom, and curtails the Division's right and ability, upon review, to challenge the correctness of each of those filings both as to personal taxable status and as to the reporting, allocation and apportionment of items and amounts thereon. Notwithstanding a filing position claiming part-year nonresident status, a taxpayer may indeed have no period of part-year *non*resident status during a given year, regardless of the fact that each of such resident periods (encompassing together the entire year) results from different statutory standards and calculations specific to each of such separate and discrete periods within the same year. Thus, a taxpayer claiming part-year domicile-based resident status may also be a statutory resident for the other part of that same year (as a nondomiciliary who, for such period, maintained a permanent place of abode and [where the claimed part-year nonresident period includes, as here, more than 183 available days] was present on at least 183 of such [available] days). Conversely, and consistently, since the physical presence "day count" is not necessary or determinative for domicile-based resident status,[7] a taxpayer may be taxable only as a part-year resident if he meets the burden of establishing the fact and date on which he became a New York domiciliary, and further establishes (for example) that his claimed part-year nonresident period is not sufficiently long to encompass the requisite number of days for statutory resident status (with whatever consequent perceived tax benefits or detriments may flow therefrom).[8]

L. The Division argues, in general, that petitioner's position, if adopted, would serve to preclude New York from taxing the "very individuals that the [1922] legislation sought to tax." The Division further specifically argues that "[i]f the state is unable to count the number of days an individual was actually domiciled within New York State in its determination of whether an individual was a statutory resident, then it would be more challenging (and in some situations impossible) for New York State to fully tax those individuals who, 'for all intents and purposes,' were residents of the state." The Division is correct in its first argument. That is, petitioner's broad claim that if a taxpayer is a domiciliary for any part of the year, then that taxpayer may not be subject to tax as a statutory resident during the same year, is not supported by the statutory framework and such claim has been rejected herein. At the same time, while the Division might prefer an interpretation that allows it to count and include days during the domicile period as available days for statutory resident purposes, this interpretation and result fails to respect the

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[7] Though not determinative for domicile-based resident status purposes (i.e., domicile based resident status does not concern itself, per se, with a specific day count), the number of days spent in a particular jurisdiction is relevant as in indicator of intent vis-a-vis one's habit or pattern of life and hence may be indicative of their domicile (***see*** 20 NYCRR 105.20[d][4]; ***Matter of Silverman***, Tax Appeals Tribunal, June 8, 1989 ***citing Matter of Trowbridge*** 266 NY 283, 289 [1935]).

[8] A taxpayer could claim and establish domicile in New York at a point in time during the year early enough to eliminate the possibility of being taxable as a statutory resident for want of a sufficient aggregate number of available days during the non-domicile period, a result that is entirely consistent with the statute. To the extent this possible "planning opportunity" may be viewed as an unintended negative or unduly beneficial consequence, the remedy therefor, if any, rests within the purview of the Legislature.

language whereby statutory resident status is determined upon *three* conditions, to wit, nondomicile status during the possible statutory residence period, coupled with physical presence and maintenance of an abode. In order to properly analyze and determine whether one is, as claimed, a nonresident as opposed to a statutory resident for a portion of a given year, it is necessary to examine *all* of the criteria concerning statutory resident status, though only for the period during which such status is claimed or challenged. The Division's argument that days within the domicile-based resident period may be counted for purposes of the statutory resident physical presence requirement effectively ignores the first of the foregoing three conditions necessary for statutory resident status. Thus, the Division may not count days during the part-year domicile period as available or applicable days for purposes of imposing statutory resident status for the claimed nonresident part-year period.

M. Further support for the foregoing (day count) conclusion may be found by comparing the definition of "resident" under Tax Law former Article 16, § 350(7), with the current definitions of "resident," "nonresident" and "part-year resident" under Tax Law Article 22 (***see*** Conclusions of Law A, B and C).[9] Under Tax Law former Article 16, § 350(7), the definition of a "resident" was set forth in one paragraph and included both a person who was domiciled in New York, and a person who (in current parlance) would be a "statutory" resident, with the latter described therein as

> "any person "who maintains a permanent place of abode within the state and spends in the aggregate more than one hundred eighty-three days of the taxable year within the state, *whether or not domiciled in the state during any portion of*

[9] Former Article 16 was replaced by Article 22, effective and applicable to short taxable years ending in 1960 and to taxable years ending on or after December 31, 1960. Former Article 16 was repealed by Laws of 1987 (ch 267, § 10, effective July 20, 1987).

*said period*, and such person shall be taxed the same as though he had been domiciled in the state during the entire taxable year" (italics added).

There was no separate definition of a "nonresident" provided under Tax Law former § 350(7).

In contrast, Tax Law Article 22, former § 605(a)(1), (2) and (b) provided separate definitions for a "resident individual," including specifically (in separate paragraphs) both a person who was domiciled in New York (Tax Law former § 605[a][1)]), and a person who would be a "statutory" resident (Tax Law former § 605[a][2]), and for a "nonresident individual" (Tax Law former § 605[b]). In 1987, the Legislature added Tax Law § 605(b)(5), specifically defining a "part-year resident individual" (L 1987, ch 28, effective April 20, 1987, and applicable to taxable years beginning after 1986). The foregoing definitions of resident and nonresident individuals, though renumbered in connection with the 1987 addition of the definition of a "part-year resident individual," carry through to the present.[10] Of particular and significant relevance here, the current definition of a "statutory" resident, as set forth in Tax Law § 605(b)(1)(B), did not carry forward and include the italicized language ("whether or not domiciled in the state during any portion of said [183 day] period") notwithstanding that such language had been in the very definition of a statutory resident under Tax Law former § 350(7). This distinction strongly supports the conclusion that for purposes of determining statutory resident status during a portion of a given year, one may not count days that fall within the domicile-based resident portion of that same year.

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[10] The definitions, formerly set forth at Tax Law § 605(a), now appear at Tax Law § 605(b).

N. Finally, the conclusion reached herein imposes no stricture on the Division's authority to challenge a taxpayer's claimed filing status of resident, nonresident or part-year resident, including specifically its ability to assert that a taxpayer claiming nonresident or part-year resident status is, in fact, a full year resident, taxable as such *either* on the basis of being a full year domiciliary or alternatively (and if the proof fails to support such assertion of full-year domicile-based resident status), on the basis of being a full-year statutory resident. The Division has cited cases concerning arguments made in the alternative, i.e., that taxpayers were domicile-based residents for the full year and, even if proof of the same failed, they were nonetheless statutory residents for the full year (***see Matter of Hero***, Tax Appeals Tribunal, September 11, 2013; ***Matter of Kornblum***, Tax Appeals Tribunal, January 16, 1992, ***confirmed*** 194 AD2d 882 [1993]; ***Matter of Veeder***, Tax Appeals Tribunal, January 16, 1992; ***Matter of Edward L. Smith v. State Tax Commn.*** 68 Ad2d 993 [1979]). Those cases dealt with the proposition that all days may be counted in the context of determining physical presence for statutory resident purposes on a full-year basis, but are not controlling for purposes of determining statutory resident status for only a portion of a year. To the extent such cases appear to indicate otherwise, they are viewed as expressing dicta, noting that the arguments raised in such cases effectively dealt with full-year analysis of taxable status under alternative bases.

O. Petitioners' motion for summary determination is hereby denied and the matter shall proceed to hearing in due course as scheduled.[11]

DATED: Albany, New York
August 20, 2015

/s/ Dennis M. Galliher
ADMINISTRATIVE LAW JUDGE

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[11] At hearing, and consistent with the conclusions reached herein, evidence may be presented as to petitioner's whereabouts (i.e., presence in or absence from New York) for statutory resident "day count" purposes, during the earlier (claimed nonresident) period. In addition, evidence may also be presented as to petitioner's whereabouts during the later (domicile-based resident period), so as to create a complete record for purposes of any appeal that may be taken with respect to the conclusions reached herein.

**S07509 Summary:**

BILL NO S07509C

SAME AS SAME AS UNI.

SPONSOR BUDGET

COSPNSR

MLTSPNSR

Amd Various Laws, generally

Enacts into law major components of legislation which are necessary to implement the state fiscal plan for the 2018-2019 state fiscal year; makes the STAR income verification program mandatory; relates to the calculation of income for basic STAR purposes; repeals subparagraphs (v) and (vi) of paragraph (b) of subdivision 4, paragraphs (b) and (c) of subdivision 5 and paragraph (c) of subdivision 6 of section 425 of the real property tax law relating to the school tax relief (STAR) exemption; and repeals section 171-o of the tax law relating to income verification for a city with a population of one million or more (Part B); makes technical corrections to various statutes impacting property taxes and repeals certain sections of law relating thereto (Part E); relates to assessment ceilings for local public utility mass real property, in relation to the effectiveness thereof (Part G); relates to the statute of limitations for assessing tax on amended tax returns (Part H); provides for employee wage reporting consistency between the department of taxation and finance and the department of labor by adjusting certain reporting periods (Part I); relates to sales and compensating use taxes imposed on food and beverages sold by restaurants and similar establishments, exempting sales for resale from such taxes (Part J); relates to sharing with the comptroller information regarding unwarranted fixed and final debt (Part K); relates to the definition of resident for tax purposes of the personal income tax (Part O); establishes that any reference to section 24 of the Internal revenue code shall be a reference to such section as it existed immediately prior to the enactment of Public Law-115-97 (Part P); extends the hire a veteran credit for an additional two years (Part Q); relates to the New York youth job program (Part R); relates to exempting from sales and use tax certain veterinary drugs and medicines and removing the refund/credit therefor (Part W); provides relief from sales tax liability for certain partners of a limited partnership and members of a limited liability company (Part X); relates to extending the revenue distribution provisions for the additional rates of sales and use tax of Genesee, Monroe, Onondaga and Orange counties (Part Z); relates to adjusting the franchise payment; establishes an advisory committee to review the structure, operations and funding of equine drug testing and research (Part EE); relates to the sums of pertaining to simulcast of out-of-state thoroughbred races, simulcasting of races run by out-of-state harness tracks and licenses for simulcast facilities (Part GG); relates to the commercial gaming revenue fund; and repeals subdivision 4 of section 97-nnnn of the state finance law relating to base year gaming revenue (Part HH); addresses changes made to the internal revenue code (Part JJ); relates to federal gross income and federal deductions allowed pursuant to the internal revenue code; and relates to the taxation of business corporations (Part KK); establishes the charitable gifts trust fund and the health charitable account, and the elementary and secondary education charitable account; relates to credits for contributions to accounts in the charitable gifts trust fund; authorizes school districts, counties and New York city to establish charitable funds; and authorizes such localities to provide a credit against real property taxes for such contributions (Part LL); establishes the employer compensation expense program (Part MM); relates to the New York Jockey Injury Compensation Fund, Inc.; creates a separate account for the horsemen's organization for the purposes of collateral to secure workers' compensation insurance coverage (Part NN); relates to the disposition of net revenue (Part OO); relates to the state low income housing credit (Part PP); extends certain tax rates (Part QQ); relates to the credit for rehabilitation of historical properties (Part RR); relates to the personal income tax on residents of the city of New York (Part SS); relates to capital awards to vendor tracks (Part TT); relates to the disposition of certain proceeds collected by the commissioner of motor vehicles, the disposition of certain fees and assessments, and certain funds; repeals subdivision 5 of section 317 of the vehicle and traffic law relating to certain assessments charged and collected by the commissioner of motor vehicles; repeals subdivision 6 of section 423-a of the vehicle and traffic law relating to funds collected by the department of motor vehicles from the sale of certain assets; and repeals subdivision 4 of section 94 of the transportation law relating to certain fees collected by the commissioner of transportation (Part UU); relates to funding of capital and operating costs related to projects in the MTA New York city subway action plan (Part VV); utilizes reserves in the mortgage insurance fund for various housing purposes; authorizes the homeless housing and assistance corporation with the office of temporary and disability assistance to administer the sum of two million dollars; further authorizes the state of New York municipal bond bank agency to provide the sum not to exceed nine million dollars to the city of Albany; increases the number of supreme court justices in judicial districts 9, 10, 11, 12 and 13 (Part XX); increases the standards of monthly need for aged, blind and disabled persons living in the community (Part YY); establishes a rental subsidy for public assistance recipients living with HIV/AIDS (Part ZZ); relates to funding local government entities from the urban development corporation (Part AAA); provides for the administration of certain funds and accounts related to the 2018-19 budget and authorizes certain payments and transfers; relates to payments, transfers and deposits; relates to funding project costs undertaken by non-public schools; relates to funding project costs for certain capital projects; relates to the financing of the correctional facilities improvement fund and the youth facility improvement fund, in relation to the issuance of bonds; relates to housing program bonds and notes; establishes the dedicated highway and bridge trust fund, in relation to the issuance of bonds; relates to the issuance of bonds by the dormitory authority; relates to issuance of bonds by the urban development corporation; relates to the issuance of bonds; relates to the state environmental infrastructure projects; increases the aggregate amount of bonds to be issued by the New York state urban development corporation; relates to financing of peace bridge and transportation capital projects; relates to dormitories at certain educational institutions other than state operated institutions and statutory or contract colleges under the jurisdiction of the state university of New York; relates to bonds and mental health facilities improvement notes; increases the bonding limit for certain public protection facilities; authorizes certain payments and transfers, in relation to the effectiveness thereof; increases the amount of authorized matching capital grants; increases the amount of bonds authorized to be issued; authorizes the issuance of bonds in relation to grants made to voluntary agencies; and provides for the repeal of certain provisions upon expiration thereof (Part BBB); relates to contracts for excellence and the apportionment of public moneys; relates to the reporting of teacher diversity; relates to teaching tolerance; relates to reporting requirements of school level funding; relates to supplemental public excess cost aid; relates to total foundation aid; relates to building aid; relates to full day kindergarten aid; relates to academic enhancement aid; relates to high tax aid; relates to universal pre-kindergarten aid; relates to the statewide universal full-day pre-kindergarten program; relates to state aid adjustments; relates to the teachers of tomorrow teacher recruitment and retention program; relates to class sizes for special classes containing certain students with disabilities; relates to reimbursements for the 2018-2019 school year; relates to withholding a portion of employment preparation education aid and relates to the effectiveness of provisions of law relating to funding a program for work force education conducted by the consortium for worker education in New York city; relates to employment preparation education programs; relates to the effectiveness of provisions of law relating to state aid to school districts and the appropriation of funds for the support of government; relates to the effectiveness of provisions of law relating to supplementary funding for dedicated programs for public school students in the East Ramapo central school district; relates to the effectiveness of provisions of law relating to conditional appointment of school district, charter school or BOCES employees; relates to the expiration of provisions of law relating to certain provisions related to the 1994-95 state operations, aid to localities, capital projects and debt service budgets; relates to the effectiveness of provisions relating to the provision of supplemental educational services, attendance at a safe public school and the suspension of pupils who bring a firearm to or possess a firearm at a school; relates to the effectiveness of provisions relating to implementation of the No Child Left Behind Act of 2001; relates to the expiration to provisions relating to providing that standardized test scores shall not be included on a student's permanent record; relates to requiring the commissioner of education to include certain information in the official score report of all students; relates to school bus driver training; relates to special apportionment for salary expenses and public pension accruals; relates to sub-allocations of appropriations; relates to the city school district of the city of Rochester; relates to total foundation aid for the purpose of the development, maintenance or expansion of certain magnet schools or magnet school programs for the 2017-2018 school year; relates to the support of public libraries; relates to certain apportionments; and relates to transportation aid (Part CCC); relates to the utilization of reserves in the mortgage insurance fund for various housing purposes (Part DDD); relates to an online application system for taxpayers to submit claims for reimbursements of certain payments (Part EEE); relates to establishing the health care transformation fund (Subpart A); and authorizes the commissioner the health to redeploy excess reserves of certain not-for-profit managed care organizations (Subpart B) (Part FFF); extends expiration of payments to members of the assembly serving in a special capacity; extends provisions relating to the operation and administration of the assembly (Part GGG); establishes a compensation committee to determine the appropriate salaries for members of the legislature and certain state officials; repealer (Part HHH); amends chapter 59 of the laws of 2014, amending the tax law relating to a musical and theatrical production credit, in relation to extending the provisions thereof (Part III); establishes the "Democracy Protection Act" relating to disclosure of the identities of political committees making certain expenditures for political communications (Part JJJ); establishes the New York City Rikers Island Jail Complex Replacement act; and provides for the repeal of such provisions (Part KKK); establishes the New York city public housing authority modernization investment act; repealer (Part LLL); enacts the "New York Penn Station redevelopment act" (Part MMM); relates to transportation services; establishes the New York city transportation assistance fund and the supplemental revenue transparency program; relates to the installation of mobile bus lane photo devices on buses operating on certain rapid transit routes in the borough of Manhattan and the disposition of revenue from fines and penalties collected from the use of such stationary bus lane photo devices; establishes the metropolitan transportation sustainability advisory workgroup and provides for the repeal of such provision (Part NNN); relates to the minority and women-owned business enterprise program (Part OOO); establishes the "New York City housing authority emergency management act" and relates to the development and execution of a plan to remediate conditions affecting the health and safety of tenants of the New York city housing authority (Part PPP); establishes the New York city BQE Design Build Act (Part QQQ); relates to union dues and the duty of fair representation (Part RRR); relates to substantial equivalence for nonpublic elementary and secondary schools (Part SSS); relates to the possession of weapons by domestic violence offenders (Part TTT); and relates to the health care facility transformation program (Part UUU).

**S07509 Text:**

# STATE OF NEW YORK

S. 7509--C                                                    A. 9509--C

# SENATE - ASSEMBLY

January 18, 2018

IN SENATE -- A BUDGET BILL, submitted by the Governor pursuant to article seven of the Constitution -- read twice and ordered printed, and when printed to be committed to the Committee on Finance -- committee discharged, bill amended, ordered reprinted as amended and recommitted to said committee -- committee discharged, bill amended, ordered reprinted as amended and recommitted to said committee -- committee discharged, bill amended, ordered reprinted as amended and recommitted to said committee

IN ASSEMBLY -- A BUDGET BILL, submitted by the Governor pursuant to article seven of the Constitution -- read once and referred to the Committee on Ways and Means -- committee discharged, bill amended, ordered reprinted as amended and recommitted to said committee -- again reported from said committee with amendments, ordered reprinted as amended and recommitted to said committee -- again reported from said committee with amendments, ordered reprinted as amended and recommitted to said committee

AN ACT intentionally omitted (Part A); to amend the real property tax law, in relation to making the STAR income verification program mandatory; to amend the tax law, in relation to the calculation of income for basic STAR purposes; to repeal subparagraphs (v) and (vi) of paragraph (b) of subdivision 4, paragraphs (b) and (c) of subdivision 5 and paragraph (c) of subdivision 6 of section 425 of the real property tax law relating to the school tax relief (STAR) exemption; and to repeal section 171-o of the tax law relating to income verification for a city with a population of one million or more (Part B); intentionally omitted (Part C); intentionally omitted (Part D); to amend the general municipal law, the education law, the state finance law, the real property tax law and the tax law, in relation to making technical corrections to various statutes impacting property taxes; and to repeal subsection (bbb) of section 606 of the tax law, section 3-d of the general municipal law and section 2023-b of the education law, relating thereto (Part E); intentionally omitted (Part F); to amend the real property tax law, in relation to assessment ceilings; and to amend chapter 475 of the laws of 2013, amending the real property tax law relating to assessment ceilings for local public utility mass real property, in relation to the effectiveness thereof (Part G); to amend

EXPLANATION--Matter in ***italics*** (underscored) is new; matter in brackets [-] is old law to be omitted.

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card (except the sale of drinks in a heated state made through such a vending machine) or is for consumption off the premises of the vendor, except where food (other than sandwiches) or drink or both are (A) sold in an unheated state and, (B) are of a type commonly sold for consumption off the premises and in the same form and condition, quantities and packaging, in establishments which are food stores other than those principally engaged in selling foods prepared and ready to be eaten.

§ 2. This act shall take effect June 1, 2018 and shall apply to sales made on and after such date.

PART K

Section 1. The tax law is amended by adding a new section 171-z to read as follows:

**§ 171-z. Information sharing with the comptroller regarding unclaimed funds. 1. Notwithstanding any other law, the commissioner is authorized to release to the comptroller information regarding fixed and final unwarranted debts of taxpayers for purposes of collecting unclaimed funds from the comptroller to satisfy fixed and final unwarranted debts owed by taxpayers. For purposes of this section, the term "unwarranted debt" shall mean past-due tax liabilities, including unpaid tax, interest and penalty, that the commissioner is required by law to collect and that have become fixed and final such that the taxpayer no longer has any right to administrative or judicial review and a warrant has not been filed; and the term "taxpayer" shall mean any individual, corporation, partnership, limited liability partnership or company, partner, member, manager, sole proprietorship, estate, trust, fiduciary or entity, who or which has been identified as owing taxes to the state. This section shall not be deemed to abrogate or limit in any way the powers and authority of the comptroller to set off debts owed the state from unclaimed funds, under the constitution of the state or any other law.**

**2. The comptroller shall keep all information he or she obtains from the commissioner confidential, and any employee, agent or representative of the comptroller is prohibited from disclosing any taxpayer information received under this section to anyone other than the commissioner or staff of the department or staff of the department of audit and control for the purposes described in this section.**

§ 2. This act shall take effect immediately.

PART L

Intentionally Omitted

PART M

Intentionally Omitted

PART N

Intentionally Omitted

PART O

Section 1. Subparagraph (B) of paragraph 1 of subsection (b) of section 605 of the tax law, as amended by chapter 28 of the laws of 1987, is amended to read as follows:

(B) who [~~is not domiciled in this state but~~] maintains a permanent place of abode in this state and spends in the aggregate more than one hundred eighty-three days of the taxable year in this state, **whether or not domiciled in this state for any portion of the taxable year,** unless such individual is in active service in the armed forces of the United States.

§ 2. Paragraph 2 of subsection (a) of section 1305 of the tax law, as amended by chapter 225 of the laws of 1977, is amended to read as follows:

(2) who [~~is not domiciled in such city but~~] maintains a permanent place of abode in such city and spends in the aggregate more than one hundred eighty-three days of the taxable year in such city, **whether or not domiciled in this city for any portion of the taxable year,** unless such individual is in active service in the armed forces of the United States.

§ 3. Subparagraph (B) of paragraph 1 of subdivision (b) of section 11-1705 of the administrative code of the city of New York, as amended by chapter 333 of the laws of 1987, is amended to read as follows:

(B) who [~~is not domiciled in this city but~~] maintains a permanent place of abode in this city and spends in the aggregate more than one hundred eighty-three days of the taxable year in this city, **whether or not domiciled in this city for any portion of the taxable year,** unless such individual is in active service in the armed forces of the United States.

§ 4. This act shall take effect immediately and shall apply to taxable years commencing on or after such date.

PART P

Section 1. Paragraph 1 of subsection (c-1) of section 606 of the tax law, as amended by section 1 of part L-1 of chapter 109 of the laws of 2006, is amended to read as follows:

(1) A resident taxpayer shall be allowed a credit as provided herein equal to the greater of one hundred dollars times the number of qualifying children of the taxpayer or the applicable percentage of the child tax credit allowed the taxpayer under section twenty-four of the internal revenue code for the same taxable year for each qualifying child. Provided, however, in the case of a taxpayer whose federal adjusted gross income exceeds the applicable threshold amount set forth by section 24(b)(2) of the Internal Revenue Code, the credit shall only be equal to the applicable percentage of the child tax credit allowed the taxpayer under section 24 of the Internal Revenue Code for each qualifying child. For the purposes of this subsection, a qualifying child shall be a child who meets the definition of qualified child under section 24(c) of the internal revenue code and is at least four years of age. The applicable percentage shall be thirty-three percent. **For purposes of this subsection, any reference to section 24 of the Internal Revenue Code shall be a reference to such section as it existed immediately prior to the enactment of Public Law 115-97.**

§ 2. This act shall take effect immediately and shall apply to taxable years commencing on or after January 1, 2018.

PART Q

New York State Bar Association

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NYSBA

Report No. 1391

# New York State Bar Association
# Tax Section
# Comments on 2018-2019 New York State Executive Budget[1]

Tax #5 March 9, 2018

**Introduction**

This report on selected tax provisions of the 2018-2019 New York State Executive Budget (the "Budget Bill") was prepared by the Tax Section of the New York State Bar Association. It focuses on certain technical, administrative and conceptual issues raised by selected provisions of the Budget Bill with reference to the New York Tax Law (the "Tax Law") and identifies aspects we think should be clarified or reconsidered prior to adoption by the Legislature.

This report offers comments and recommendations on the following parts of the Budget Bill:

Part H: Extend the State of Limitations on Amended Tax Returns.

Part K: Allow Warrantless Tax Debt to be Assessed Against Unclaimed Funds.

Part M: Carried Interest Provision.

Part N: DTF Right to Appeal DTA Tribunal Decisions.

Part O: Clarify New York Residency Requirements for Tax Purposes.

[1] The principal drafters of this report were: Jack Trachtenberg, Megan L. Brackney, Paul R. Comeau, Peter L. Faber, Joshua E. Gewolb, Debra Silverman Herman, Sherry S. Kraus, Alysse McLoughlin, Elizabeth Pascal, Dennis Rimkunas, Leah Robinson, Arthur R. Rosen, Irwin M. Slomka, and Andrew W. Wright. Helpful comments were received from Andy Braiterman, Elizabeth Kessenides, Stephen B. Land, Michael Schler, and Andrew P. Solomon and Karen G. Sowell. This report reflects solely the views of the Tax Section and not those of the NYSBA Executive Committee or House of Delegates or any other party.

Part S: Defer Business Related Tax-Credit Claims.

Part T: Amend the Refund and Joint Liability Provisions of the Real Estate Transfer Tax.

Part X: Provide Responsible Person Sales Tax Relief for Minority LLC Owners.

Part AA: Impose an Internet Fairness Conformity Tax.

**Discussion**

**I. Part H: Extend the State of Limitations on Amended Tax Returns**

**A. Current Law**

The general period of limitations for assessment of tax is three years after the filing of a return. *See* Tax Law §§ 683(c), 1083(c), and City of New York Administrative Code § 11-1783(c). There are numerous exceptions that provide for extension of this time period in particular circumstances, such as where the return is fraudulent or where more than 25% of gross income is omitted, but the filing of an amended return is not currently one of them. *See In re George and Carol Bello*, N.Y. Tax App. Trib. Dkt No. 806543 (1993) (citing *Dowell v. Commissioner*, 68 T.C. 646, 649, *rev'd on other grounds*, 614 F.2d 1263 (1980), and then adopting the court's interpretation that the three-year statute of limitations runs from the filing of an original return, not from an amended return).

To claim a refund, an amended return must be filed three years from the filing of the original return, or two years from the payment of the tax, whichever is later. Tax Law §§ 687(a), 1087. The Department has authority to examine any and all aspects of an amended return to compute the correct tax for the year at issue. Unless limited by statute, the review is not necessarily restricted to consideration of the particular items of adjustment proposed in the refund claim, although the expiration of the limitation period may preclude assessment of a deficiency. *See e.g., Bankers Trust Corp. v. New York City Dept. of Finance,* 750 N.Y.S.2d 29, 35-36 (1st Dep't 2002).

Where an erroneous refund has been paid, the refund is considered an underpayment of tax on the date made, and "an assessment of a deficiency arising out of an erroneous refund may be made at any time within two years from the making of the refund." This period is extended to five years if "it appears that any part of the refund was induced by fraud or misrepresentation of a material fact." Tax Law §§ 683(c)(5) and 1083(c)(5); City of New York Administrative Code § 11-1783(c)(5). The term "erroneous refund" generally means a refund that was issued as a result of a mathematical or clerical error made by an employee of the Department. *See* 20 NYCRR §§ 36.1(a) and 107.7(a).

**B. Proposed Changes**

Part H of the Budget Bill would amend the limitations on assessment provisions of Tax Law §§ 683(c) and 1083(c), and City of New York Administrative Code § 11-1783(c), to add the following paragraph:

> Except as otherwise provided in paragraph three of this subsection, or as otherwise provided in this section where a longer period of time may apply, if a taxpayer files an amended return, an assessment of tax (if not deemed to have been made upon the filing of the amended return), including recovery of a previously paid refund, attributable to a change or correction on the amended return from a prior return may be made at any time within three years after such amended return is filed.

The stated purpose for the extended period of limitations is to limit refund abuse:

> The Executive Budget will reduce refund abuse by extending the statute of limitations to three years after the filing date of the amended return, rather than three years after the original return filing date. Currently, taxpayers can file an amended return containing a refund request close to three years after the due date of their initial return, hampering the possibility of an audit and assessment by DTF.

FY 2019 Executive Budget Briefing Book, at 18.

**C. Comments**

Limitations on the assessment of tax serve an important purpose, as "public policy favors the effective, timely, and definitive collection of unpaid taxes." *In re King Center Corp*., 573 B.R. 384, 398 (Bkrtcy. E.D.N.Y. 2017). As stated by the U.S. Supreme Court, tax "recomputations are immensely difficult or impossible when a long period has intervened." *Hanover Shoe, Inc. v. United Shoe Machinery Corp*., 88 392 U.S. 481, 503 (1968). Extension of the limitation period should only be made where a systemic problem exists under the existing period that hampers the government's ability to timely assess the tax. Otherwise, for the majority of taxpayers who file non-fraudulent amended returns, the additional lengthy period of limitations imposes additional burdens to maintain records, and fails to provide the closure necessary for financial reporting and business planning. Before broadly extending the period of limitations, these important policy considerations should be taken into account.

1. *Clarify the Meaning of "Attributable To"*

The proposed amendment limits the Department's ability to assess additional tax under the extended statute of limitations to assessments that are "attributable to a change or correction on the amended return." In this regard, we note that it is unclear what the phrase "attributable to" means. For example, if a corporate taxpayer files an amended return to change the composition of its combined group (i.e., to add or remove entities from the combined return), is the Department's ability to assess additional tax under the extended statute of limitations limited to only re-adjusting which affiliated entities should be in the combined group? Or could the Department also adjust the apportionment factors of the entities in the combined group on the grounds that a change to the group's apportionment is "attributable" to the change in the group composition reported by the taxpayer? The Tax Section encourages the legislature to clarify that the proposed amendment is intended to prevent the Department from opening the taxpayer's entire return for audit under the extended statute of limitations and to consider providing a definition of what it means for the Department's assessment to be "attributable to" a change on the amended return. Opening the entire return would unfairly burdens taxpayers who file amended returns to correct errors in favor of New York, or to claim refunds to which they are lawfully entitled. In other words, a taxpayer should not have to weigh the purpose of amending its return for a single issue against the possibility that data-intensive aspects of a return could be revisited years after the natural close of the statutory period.

### 2. *Absent Clarification, the Amendment May Discourage Taxpayers from Self-Correcting Erroneous Returns*

In general, there is no legal obligation to file an amended tax return, although a taxpayer is required to file an amended return to report Federal changes, corrections, and disallowances, or if the taxpayer has filed a Federal amended return. Tax Law § 659; 20 NYCRR §§ 159.2, 159.3. If the proposed amendment is not clarified to limit the scope of the Department's review and ability to assess additional tax under the extended statute of limitations, taxpayers may be discouraged from self-correcting returns (including to make adjustments in favor of the taxing authority) and filing claims for refund that are rightfully owed to the taxpayer. As noted above, taxpayers may fear that filing an amended return for a discrete issue could result in a burdensome audit related to other aspects of the return.

### 3. *The Amendment May Conflict with Sections 687(b) and 1087(b) of the Tax Law*

Absent clarification, the Tax Section is also concerned that the proposed statute would undo the protections provided in Tax Law §§ 687(b) and 1087(b). Those code sections provide that, if the taxpayer and the Department have entered into an agreement to extend the period for the assessment of additional tax (i.e., a waiver) and have done so within the period prescribed for the filing of a refund claim, then the period for filing a refund claim shall not expire prior to six months after the expiration of the waiver. While these provisions extend the period of limitations for the taxpayer to file a refund claim, they do not extend the period of limitations for assessment. Accordingly, under existing law, when taxpayers avail themselves of their right to file a claim for refund pursuant to section 687(b) or 1087(b), the Department is permitted to defend against the refund claim, but cannot open the entire return up for review and assessment of additional tax.

Sections 687(b) and 1087(b) were designed to give taxpayers sufficient time to raise claims for credit or refund as a means to offset assessments of additional tax asserted by the Department near the end of the limitations period for filing such claims. We believe this is a laudable policy goal and are concerned that the proposed amendments to sections 683(c) and 1083(c) would be in conflict with the protections provided under sections 687(b) and 1087(b). Specifically, if the "attributable to" language in the proposed amendment is not clarified to limit the scope of the Department's ability to assess additional tax under the extended statute of limitations, it may give the Department the right to audit other aspects of an amended return filed pursuant to sections 687(b) and 1087(b), which is precisely what those sections were designed to prohibit. At a minimum, the proposed amendments should be clarified to provide that the Department cannot avail itself of the additional time to audit an amended return if such return was filed during the extended six month period provided for in sections 687(b) and 1087(b).

### 4. *The Proposed Amendment Should be Modified to Provide for a Shorter Extension of the Statute of Limitations*

A three-year extension of the statute of limitations could be viewed as extensive. While some states have adopted a three-year extension of the statute of limitations in the context of amended returns, *see* Conn. Gen. Stat. § 12-733(e); Md. Code Ann. Tax-Gen. § 13-1101(d), other states have adopted much shorter (e.g., six month to one year) extensions. *See e.g.*, Ga. Code Ann. § 48-2-49(e); Kan. Stat. Ann. § 79-3230(a). We note that a shorter six-month extension of the statute of limitations would parallel the six-month extension of time that is granted to taxpayers to seek offsets of assessments issued by the Department as a result of an audit conducted pursuant to a waiver issued by the taxpayer (discussed above).

Alternatively, the proposed legislation could be narrowed to conform to the Internal Revenue Code, which provides for a limited extension in the case of amended returns filed within the 60-day period ending on the day on which the statute of limitations would otherwise expire. For those amended returns, the IRS has an additional 60 days to assess additional tax. IRC § 6501(c)(7). Enacting a similar provision would address the legislature's concern that some taxpayers attempt to hamper the ability of the Department to assess additional tax by filing an amended return just before the statute of limitations expires. As this group of amended returns is most likely to be problematic, the extension provision could be limited to them. We note, however, that while the Internal Revenue Service has only 60 days to assess additional tax when an amended return is filed within the 60-day period ending on the day on which the statute of limitations would otherwise expire, it has two years to recover erroneously issued refunds. The Department also has two years to recover erroneously issued refunds, but it, unlike the Internal Revenue Service, is limited to recovering erroneous refunds that were issued as a result of a mathematical or clerical error by an employee of the Department.

## II. Part K: Allow Warrantless Tax Debt to Be Assessed Against Unclaimed Funds

Part K allows the Department to share information with the State Comptroller to satisfy past-due tax liabilities with unclaimed funds without the necessity of filing a tax warrant. As stated in the Memorandum in Support of the Budget Bill, "secrecy statutes in the Tax Law prevent the Commissioner from sharing debtor/taxpayer information with the Comptroller when warrants have not been filed," therefore the change "is needed so the Commissioner has authorization to share taxpayer information with the Comptroller regarding unwarranted fixed and final debts so the debts can be satisfied, in whole or in part, with unclaimed funds."

### A. Current Law

Currently, the Commissioner and Comptroller share information regarding warranted fixed and final debts, which results in the Commissioner routinely applying a taxpayer's unclaimed funds to fixed and final warranted tax debt. Thus, this proposal provides the Department with a modified tool to enforce the collection of past-due liabilities.

### B. Proposed Change

Part K of the Budget Bill would allow the Department to share information with the State Comptroller regarding fixed and final unwarranted debts of taxpayers for purposes of collecting unclaimed funds from the Comptroller, who serves as the custodian of the funds, to satisfy the taxpayers' past-due liabilities.

The authorization is limited to the release of information regarding fixed and final unwarranted debts of taxpayers for purposes of collecting unclaimed funds from the Comptroller to satisfy fixed and final unwarranted debts owed by taxpayers. The phrase "unwarranted debt" is defined as "past-due tax liabilities, including unpaid tax, interest and penalty, that the commissioner is required by law to collect and that have become fixed and final such that the taxpayer no longer has any right to administrative or judicial review and a warrant has not been filed." And, "taxpayer" is defined as "any individual, corporation, partnership, limited liability partnership or company, partner, member, manager, sole proprietorship, estate, trust, fiduciary or entity, who or which has been identified as owing taxes to the state." The term "unclaimed funds" is not defined in the legislation.

The State Comptroller would be required to keep all information obtained from the Department confidential.

### C. Comments

The Tax Section commends the Budget Bill's proposal to allow the Commissioner to share information with the State Comptroller to facilitate the collection of taxpayers' past-due liabilities from unclaimed funds, without the need to file a tax warrant. Without this authority, the Commissioner would continue to be required to file a public tax warrant with the appropriate county clerk's office and the Department of State prior to the undertaking of any enforcement action with respect to unclaimed funds. Publicly filed tax warrants can impose harms and burdens on taxpayers that may not be necessary to effectively enforce the state's tax laws. These include negatively affecting the taxpayer's credit report, causing an increase to the taxpayer's insurance premiums rates, and jeopardizing employment opportunities with employers that conduct credit checks as part of the hiring process. By allowing the Department to share information with the Comptroller regarding fixed and final unwarranted debts of taxpayers, the Department will be permitted to engage in a routine and productive tax collection technique without creating unnecessary burdens and hardships for taxpayers.

The Tax Section has previously issued reports acknowledging the many benefits from the Department's warrantless wage garnishment, which also permits the Department to engage in a routine collection action, without the necessity of filing a tax warrant.

While we commend this legislation, we note the following technical comments. First, we believe the title of the provision could be changed to better describe the provision and parties involved. The proposed title is "Information sharing with the Comptroller regarding unclaimed funds." An alternative option is "Information sharing with the State Comptroller regarding tax debt for collection of unclaimed funds." (Similarly, the word "State" should also be added throughout the statute before the term Comptroller).

Second, the term "taxpayer" is defined to include generally an entity or person "who or which has been identified as <u>owing taxes</u> to the state" (emphasis added). This language seems overbroad. We suggest that the language be revised to apply solely to an entity or person "who or which has been identified as owing <u>past-due tax liabilities</u> to the state" (emphasis added).

Third, the term "unclaimed funds" is not currently defined in the legislation. We believe it should be defined to provide clarity, such as "unclaimed funds under New York's Abandoned Property Law." Furthermore, in this regard, the Memorandum in Support cites to general common law and case law as the basis for the Comptroller to satisfy debt owed to the State with unclaimed funds of a debtor/taxpayer. Specifically, the Memorandum in Support states that "common law and case law authorize and permit the Comptroller to satisfy debt owed to the State with unclaimed funds of a debtor/taxpayer when 1) a debt is owed; 2) the debtor/taxpayer received notice of the debt; and, 3) the debtor/taxpayer no longer has any right to administrative or judicial review of the debt."

Presumably the common law doctrine being referred to is the Comptroller's common law right to offset any valid claim or debt owed to the State against a claimant who is due money under the Comptroller's control, even if the setoff is unrelated to the state's debt to that claimant. Or, stated differently, if a claimant is owed money by a state agency but also owes money to the same or another state agency, the Comptroller may subtract and withhold the money owed to the state from the money owed by the state, thereby facilitating the collection by the state of the money it is due. *See, e.g., Suburban Restoration Co., Inc. v. Office of the State Comptroller*, 2012 NY Slip Op 07022 (3rd Dep't).

The Tax Section is concerned that there is no written agreement between the Department and the State Comptroller that addresses the enforcement of delinquent tax liabilities through unclaimed funds. For example, the procedures for identifying unclaimed funds, provisions addressing certifications that the funds are unclaimed (i.e., proper notice has been provided to the claimant), and/or procedures for transferring the funds so the funds can be applied to satisfy past-due unpaid tax liabilities. It is our understanding that the current unclaimed funds program against warranted debt has generated substantial returns, through both automated funds offsets and manual exceptions (i.e., unclaimed funds primarily related to intangible property). Under current federal and state debtor protection laws, the Department cannot reach by levy to pay tax debts a tax debtor's social security payments, public assistance payments, veteran's benefits, unemployment insurance, child support and workers compensation payments. If the Department levies a bank account containing exempt funds, there is a procedure available for the owner of the account to claim an exemption for the exempt funds. *See* CPLR § 5222-a. Consideration should be given to the fact that unclaimed funds in New York can include bank accounts. Also, in the case of decedents, there is a possibility that the unclaimed funds no longer belong to the named claimant decedent, but rather are the property of the decedent's beneficiaries. Federal and state debtor protection laws should not be violated as a result of this enforcement action. In this regard, we think it is instructive to look at the written agreements required under Tax Law § 171 relating to the enforcement of delinquent tax liabilities through the suspension of drivers' licenses (Tax Law § 171-v) , enforcement of delinquent state tax liabilities through the suspension of eligibility for STAR exemptions (Tax Law § 171-y) and various provisions relating to the Commissioner's authority to credit any overpayments of taxpayers against outstanding debts owed to a state agency (Tax Law § 171-f) or to New York City (Tax Law § 171-l).

Upon being turned over to the Comptroller, abandoned property does not become the property of the State; instead the State assumes its care and custody in a special fund for the benefit of those entitled to receive it, and any person who can prove his or her right to such property is entitled to have it paid over to him or her at any time. The Tax Section is concerned that once the State Comptroller transfers the unclaimed funds to the Commissioner, there is no public record that a claimant ever had unclaimed funds. Presumably, the State Comptroller could be required to maintain a public list that details the names of claimants for which it transferred unclaimed funds to the Department to satisfy past-due tax liabilities. However, the legislation at issue is necessary precisely because the Commissioner is unable to disclose unwarranted tax debt of taxpayers due to taxpayer secrecy provisions. Indeed, the provision requires that the Comptroller keep all of the information confidential. Thus, no public record would be available to notify claimants of unwarranted debts that their unclaimed funds were transferred to the Department to satisfy such debts.

## III. Carried Interest Provision

### A. Current Law

The Tax Law has no special provisions dealing with income from a carried interest. In general, partnership income that is taxed to the partners has the same character in the hands of the partners as it had in the hands of the partnership regardless of how the partner acquired his or her partnership interest. For example, partnership investment income, including long-term capital gains, flows through to the partners and is treated the same in their hands even if one or more partners acquired their partnership interest in exchange for services rendered to the partnership or to other partners.[2]

A carried interest is an interest in a partnership that is disproportionately high relative to the partner's capital contribution. It is common for the organizers of an investment partnership to contribute a small amount of the partnership's capital but to receive a much higher interest in partnership profits. Arguably, this disproportionate interest is received in exchange for services rendered in organizing and/or operating the partnership. Nevertheless, New York State, mirroring the federal income tax treatment, has treated income from a carried interest just like any other partnership income that is taxed to the partners. Until the enactment of the federal Tax Cuts and Jobs Act of 2017 ("TCJA"), the Internal Revenue Code contained no special provisions for carried interest income and the Internal Revenue Service treated the income as retaining the character that it had in the hands of the partnership. The TCJA amended section 1061 of Internal Revenue Code to provide, in general, that a partner who received a partnership interest in connection with the performance of substantial services would not treat long-term capital gains realized by the partnership as long-term capital gains unless the property sold by the partnership had been held by the partnership for more than three years. Section 1061 does not treat carried interest income as income received in exchange for services or as business income; its only effect is to convert what otherwise might have been long-term capital gains to short-term capital gains.

[2] References to partnerships and partners include limited liability companies and their members to the extent that they are treated as partnerships and partners for income purposes.

### B. Proposed Changes

Part M of the Budget Bill would add a new section 44 to the Tax Law and would amend sections 208.6(a), 617(b), and 632(b) to change the treatment of carried interest income. The Memorandum in Support of the Budget Bill explains that the provisions are intended to "close the carried interest loophole" by treating carried interest income as income from a trade or business and not as capital gains. One consequence of this recharacterization would be that carried interest income would be taxable to a nonresident of New York to the extent that the partnership's income was attributable to New York sources. In addition, the Budget Bill would impose a 17% "carried interest fairness fee" on a portion of carried interest income that, in the words of the Memorandum, "would remain in effect until federal law is amended to treat the provision of investment management services for federal tax purposes substantially the same as under this legislation." The provisions of the Budget Bill would take effect only upon the enactment of similar legislation by Connecticut, New Jersey, Massachusetts, and Pennsylvania.

### C. Comments

The Tax Section takes no position with respect to whether carried interest income should be treated as business income or should be given favorable tax treatment.

The Budget Bill applies the new regime to income that a partner is deemed to have received from "investment management services." Section 44 defines this phrase as including investment advice regarding the purchase or sale of securities as defined in section 475(c)(2) of the Internal Revenue Code, real estate held for rental or investment, and certain partnership interests, including managing, acquiring, or disposing of such assets, arranging financing with respect to the acquisition of such assets, and related activities.

The operative provision of section 44 indicates that a partner who performs investment management services for a partnership will not be treated as a partner with respect to the partner's distributive share of income, gain, loss, and deduction, including guaranteed payments, "that is in excess of the amounts such distributive share would have been if the partner had performed no investment management services for the partnership." That excess amount will be treated as a business receipt for services and for purposes of the personal income tax as income attributable to a trade, business, profession, or occupation. Similar provisions would apply to an S corporation shareholder. An exception would be provided for certain real estate businesses. A partner or shareholder will not be deemed to be providing investment management services if at least 80% of the average fair market value of the partnership's assets consists of real estate held for rental or investment.

It may be difficult to determine whether a partner received all or part of a partnership interest in exchange for investment management services. It does not automatically follow that an interest that is disproportionate to a partner's capital contribution is received in exchange for investment management services or, for that matter for any services. For example, the organizers of a partnership might be willing to give a particularly prestigious individual a disproportionately high partnership interest because the person's name might enhance the partnership's reputation or ability to attract other investors or otherwise assist in relations with private or public organizations. Other partners might simply strike a hard bargain and succeed in negotiating for a partnership interest that is disproportionately high relative to their capital contributions.

The new regime applies to income received by a partner for services performed by that partner. As written, it would not apply to income received by a partner who received a partnership interest as a gift from a person who performed services for the partnership (e.g., the service provider's spouse or children).

Section 44(c) provides for "an additional tax, referred to as the 'carried interest fairness fee.'" This fee is equal to 17% of the amount treated as business income under section 44(b). This fee will remain in effect until "federal legislation has been enacted that treats the provision of investment management services for federal tax purposes substantially the same as provided in this section." It is not clear what kind of federal legislation would be needed to result in a termination of the fee. The bill converts investment income to business income. If Congress wanted to completely eliminate favorable treatment for capital gains realized by partnerships that had partners with carried interests, it could do so by expanding on the approach taken by the TCJA and simply providing that all long-term capital gains realized by a partnership will be treated as short-term capital gains to the extent that they are passed through to carried interests. That would eliminate any federal preference for carried interest income, but it would not treat that income as business income as the New York statute does. It would still be investment income for other purposes of the federal tax laws. That would not result in treatment "substantially the same as provided" in the New York law.

The carried interest provisions take effect only if Connecticut, New Jersey, Massachusetts, and Pennsylvania all adopt legislation "having substantially the same effect as this act." It is unclear what this phrase means. In the unlikely event that all four states adopt some kind of legislation dealing with carried interest income, they could take different approaches. They could recharacterize carried interest income as business income but not impose a punitive "fairness fee," or they could impose a "fee" that was much lower than New York's fee.

## IV. Part N: DTF Right to Appeal DTA Tribunal Decisions

### A. Current Law

The statute that created the Division of Tax Appeals within the Department of Taxation and Finance has, since its enactment in 1986, provided a mechanism for taxpayers to appeal adverse decisions rendered by the Tax Appeals Tribunal (the "Tribunal"); such appeals are made to Supreme Court, Appellate Division (Third Department) under a specially modified procedure under Article 78 of the Civil Procedure Law and Rules. The Department, however, has been provided no such appeal opportunity and thus decisions of the Tribunal in which the taxpayer prevails are final. Consequently, inasmuch as Tribunal decisions are precedential, the Department has occasionally resorted to seeking legislative changes to substantive Tax Law provisions when it has believed the law should be different than as interpreted by the Tribunal.

### B. Proposed Changes

Part N of the Budget Bill would modify the Tax Law by providing the Department with the same appeal rights as currently afforded taxpayers.

### C. Comments

From the time that the original Division of Tax Appeals legislation was being developed in the early 1980s through as recently as 2009, the Tax Section has supported placing the Department on equal footing with taxpayers in the context of appeal rights. This position was based on two important considerations. First, unlike the former State Tax Commission, which exercised adjudicative as well as administrative and regulatory functions, the Tribunal is an independent, adjudicative body. Thus, whereas there was no need for a right of appeal when the State Tax Commission (i.e., the Department) made its own final determinations of tax cases (because it had ultimate control of such determinations), each litigant before the independent Tribunal should have the right to appeal. Such a procedure would be consistent with the procedure at the United States Tax Court, which permits the Internal Revenue Service to appeal adverse United States Tax Court decisions. *See* NYSBA Report #382, "Need For and Feasibility of a New York Tax Tribunal (Jan. 4, 1983); *see also* Letter from Erika W. Nijenhuis, Chair, Tax Section, NYSBA to Hon. David A. Paterson, Governor, New York State (Apr. 24, 2009).

Second, the Tax Section's historic support for granting the Department a right to appeal an adverse Tribunal decision was based on the belief that in cases where (a) the degree of the persuasiveness of the adverse parties' positions are approximately equal and (b) only one party can appeal further, a decision-making body will tend to rule against the party that has the opportunity to pursue such an appeal. This seems to be especially true when broad questions, such as Constitutional issues, are being decided. The Tax Section's concern has been that this will create the perception, whether valid or not, that the system lacks fairness because the Tribunal will decide close cases involving important tax principles against taxpayers. The Tax Section sees no reason why these considerations do not remain valid.

With the passage of time, however, some members of the Tax Section have come to believe that the existing process for adjudicating tax disputes before the Division of Tax Appeals has worked well and that the prohibition on the Department appealing adverse Tribunal decisions should not be changed. The primary concern of these members is that granting the Department an appeal right would create undue burdens on taxpayers that are not justified by the reasons asserted for granting the appeal right.

By the time a taxpayer's case has reached the Tribunal, the taxpayer (whether an individual or a corporation) will typically have gone through several stages of administrative proceedings, including an audit by the Department, a protest before the Department's Bureau of Conciliation and Mediation Services, and a hearing before an administrative law judge at the Division of Tax Appeals. These proceedings frequently take years to resolve and often require taxpayers to expend significant resources. If the proposed amendment is adopted, the Department would have the power to extend the litigation process beyond these proceedings, not just to the New York State Supreme Court, Appellate Division, Third Department, but potentially to the New York State Court of Appeals. Those Tax Section members who oppose granting the Department an appeal right are concerned that a large segment of the taxpayer community will be unable to endure an extended litigation process due to financial, time or other resource constraints, or even because the taxpayer does not have the psychological stamina to proceed.

In this regard, the potential imbalance in "staying power" between the government and taxpayers should be considered, as should the legislative history behind the 1986 legislation creating the Tribunal. That legislative history makes it clear that the Tribunal was created primarily to benefit taxpayers by, among other thing, establishing an independent adjudicative body and providing for a "rapid" system for resolving tax dispute. *See* Memorandum of State Executive Department, L.1986, c.282 at 2898-2899 (July 19, 1986). Permitting the Department to extend litigation beyond the Tribunal arguably goes against the purpose of the 1986 legislation.

In light of the above, those Tax Section members opposing the appeal right question whether the justifications set forth in the Memorandum in Support of the Article VII Legislation justify changing the current system. According to the Memorandum in Support, the Department should be granted the right to appeal adverse Tribunal decisions because "[j]udicial review presents the quickest and most efficient method of reaching finality: in the absence of judicial review, the Department's only recourse is to seek legislation to reverse significant Tribunal decisions with which the Department disagreed as a matter of law." Those Tax Section members who do not support providing the Department with the proposed appeal right find the assertion that judicial review is quicker and more efficient to be dubious. The judicial appeal process can take years to complete, whereas the Department has routinely succeeded in quickly persuading the legislature to adopt legislation—often retroactive in nature—to overturn Tribunal decisions with which it disagrees.[3] The Department has also been successful in overturning, through legislation, adverse decisions of the very judicial courts that it now says it must be permitted to appeal to for redress when the Tribunal issues a decision with which it disagrees.[4]

We also note that the Department has successfully utilized the Tribunal's rehearing process to convince the Tribunal to overturn its own decisions. The rehearing process permits a party to a proceeding before the Tribunal, including the Department, to file a motion with the Tribunal to reargue its case. In recent times, the Department has used the rehearing process to demonstrate to the Tribunal that its original decision misapprehended important issues of fact or law.[5] Currently, the Department has moved to reargue the two September 2017 decisions regarding the non-discrimination clause of the United State-Germany 1989 Tax Treaty that are referenced in the Memorandum in Support as further support for permitting the Department to appeal adverse Tribunal decisions. In this regard, the Memorandum in Support inaccurately

[3] Recent examples include legislation to retroactively overturn the Tribunal's decisions in *Matter of Baum*, Tax Appeals Trib. (Feb. 12, 2009) and *Matter of Weber*, Tax Appeals Trib. (Aug. 25, 2016).

[4] *See, e.g.*, *Tenn. Gas Pipeline v. Urbach*, 96 N.Y.2d 124 (2001).

[5] *See e.g.*, *Matter of Gaied*, Tax Appeals Trib. (June 16, 2011).

states that “judicial review is the only avenue for seeking reversal of [these] adverse opinion[s].”

While the majority of the Tax Section supports granting the Department an appeal right, it also acknowledges the validity of the concerns of those who believe that providing such an appeal right will impose an undue burden on taxpayers, especially those with limited resources and/or limited tax amounts at issue in a particular case. Several approaches to addressing these concerns have been raised since the early 1980s. Among the proposals (some of which are not mutually exclusive of some others) that should be considered are:

1. Provide the Division of Taxation the right to seek leave to appeal from the Appellate Division, Third Department, based on specified criteria (i.e., the Division would need permission from the Third Department before being permitted to proceed with the appeal).

2. Require the Department to reimburse the taxpayer’s reasonable litigation costs if the Department is unsuccessful in its appeal.

3. Provide that the Attorney General must approve of the Division of Taxation’s request to appeal and provide written justification as to why: (1) an appeal is in the best interest of the State; and (2) imposing the litigation burden on the particular taxpayer is warranted.

4. Provide a mechanism by which the Division of Taxation may move the Tax Appeals Tribunal to render its decision non-precedential (similar to “unpublished decisions” in many states), rather than appeal.

5. Provide that the Division of Taxation may appeal an adverse Tax Appeals Tribunal decision only where either the dollar amount at issue exceeds a certain threshold and/or the taxpayer’s net worth exceeds a certain threshold.

It is important to note that virtually all of these approaches would require a change to the current Article 78 principles and procedures since Article 78 is the codification of the common law proceedings for mandamus, prohibition, and certiorari, which are proceedings against the government since if the Division of Taxation has the right to undertake an appeal, the situation would be one where the government is proceeding against a taxpayer. We believe that these present mere "mechanical" issues that can be addressed by relatively simple legislation.

## V. Part O: Clarify New York Residency Requirements for Tax Purposes

The Budget Bill proposes to amend the definition of a New York State and New York City "resident individual" under Tax Law §§ 605(b)(1)(B) and 1305(a) for personal income tax purposes.

### A. Current Law

In addition to most individuals domiciled in the state, the Tax Law currently defines a "resident individual" to include someone "***who is not domiciled in this state but*** maintains a permanent place of abode in this state [city] and spends in the aggregate more than one hundred eighty-three days of the taxable year in this state [city]."[6] This is commonly referred to as the "statutory residency" test. The highlighted language was the subject of a 2015 Order from New York's Division of Tax Appeals in *Matter of Sobotka*.[7] In *Sobotka*, an Administrative Law Judge determined that days spent in New York during the part of a tax year when the taxpayer was domiciled in New York could not be counted toward the 183-day limit found in Tax Law §§ 605(b)(1)(B) and 1305(a)(2).

[6] Tax Law §§ 605(b)(1)(B) and 1305(a)(2). Other than the geographic descriptors, the language in the Tax Law sections applicable to state and city statutory residency is identical.

The underlying bases for this ruling were (1) the plain language in Tax Law §§ 605(b)(1)(B) and 1305(a)(2) stating that statutory residency test applies only to an individual "who is not domiciled in the state" and (2) the legislative history of a 1922 amendment to the Tax Law section defining resident individuals (Tax Law former §350(7)).

The Department claimed it has historically counted all days an individual is present in New York during a given tax year—regardless of whether that individual is a part-year domiciliary of New York—to determine whether that individual is a statutory resident. In the *Sbotka* decision, the Division of Tax Appeals held that the Department's interpretation was inconsistent with the language of the statute and was not supported by the legislative history.

**B. Proposed Changes**

The Budget Bill proposes two changes to Tax Law §§ 605(b)(1)(B) and 1305(a)(2). First, it eliminates the language highlighted above, ridding the statute of the requirement that an individual not be domiciled in the state [city] to meet the definition of a statutory resident. Second, it adds language stating that an individual who meets the two-pronged requirement of statutory residency (maintenance of a permanent place of abode plus more than 183 days spent in New York) is a resident individual "whether or not domiciled in this state for any portion of the taxable year."

The Budget Bill would make these changes effective prospectively and retroactively to all taxable years for which the statute of limitations for seeking a refund or assessing additional tax is still open.

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[7] *Matter of Sobotka*, New York Division of Tax Appeals, Administrative Law Judge (DTA No. 826286), August 20, 2015.

### C. Comments

The Court of Appeals has twice held (in *Gaied v. N.Y. Tax Appeals Tribunal* and *Tamagni v. Tax Appeals Tribunal of the State of New York*[8]) that the legislative history of the statutory residency provision was to tax as residents those individuals who "for all intents and purposes" were residents of New York State, but claimed domicile elsewhere. While we take no position on whether the Legislature should amend the Tax Law's statutory residency provisions to reject the analysis of the administrative law judge in *Sobotka*, we note that the proposed amendment would have the effect of taxing individuals as full-year residents of New York when they are "for all intents and purposes" only part-year residents.

Such results would, arguably, also be inconsistent with the Court of Appeals decision in *Gaied*. In *Gaied*, the Court of Appeals noted that "[t]he legislative history of the statute, to prevent tax evasion by New York residents, as well as the regulations, support the view that in order for a taxpayer to have maintained a permanent place of abode in New York, the taxpayer must, himself, have *a residential interest* in the property." The proposed law change here would do nothing to address this issue. In the above example, the proposed law change would result in Iris being taxed as a full-year resident, despite the fact that she did not, under the Court of Appeals decision in *Gaied*, have a "residential interest" in her New York property for nearly half of the year.

It is also worth noting that, in recent years, there have been bills introduced that would ameliorate the impact of the statutory residency rules for taxpayers in circumstances similar to the taxpayer in *Matter of Barker*.[9] In *Barker,* the Department applied the statutory residency

[8] *Tamagni v. Tax Appeals Tribunal of the State of New York,* 695 N.E.2d 1125 (N.Y. 1998).

[9] *Matter of Barker,* Division of Tax Appeals, N.Y. Tax Appeals Tribunal (Docket No. 822324), January 13, 2011.

test mechanically, taxing Connecticut domiciliary Mr. Barker as a New York State resident. Though Mr. Barker spent well over 183 days in New York State, only about 15-20 days each summer were actually spent at his Hamptons abode, and the remainder were days spent in New York City where Mr. Barker worked as an investment banker, but had no living quarters whatsoever.

The Memorandum in Support of Part O of the Budget Bill suggests that the proposed amendment is needed to ensure that individuals are taxed if they are, "for all intents and purposes," residents of New York. If the Legislature is going to amend the definition of a statutory resident to address the *Sobotka* decision, it ought to consider a comprehensive revision to the statutory residency provisions so that taxpayers who clearly do not meet the "for all intents and purposes" test do not get caught up in the statutory resident net.

Some might argue that the Legislature could achieve both the original intent of the statutory-resident rules and avoid the possibility of untoward results, by drafting a proposed change that is more consistent with the "for all intents and purposes" test. For instance, the Legislature could adopt a pro-rated day count test for statutory residency to be applied to individuals who are domiciled in New York for less than all of the year in question. As applied to the Iris example, such a test might have allowed Iris to spend up to 90 days in New York during the non-domiciliary part of the tax year (July 5–December 31) before she became a statutory resident for that part of the tax year.

Finally, the changes proposed in Part O of the Budget Bill take effect immediately and apply to all tax years for which a statute of limitations for seeking a refund or assessing additional tax is still open. Absent compelling circumstances, changes to longstanding statutes should not be made retroactively applicable. Here, the only rationale for retroactive application would seem to be generating additional tax revenue, which is not, alone, a compelling justification. We appreciate the goal of revenue protection. But, retroactively-effective legislation, in addition to being susceptible to Constitutional challenges, is almost never good policy. Inasmuch as the current law fully comports with the legislative history of the current law, and the specific provision in question was tested by an August 2015 Division of Tax Appeals case that the Department chose not to appeal, retroactive application would not be good policy in this instance.

## VI. Part S: Defer Business Related Tax-Credit Claims

### A. Current Law

There is no current law, but a similar deferral regime was in effect for taxable years beginning on or after January 1, 2010 and ending on or before December 31, 2012. We note that the prior deferral of tax credits survived a constitutional challenge.[10]

### B. Proposed Changes

Under Part S of the Budget Bill, taxpayers would be required to defer the use and refund of certain business tax credits in excess of $2 million in taxable years beginning on or after January 1, 2018 and ending on or before December 31, 2020. The Budget Bill provides a formula to proportionately reduce each credit by a specified fraction with the result that the taxpayers are only able to use up to $2 million of credits in each taxable year. The total amount of credits deferred under the Budget Bill would be paid back to taxpayers (without interest) over tax years 2021, 2022 and 2023. The timing and amount of the repayment would depend on whether the credits are refundable or non-refundable under the current law. The credits subject to deferral would be expanded from those covered under the prior deferral

[10] *Empire Gen Holdings, Inc. v. Governor of NY*, 967 N.Y.S.2d 919 (Sup. Ct. Albany Cty. June 25, 2013).

regime and, would include brownfields, low-income housing, and historic tax credits, among others.

### C. Comments

Some of the tax credits that would be subject to the deferral are used to finance real estate developments across the state and function as an alternative to government issued bonds. We note that the proposed deferral of the tax credits would create uncertainty regarding the viability of tax credits as a financing tool and likely decreases their value, resulting in higher borrowing costs.

## VII. Part T: Amend the Refund and Joint Liability Provisions of the Real Estate Transfer Tax

### A. Current Law

Under section 1412 of the Tax Law, grantors and grantees claiming to have erroneously paid real estate transfer taxes are allowed to file a refund claim within two years from the date of payment. An additional tax is imposed under section 1402-a on the conveyance of residential real property for consideration of $1 million or more ("the mansion tax"). The mansion tax is imposed on the grantee, but if the grantee is exempt from the tax, the grantor becomes liable for the tax.

### B. Proposed Changes

Part T of the Budget Bill would extend the statute of limitations to three years for the filing of a refund claim. The bill would also make the grantor liable for the mansion tax when the grantee fails to pay the tax (not just when the grantee is tax exempt). If the grantor becomes liable, the grantor and grantee would be jointly and severally liable for the tax.

### C. Comments

The extension of the statute of limitations to file refund claims to three years is commendable. We believe that the three year refund period promotes fairness to taxpayers by putting the taxpayer and the Department on equal footing (because the Department has three years to assess additional tax). It also promotes procedural uniformity across the various other taxes, thus helping eliminate inadvertent mistakes by taxpayers regarding the timeliness of their refund claim.

We note, however, that the period for refund claims with respect to real property transfers pursuant to Articles 31-a through 31-G remains two years. For consistency purposes, we recommend that the statute of limitations under these Articles also be extended to three years.[11]

## VIII. Part X: Provide Responsible Person Sales Tax Relief for Minority LLC Owners

### A. Current Law

Section 1131(1) of the Tax Law defines the "persons required to collect tax" for New York State sales tax purposes. The provision imposes absolute liability for unpaid sales taxes of a partnership upon any member of the partnership without regard to whether the member is a general partner or a limited partner. The same clause also imposes absolute liability for unpaid sales taxes of a limited liability company upon any member of the limited liability company without regard to whether the member had any involvement in the financial affairs or management of the business. Unlike the liability imposed on directors, officers, employees or

[11] We note that New York City's statutes of limitations to request refunds of various local taxes is one year, whereas the statutes of limitations for audit purposes is three years. See, e.g., NYC Admin Code §§ 11-2108, 11-2116 (Real Property Transfer Tax); NYC Admin Code §§ 11-2507, 11-2517 (Hotel Room Occupancy Tax). We recommend that the legislature addresses the discrepancy between the statutes of limitation and extend the time to claim a refund to three years.

managers, there is no requirement that the partner or member be "under a duty to act" for the business in complying with the sales tax laws in order to be held liable.

This "strict liability" language is inconsistent with all other "responsible person" provisions of federal and state tax law as they apply to other forms of doing business (*e.g.*, corporations) and other types of trust fund taxes (withholding taxes). In all other cases, the liability is imposed only on those persons with "a duty to act" in assuring compliance with the laws for collection and paying over the trust fund taxes (sales taxes and withholding taxes).

The absolute liability imposed by the law is also in direct conflict with other provisions of New York law intended to encourage investment in limited liability companies and limited partnerships by protecting passive investors from the liabilities of the business. *See* Limited Liability Company Law §609(a) and New York Partnership Law §§ 121-303.

In Report #1035 (July 22, 2003), the Tax Section of the New York State Bar Association recommended amendment of section 1131(1) to correct what we believed was the unintended effect of amendment of the law in 1994 when New York adopted legislation permitting the creation of limited liability companies. If read strictly, the law imposes personal liability for all unpaid sales taxes on limited partners of a limited partnership and members of a limited liability company even if the limited partner or LLC member was merely a passive investor having no role in the operations of the business.

Since that report was published, there have been several legislative efforts to amend the law to remove the absolute liability provisions. In 2011, a departmental bill from the Department recommended an amendment to section 1131(1) to eliminate the language imposing absolute liability. However, after that effort stalled in the legislature, the Department issued Technical Memorandum TSB-M-11(17)S (Sept. 19, 2011) to provide some administrative relief from the harsh effects of the law. The TSB allows a limited partner or LLC member with less than a 50% ownership interest and who did not have a "duty to act" in assuring compliance with the sales tax laws, to settle his or her sales tax liability under the law by paying a percentage of the sales taxes owed (inclusive of statutory interest) equal to his or her percentage ownership in the business.

In 2015, Assemblyman Daniel Farrell, Chair of the New York State Assembly Ways and Means Committee., introduced Assembly Bill #1983, which proposed to amend the "responsible person" provisions of the sales tax law to make changes consistent with the recommendations made in Tax Section Report #1035. The bill was identical to the language drafted by the Department in 2011. The Tax Section submitted informal comments on Assembly Bill #1983 in which we agreed with the proposed language amending section 1131(1) to remove the absolute liability provisions. However, we objected to certain other provisions in the bill creating new and onerous registration reporting requirements as well as a provision doubling the statute of limitation for liability (from three years to six years) for anyone failing to comply with those reporting requirements. Our objections noted that the earlier (2011) Department concerns regarding identification of responsible persons likely no longer existed as a result of new questionnaires then being used by the Department to obtain responsible person information when a business registers to become a vendor for the collection of sales taxes. Assembly Bill 1983 was referred to the Assembly Ways & Means Committee, but never moved forward.

### B. Proposed Changes

The Budget Bill would amend section 1133(a)(2) of the Tax Law to essentially codify the Departmental policy set forth in TSB-M-11(17)S. That TSB has, as described above, provided some measure of relief to limited partners of a limited partnership and members of a limited liability company from the imposition of absolute liability for sales tax delinquencies owed by the partnership or limited liability company. Under that TSB, the limited partner or member may settle his or her sales tax liability by paying a percentage of the sales taxes owed (inclusive of statutory interest) equal to his or her percentage ownership in the business if the limited partner or member can demonstrate that he or she had a minority interest (less than 50%) in the business and had no "duty to act" in assuring compliance with the Tax Law. To qualify for relief, the Budget Bill adds the requirements that the person seeking relief cannot: (1) have acted on behalf of the limited partnership or limited liability company in complying with the sales tax laws; (2) have been convicted of a crime under the tax law; or (3) have a past-due tax liability. The Budget Bill does **not** propose any amendment to section 1131(1) to remove the "absolute liability" provisions that include within the definition of "persons required to collect tax" all partners in a limited partnership (including limited partners) and all members of a limited liability company even if they have no involvement in the financial affairs or management of the business.

### C. Comments

While we have commended the Department for extending administrative relief to limited partners and limited liability members who, under a strict reading of the current language of section 1131(1), have been found to have absolute liability for sales taxes owed, we continue to take the position that the TSB relief does not go far enough to address the unfairness of the statute. We continue to believe that section 1131(1) needs to be amended to remove the absolute liability language. If the LLC member or limited partner is merely a passive investor without any involvement in the business, he or she should have no "responsible person" liability for unpaid sales taxes. Sales tax liabilities are potentially some of the largest of the trust fund liabilities and even a very small percentage ownership interest can result in very large liabilities owed even under the relief provisions of the TSB. As accurately described in the "Justification" of Assembly Bill 1983, "[t]he existing language of the state law that creates personal liability in passive investors is not just grossly unfair, it could deter investment in New York State businesses."

While the codification of TSB-M-11(17)S would assure a permanency and an interpretive weight to the relief provision that does not currently exist in its form as a TSB-M (which is merely an informational statement of existing department policies and may be changed by the Department), it is disappointing that the Budget Bill does not seek to amend section 1131(1) and finally address the unfairness of imposing absolute liability for sales tax on mere investors in a business especially when there is no policy justification for the law, no consistency with similar federal or state "responsible person" provisions, and the law is in direct conflict with other provisions of New York law intended to limit liability of passive investors.

Furthermore, in contrast to the provisions of TSB-M-11(17) S, the Budget Bill adds the following requirements for relief:

> "[T]he commissioner may deny an application for relief to any such limited partner or member who the commissioner finds *has acted on behalf of such limited partnership or limited liability company in complying with any requirement of this article* or has been convicted of a crime provided in this chapter or *who has a past-due liability, as such term is defined in section one hundred seventy-one-v of this chapter."* (emphasis added).

We believe that the above wording creates some ambiguities. We do not believe that relief should be denied to a limited partner or limited liability company member who may become aware that there is a delinquency in the filing of sales tax returns or the payment of sales taxes by the business and attempts to intervene in some positive way to demand that the business become compliant with the Tax Law or make arrangements for payment of sales tax delinquencies. Under the above language, even a positive effort on the part of the limited partner or member to right the wrong could place them at risk for denial of relief. Perhaps a better way of expressing the above requirement would be:

> "has *acted on behalf of such limited partnership or limited liability company in* ***thwarting compliance*** *with any requirement of this article …."*

Similarly, the denial of relief to anyone "*who has a past-due liability, as such term is defined in section one hundred seventy-one-v of this chapter"* is overbroad and overly restrictive. Under section 171-v, the term "past-due liability" means "any tax liability or liabilities which have become fixed and final such that the taxpayer no longer has any right to administrative or judicial review." This means that any limited partner or member who owes even a single dollar of unpaid tax liability would not qualify.

This additional limitation represents a significant narrowing of the relief provided by TSB-M-11(17)S, though we understand it may be consistent with how the Department is currently administering the policy. In any event, while the Tax Section supports a more vigorous reworking of the statute to entirely remove the absolute liability language for LLC members and limited partners, we at a minimum recommend that the restriction on providing relief to individuals with other tax debts be reconsidered. In our view, the unfairness of holding minority, passive investors responsible for entity-level sales and use tax debts should be mitigated as a matter of good tax policy and administration.

## IX. Part AA: Internet Fairness Conformity Tax

Part AA of the Budget Bill proposes (i) a major change to the way sales and use taxes would be collected for sales made through so-called "marketplace providers" and (ii) a system whereby persons not required to collect tax in New York would be required to submit certain reports to New York State and to purchasers.

The marketplace proposal would shift the burden of collecting sales tax from the retailer to a "marketplace provider" that "facilitates sales of tangible personal property." It also has the effect of increasing the reach of New York's authority to require the collection of sales tax on online sales made by out-of-State sellers through marketplace providers with New York State nexus. Additionally, it would shift responsibility for the collection of sales tax for sales by an in-State seller to the marketplace provider in regard to particular sales.

The reporting proposal would require sellers and marketplace providers who are not required to obtain a certificate of authority to submit information returns with respect to sales to New York purchasers to New York State, as well as annual statements of purchases with notices that sales tax may be due to the purchasers.

## A. Current Law

### 1. *Marketplace Provider*

Under current law, the responsibility to collect and remit sales taxes on taxable in-State sales is limited to "vendors."[12] A vendor is defined as a person "making sales" that has a sufficient connection to New York State to require the vendor to collect and remit sales tax on sales to customers in the State.[13] In certain circumstances, an agent of the vendor can be treated as a "co-vendor," with joint responsibility for collecting and remitting the sales tax.[14] When sales tax is not collected by the vendor on a taxable sale, the purchaser is obligated to remit use tax with respect to the use of the purchased property. [15]

Because vendors are defined as the persons actually making sales, a party that merely facilitates a sale between a seller and a buyer through a physical or online marketplace forum is not a vendor and does not have tax collection responsibilities, even if such party has in-State nexus. The responsibility for collecting sales tax lies with the seller itself. Critically, an out-of-State seller that does not otherwise have nexus with New York does not create in-State nexus by selling goods through an online marketplace, and is not required to collect and remit sales tax on sales made through an online marketplace.[16] This does not relieve in-State purchasers from liability for use tax.[17] Use tax is generally acknowledged to be

[12] Tax Law §§ 1131(1), 1132(a)(1).

[13] Tax Law § 1101(b)(8).

[14] Tax Law § 1101(b)(8)(ii)(A).

[15] Tax Law § 1110.

[16] Tax Law §§ 1101(b)(8)(v)(A).

[17] Tax Law § 1110.

underreported.[18] Thus, in an effort to increase use tax compliance, in lieu of having purchasers compute the use tax on each individual purchase, New York offers a simplified method whereby residents can elect on their personal income tax return to pay an estimated aggregate use tax on all purchases costing less than $1,000 each, which estimate is based on the residents' taxable income.[19]

### 2. *Information Reporting*

Under current law, no information reporting requirements are imposed on sellers or on marketplace providers.

## B. Proposed Changes

### 1. *Marketplace Provider*

Part AA of the Budget Bill would alter the structure of current law by placing the burden of collecting tax on sales facilitated through an online or physical marketplace on the "marketplace provider." Under the proposal, a "marketplace provider" is defined as any person who "facilitates a sale of tangible personal property" by a "marketplace seller." A marketplace provider facilitates sales when it (i) "provides the forum" in which, or by means of which, the sale takes place and (ii) such person or an affiliate of such person either collects the receipts paid by a customer to a marketplace seller for the sale of tangible personal property or contracts with a third party to collect such receipts. A "forum" includes an internet website, catalog or similar forum or a physical forum, such as a "shop, store, or booth." Importantly, a

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[18] Memorandum in Support, Part AA (stating that the proposal will increase revenues by $80 million in 2019 and $159 million annually thereafter).

[19] Form IT201i, p. 26.

person who facilitates sales exclusively by means of the Internet is not a marketplace provider if its annual sales have been no more than one hundred million dollars for every calendar year after 2016. The proposal would take effect on September 1, 2018.

### 2. *Information Reporting*

Part AA of the Budget Bill would also require sellers and marketplace providers who are not required to obtain a certificate of authority to submit information returns to the Commissioner with respect to sales to New York purchasers, as well as annual statements of purchases with notices that sales tax may be due to the purchasers.

The first requirement applies to "non-collecting sellers" who are defined as persons who make sales of tangible personal property, are not required to obtain a certificate of authority in New York, and do not collect sales tax in regard to tangible personal property delivered to New York. A non-collecting seller is required, upon, request of the Commissioner, to provide to the Commissioner each New York purchaser's name and last known address, and the total of the non-collecting seller's receipts from purchases by the New York purchaser.

In addition, non-collecting sellers with receipts of five million dollars or more during the calendar year are required to file an annual information return with the Commissioner. The return must include the total of the non-collecting seller's receipts from sales of tangible personal property that are delivered to New York "together with such other information the Commissioner may prescribe." In addition, such non-collecting sellers are required to provide an annual statement of purchases to each New York purchaser for purchases of tangible personal property delivered to a location in New York. This document must include both a statement that sales or use tax was not collected and that the purchaser may be required to remit such tax directly to the Commissioner and a list of transactions entered into during the prior calendar year by the purchaser showing the date of each purchase, a description of the item purchased, and the amount paid for each item. Non-collecting sellers **over the $5 million threshold** are also required to prominently display a notice on all order forms and sales receipts (including screens that summarize the transaction prior to the completion of sale) stating that a purchaser may be required to submit tax directly to the State.

A separate requirement applies to "non-collecting marketplace providers," which are marketplace providers (as defined above, including the $100 million threshold embedded in the definition) who are not required to obtain a certificate of authority under the new requirements described above and who do not collect sales tax in regard to tangible personal property delivered to New York. Non-collecting marketplace providers are required to perform the requirements set forth above on behalf of a non-collecting seller for all sales they facilitate for such non-collecting sellers. Non-collecting marketplace providers are required to provide notice to each non-collecting seller for whom they facilitate sales of tangible personal property that states that the seller may be required to obtain a certificate of authority and informs the seller of information that the marketplace provider may provide to the Commissioner.

### C. Comments

At the outset we note that the Supreme Court has issued a writ of certiorari in the matter of *South Dakota v. Wayfair, Inc.*, No. 17-494, in which South Dakota has asked the Supreme Court to reconsider the sales-tax only physical presence nexus requirement established by *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). The Supreme Court's ultimate determination in this matter has the potential to fundamentally change the underlying constitutional jurisprudence that has resulted in New York's inability to directly impose sales tax on Internet sales. The proposals in Section AA of the Budget Bill, which appear designed to navigate around the constitutional constraints, may no longer be necessary. Given the possibility of change in the underlying federal law, we note that this is an unusual juncture for New York to propose the significant new changes set forth in the Budget Bill. We suggest that consideration be given to the *Wayfair* matter in connection with review of the proposals in the Budget Bill.

**1.** *Marketplace Provider*

The proposed approach in the Budget Bill would significantly alter nationwide practices as to the party responsible for collecting sales tax on sales facilitated through third parties.[20] The proposal would impose significant compliance obligations and potential tax liabilities on marketplace providers, parties whose sole role in the transaction is to facilities sales between two unrelated parties, and who may not be in a position to make determinations as to taxability. Under the proposal, this designation of collection responsibility is mandatory—if a marketplace provider facilitates sales, the marketplace provider will be responsible for sales tax compliance for those sales.[21] The Tax Section expresses no opinion on this provision as a policy matter, although we note that it would represent a substantial change.

The shifting of responsibility for collecting tax from the marketplace seller to the marketplace provider under the proposal appears to have two major effects. First, with respect to sellers that already have nexus in New York, it would appear to relieve them of the

[20] For states with similar statutes, see Minnesota H.F. 1 (2017) and Washington H.B. 2163 (2017).

[21] Budget Bill Part AA § 2.

responsibility of collecting sales tax and shift that responsibility to the marketplace provider.[22] Second, it appears to provide a mechanism for the collection of sales tax for sales by sellers that do not have any nexus with the State. The marketplace provider would be responsible for collecting and remitting the tax on sales made by both in-State and out-of-State sellers.

#### *i. Nexus*

We have not identified any obvious constitutional infirmity in placing the responsibilities set forth in the Budget Bill on marketplace providers, so long as the marketplace provider meets the statutory and constitutional nexus requirements with the State. Indeed, it may be analogized to imposing a sales tax collection responsibility on in-State co-vendors (discussed below).[23] We do, however, recommend that the Tax Law make clear that only marketplace providers with nexus to New York are required to collect sales tax. At a minimum, the law should provide that marketplace providers must have "a connection with the state which satisfies the nexus requirement of the United States constitution."[24]

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[22] We note that under the proposal, in order to be relieved of responsibility for collecting sales tax, the seller must obtain a "completed certificate of collection" from the marketplace provider which states that the marketplace provider will collect the sales tax. Budget Bill Part AA § 3.

[23] *See*, *e.g.*, TSB-A-86(13)S (N.Y.S. Dep't of Taxation & Fin., Mar. 26, 1986) (ruling that a household appliance telephone ordering service is responsible for collecting and remitting sales tax as a co-vendor on sales made on behalf of out-of-state suppliers).

[24] We note that under the Budget Bill, marketplace sellers that have nexus with New York must ascertain whether the marketplace provider has nexus in order to determine which party will bear tax collection responsibilities. If the marketplace provider has nexus with New York, the marketplace seller will be relieved of sales tax collection responsibilities with respect to those sales that it makes through the marketplace provider. However, if the marketplace provider does not have nexus with New York, sales tax collection responsibilities for those sales will remain with the marketplace seller.

As described above, we note that these nexus requirements may change depending on the U.S. Supreme Court's determination in the *Wayfair* matter. Based on current law, in order to satisfy constitutional requirements to be required to collect and remit sales tax on behalf of New York, a marketplace provider would need to have a non-de minimis physical presence in New York, either directly or through *Scripto/Tyler Pipe*-type agency or representative nexus. In *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), which will be revisited in *Wayfair*, the U.S. Supreme Court reaffirmed its decision in *National Bellas Hess, Inc. v. Dep't of Revenue*, 386 U.S. 753 (1967) establishing a "bright-line" physical presence rule under the Commerce Clause; under this bright-line rule a state can compel those out-of-state mail order sellers having a physical presence in the state to collect its use taxes, but cannot impose a collection obligation on those who do no more than communicate with customers in the state by mail or common carrier as part of an interstate business. Accordingly, a marketplace provider would have nexus with the State only if it has a physical presence in the state, such as if personnel of the marketplace provider are physically present in the State on a regular or systematic basis. While in-state physical presence is a necessary predicate to nexus, such in-state presence need not be "substantial;" rather, it need only be demonstrably more than the slightest presence.[25] For example, it is unclear whether merely having a server in the State would meet this nexus standard.

Nexus can also be established through attribution from independent contractors or agents under the U.S. Supreme Court decisions in *Scripto* and *Tyler Pipe*. In *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960), the Supreme Court held that regular solicitation of sales by independent contractors (and not employees) was sufficient to establish a sales and use tax

[25] *National Geographic Soc. v. California Bd. Of Equalization*, 430 US 551 (1977); *Orvis Co. v. Tax Appeal*

collection obligation by an out of state corporation with no physical presence in the state. Indeed, the Supreme Court has stated that "the crucial factor governing nexus is whether the activities performed in [the] state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in [the] state for the sales.'"[26]

In view of the above precedent, and in the absence of direct precedent regarding marketplace providers, the Tax Section does not take a position on the required nexus where the marketplace seller does not itself have nexus with the State, but raises it as an issue that should be considered and addressed in the legislation, or else by regulation, and notes that any such guidance may need to be revisited in light of the final determination in *Wayfair*. We also acknowledge the decision of the New York State Court of Appeals in *Amazon.com, LLC v. New York State Department of Taxation and Finance*,[27] in which the court found substantial nexus in the absence of actual physical presence.

#### *ii. Scope of Application*

The proposed reporting requirements are limited to sales of personal property. We note that for purposes of New York's sales and use tax, personal property includes computer software,[28] therefore bringing within the ambit of the marketplace provider provisions those online marketplaces that sell software applications and computer games. Prior versions of

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*Tribunal*, 86 N.Y.2d 165 (1995).

[26] *Tyler Pipe Indus., Inc. v. Washington State*, 483 U.S. 232 (1987) (quoting *Tyler Pipe Indus. v. Dep't of Revenue*, 105 Wash.2d 318, 323 (1986)).

[27] 20 N.Y.3d 586 (2013).

[28] 1101(b)(6)

proposed marketplace reporting requirements would also have included sales of occupancies or admissions, which are no longer covered by the current proposal.[29]

Under the proposed definition, an entity is a "marketplace provider" only if it collects the receipts paid by a customer. We understand that there are "peer-to-peer" online marketplaces where the buyer has the ability to pay the seller directly, resulting in the marketplace provider not collecting such receipts. It appears that such sales are excluded from the application of this section, especially in light of the deletion of language that has been present in former marketplace reporting proposals that provided that the term "marketplace provider" included organizations that arrange for exchange of messages between customers and sellers.[30]

We also understand that there are companies that create and manage websites that are branded in the name of the selling business, and may provide the types of services identified in the definition of a "marketplace provider." For example, in addition to creating a website for the seller, such companies may also collect the receipts from the seller's customers through the website and remit them to the seller. If the intent of the proposal is to treat as a "marketplace provider" an entity that facilitates sales through a website address that is specific to a single business, rather than a website address that identifies a marketplace, then we recommend that the proposal make that clear.

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[29] See Part X, 1/19/15 Budget Bill.

[30] See Part X, 1/19/15 Budget Bill.

### *iii. Physical Marketplaces*

In identifying the "forum" through which a marketplace provider facilitates a sale, the proposal also refers to a "shop, store, or booth" in addition to online marketplaces. We have struggled to identify a situation where a physical marketplace such as a store that does not already have tax collection responsibilities would meet the criteria specified in the statute.

We note that the exception for sellers that facilitate sales *exclusively* by means of the Internet applies only if the seller facilitated less than one hundred million dollars annually for every calendar year after 2016. We agree that the high threshold is appropriate here given the burden of compliance with the law. It is not clear to us why this exception would apply only to Internet websites and not to other retailers. For example, an Internet website that is under the threshold would immediately become a marketplace provider if it were to publish a catalogue.

### *iv. Other Matters*

The Budget Bill states that generally a seller would be relieved from its duties to collect tax if it has received in good faith a properly completed certificate of collection from the marketplace provider certifying its compliance. It then goes on to provide that the Commission may (i) develop a contractual provision or approve a contractual provision developed by the marketplace provider which, if included in the contract, will have the same effect as the certificate of collection and (ii) provide by regulation or otherwise that inclusion of such provision in the publicly available agreement between the marketplace provider and the marketplace seller will have the same effect as the certificate of collection. We note that this provision differs from the rules applicable for other sales tax exemptions. For example, a certificate of exemption must be obtained from a non-profit organization; it is not sufficient to recite in the contract that the organization is non-profit. We are unclear as to the meaning and scope of the prong requiring inclusion of the contractual provision in a publicly available agreement and suggest that this be clarified. We are concerned that requiring public availability of the commercial contract, including sensitive business terms, may dissuade parties from using this provision.

We note that the Budget Bill states that the Department may provide by regulation or otherwise that a seller will be relieved of duty to collect tax for sales facilitated by a marketplace provider only if such marketplace provider is not on a list on the department's website of marketplace providers whose certificates of authority have been revoked at the commencement of the applicable quarterly period. We are concerned about the potential burden on sellers of needing to check this list on such a frequent basis and would suggest that an annual period be considered.

### *v. Co-Vendor Approach*

One alternative to the Budget Bill's approach that could achieve the bill's apparent policy objectives would be to amend the law to permit a marketplace provider to be treated as a co-vendor under Tax Law § 1101(b)(8)(ii). Under existing law, the Department has the authority to treat any "salesman, representative, peddler or canvasser" as the seller's agent, and thus as jointly liable for collecting and remitting the sales tax.[31] By allowing the Commissioner to treat the marketplace provider as a co-vendor, the marketplace seller would remain the party primarily responsible for collecting and remitting the tax, but where the Commissioner determines it to would be efficient for administration of the tax, the marketplace

[31] Tax Law § 1101(b)(8)(ii).

provider could be held jointly responsible. Under this approach, whether or not a marketplace seller has New York nexus, the marketplace provider could be treated as responsible for collecting the sales tax upon reasonable notice by the Department.

2. *Information Reporting*

The proposed approach in the Budget Bill follows the general approach taken by Colorado in Colo. Rev. Stat. §39–21–112, which was the subject of litigation in *Direct Mktg. Assn. v. Brohl*, 814 F.3d 1129 (10th Cir. 2016), cert. denied, 580 U.S. 16-267. In that case the 10$^{th}$ Circuit held both that Colorado's law does not violate the dormant Commerce Clause because it does not discriminate against or unduly burden interstate commerce and that *Quill's* bright-line physical presence test did not extend beyond tax collection to information reporting. We note that the Budget Bill would expand the information reporting obligation not just to sellers but to marketplace providers; it has not been determined whether the rationale of *Direct Mktg. Assn.* would properly extend this obligation beyond sellers to marketplace providers as well.

*i. Privacy Concerns*

We have significant privacy concerns with the proposal in the Budget Bill. Under the proposal, the State would be entitled to request that each non-collecting seller or non-collecting marketplace provider furnish the Commissioner with a listing of the name of each New York purchaser and the total of the non-collecting seller's receipts from each purchaser. The mere fact that a purchaser has made a purchase from a particular website may be sensitive information that a purchaser may not want to disclose to the State. Similarly, in order for purchasers to obtain assistance from tax preparers in determining whether purchases are taxable (see below), they will need to share what may be sensitive information regarding the details of their purchases (even those of *de minimis* value) with their tax preparers.

*ii. Purchasers*

Under the proposal, the State would receive a listing with the name of each New York purchaser and the total of the non-collecting seller's receipts from each purchaser, but no information on the purchase itself or whether the purchase is taxable. This may result in a situation where the State makes inquiry of a purchaser with respect to potential tax due where the items purchased were not in fact taxable.

Similarly, the notice requirement applies to each sale of tangible personal property, whether taxable or not. The notices to the seller may accordingly be misleading: A seller would be required to submit a statement to a purchaser specifying that "the purchaser may be required to remit tax" even when the item sold to the purchaser is clearly not taxable.

For purchasers that use income estimates for computation of use tax as described above, the information provided on the notices will be irrelevant. Accordingly, consideration should be given to requiring the notices to explain the availability of this method so as to make purchasers aware that there is an alternative method to be used instead of adding up all purchases made and determining the taxability of each item.

*iii. Notices*

The requirement that repeated notices about use tax obligations be included by non-collecting sellers on all order forms, sales receipts, and screens summarizing transactions prior to completion seems to us to go too far. A single notice on the sales receipt and on the final screen commemorating the transaction would seem to suffice for this purpose.

With respect to the annual tax notice that must be provided by the marketplace provider to the seller, it is not clear to us why this should be, in the first instance, sent by mail. Email is the typical method of communication utilized by Internet vendors and the cost of mailing notices to sellers may be significant. We note that New York State does not send its own Forms 1099G by mail but instead delivers them by Internet download.[32]

[32] https://www.tax.ny.gov/pit/file/1099g.htm

**Technical Memorandum**
**TSB-M-18(2)C, (3)I**
Income Tax
Corporation Tax
**April 6, 2018**

# New York State Tax Treatment of Nonqualified Deferred Compensation

Federal Public Law 110-343 (the "Public Law") added § 457A to the Internal Revenue Code (IRC) to address the taxation of certain nonqualified deferred compensation attributable to services performed on or after January 1, 2009. For nonqualified deferred compensation to which IRC § 457A does not apply due solely to the fact that the amount deferred is attributable to services performed before January 1, 2009, the Public Law, Division C, § 801(d)(2) requires such deferrals, to the extent such amounts are not includable in gross income in a tax year beginning before January 1, 2018, to be included in gross income for federal tax purposes in the later of:

- the last tax year beginning before January 1, 2018; or
- the tax year in which there is no substantial risk of forfeiture of the rights to such compensation.

This memorandum addresses the New York State tax treatment of such amounts, and applies to:

- resident and nonresident individuals;
- sole proprietorships;
- partnerships (including limited liability companies [LLCs] and limited liability partnerships [LLPs] that are treated as partnerships for federal income tax purposes);
- estates and trusts; and
- Article 9-A taxpayers.

## Article 22 resident individuals

Under Tax Law § 611, the New York taxable income of a resident individual is the individual's New York adjusted gross income (NYAGI) less the individual's New York deductions and exemptions. The NYAGI of a resident individual is the individual's federal adjusted gross income (FAGI), taking into account any addition or subtraction modifications required under Tax Law § 612. For New York State income tax purposes, all nonqualified deferred compensation (including all appreciation and earnings related to such deferrals) that is required to be included in FAGI in a tax year in accordance with the Public Law, Division C, § 801(d)(2), must be included in NYAGI in that tax year, if the taxpayer is a New York resident in such year.

Resident taxpayers may be allowed a resident tax credit for any income sourced to and taxed by another state. See Form IT-112-R, *New York State Resident Credit*, for more information about this credit.

## Article 22 nonresident individuals

Under Tax Law § 601(e), nonresident individuals are subject to tax on taxable income derived from New York sources. The New York source income of a nonresident individual is the sum of the net amount of income, gain, loss, and deductions included in the individual's FAGI and derived from or connected with New York sources, taking into account any addition or subtraction modifications required under Tax Law § 612. New York source income includes income that is included in the nonresident individual's FAGI and is related to a business, trade, profession, or occupation previously carried on in the state, whether or not as an employee. See Tax Law § 631(b)(1)(F). This income includes nonqualified deferred compensation (including all appreciation and earnings related to such deferrals) that is required to be included in FAGI in a tax year in accordance with the Public Law, Division C, § 801(d)(2), if such compensation is related to a business, trade, profession, or occupation previously carried on in the state, whether or not as an employee.

The amount of such nonqualified deferred compensation that must be included in a nonresident's New York source income is determined as follows:

- If the business, trade, profession, or occupation was carried on wholly in New York State in the tax year the services were performed, the entire amount of nonqualified deferred compensation must be included in New York source income.

- If the business, trade, profession, or occupation was carried on wholly outside New York State in the tax year the services were performed, none of the nonqualified deferred compensation is included in New York source income.

- If the business, trade, profession, or occupation was carried on partly in and partly outside New York State during the tax year the services were performed, the amount of nonqualified deferred compensation to be included in New York source income is determined using the rules described below for:

    - an *employee*, if the nonresident performed the services as an employee; or

    - a *business*, if the nonresident was carrying on a business in New York State. For purposes of this memorandum, a *business* includes sole proprietorships and partnerships (including LLCs and LLPs that are treated as partnerships for federal income tax purposes). For the allocation rules for income earned as a nonresident shareholder of a New York S corporation, see *Taxation under Article 9-A* below.

## Services previously performed partly in and partly outside New York State

### Employee

If a nonresident individual is required to include nonqualified deferred compensation in FAGI in a tax year in accordance with the Public Law, Division C, § 801(d)(2), and such compensation relates to services performed as an employee in a previous tax year, the following method is used to determine the amount of such compensation that must be included in New York source income in the year such income is included in FAGI.

The individual computes a fraction:

- the numerator is the number of working days employed in New York during the tax year the services were performed; and

- the denominator is the total number of working days employed both in and outside New York during the tax year the services were performed.

Such fraction is multiplied by the amount of nonqualified deferred compensation (including all appreciation and earnings related to such deferrals) included in FAGI that relates to services performed as an employee in that tax year. See 20 NYCRR § 132.18.

If nonqualified deferred compensation (including all appreciation and earnings related to such deferrals) from services performed in more than one tax year is included in FAGI, these rules are applied separately for each tax year that such services were performed, and the aggregate amount of New York source income is reported on the individual's New York State nonresident income tax return for the tax year the taxpayer is required to include such nonqualified deferred compensation in FAGI for federal tax purposes.

For an employee who is a nonresident for the tax year the nonqualified deferred compensation is included in FAGI for federal tax purposes, but who was a resident for the tax year the services were performed, the amount that is included in New York source income is calculated using the same methodology described above. Taxpayers must maintain documentation to substantiate the allocation.

**Business**

If a nonresident individual is required for federal income tax purposes to include in FAGI any nonqualified deferred compensation (including all appreciation and earnings related to such deferrals) that:

- is related to services performed by the nonresident individual in a previous tax year as a sole proprietor; or

- is related to services performed by a partnership (including LLCs and LLPs that are treated as partnerships for federal income tax purposes) in a previous tax year,

then the nonresident individual's New York source income related to such nonqualified deferred compensation is determined using one of the following methods:

- If the books and records of the sole proprietorship or partnership, from the year the services were provided, adequately disclose and represent the proportion of the net amount of the items of income, gain, loss and deduction derived from or connected with New York sources, the total amount of items and net amount of such items for the tax year the services were provided may be used to determine the allocation. A partnership must report these amounts to the nonresident partner on Form IT-204-IP and must also complete item P on Form IT-204-IP.

- If the books and records of the sole proprietorship or partnership, from the year the services were performed, do not adequately disclose and represent the proportion of the net amount of the items of income, gain, loss and deduction derived from or connected with New York sources, the proportion of income that is attributable to New York sources is determined using the three factor formula described in 20 NYCRR 132.15(c), calculated by the sole proprietorship or partnership for the tax year the services were performed. A partnership must report these amounts to the nonresident partner on Form IT-204-IP and must also complete item P on Form IT-204-IP.

If the methods described above do not fairly and equitably allocate and apportion the items of income, gain, loss and deduction attributable to the partnership for a tax year, the department may prescribe an alternative method of allocation. A sole proprietor or partnership may also submit an alternative method of allocation, provided that the proposed method is thoroughly explained and disclosed on the taxpayer's income tax return. If the department approves the proposed allocation and apportionment, the method may be used in lieu of the methods described above. See 20 NYCRR 132.25.

If nonqualified deferred compensation (including all appreciation and earnings related to such deferrals) from services performed by a sole proprietor or a partnership in more than one previous tax year is included in a nonresident individual's FAGI, these rules are applied separately for each tax year that such services were performed. The aggregate amount of New York source income must be reported by a partnership to the nonresident partner, and must be reported on the nonresident individual's New York State nonresident income tax return, for the tax year the taxpayer is required to include such nonqualified deferred compensation in FAGI for federal tax purposes.

## Part-year residents

If an individual changes resident status during the tax year, the rules described in this memorandum under *Article 22 resident individuals* apply where the nonqualified deferred compensation (including all appreciation and earnings related to such deferrals) is properly reportable in the resident period of the tax year, and the rules described under *Article 22 nonresident individuals* apply where the nonqualified deferred compensation (including all appreciation and earnings related to such deferrals) is properly reportable in the nonresident period of the tax year.

## Nonresident and part-year resident estates and trusts

The rules described in this memorandum apply to nonresident estates and trusts and part-year resident trusts where the nonqualified deferred compensation (including all appreciation and earnings related to such deferrals) is includible in the federal income of the estate or trust.

## Yonkers nonresident earnings tax

The Yonkers nonresident earnings tax is imposed on wages and net earnings on self-employment attributable to a business, trade, profession, or occupation carried on in the city of Yonkers. Under the rules described in this memorandum, if an individual performed services in the city of Yonkers, the nonqualified deferred compensation (including all appreciation and earnings related to such deferrals) is allocated to Yonkers using the same rules that apply to nonresidents of New York State.

## Taxation under Article 9-A

For corporations taxable under Tax Law Article 9-A (including New York S corporations), nonqualified deferred compensation (including any appreciation and earnings related to such deferrals) that is includible in federal taxable income in accordance with the Public Law, Division C, § 801(d)(2), is considered business income under Article 9-A and is included in the apportionment factor under the rules in Tax Law § 210-A and the applicable regulations.

For a resident individual who is a shareholder of a New York S corporation, such individual's distributive share of nonqualified deferred compensation (including all appreciation and earnings related to such deferrals) from the S corporation that is required to be included in FAGI in a tax year in accordance with the Public Law, Division C, § 801(d)(2), must be included in NYAGI in that tax year.

A nonresident individual who is a shareholder of a New York S corporation determines the amount of such nonqualified deferred compensation derived from New York sources by applying the S corporation's business apportionment factor to such amounts included in New York adjusted gross income (see TSB-M-15(7)C, (6)I, *Impact of New York State Corporate Tax Reform on New York S Corporations and their Nonresident and Part-Year Resident Shareholders*).

However, if a nonresident individual who is a shareholder of a New York S corporation is required to include nonqualified deferred compensation in FAGI in a tax year in accordance with the Public Law, Division C, § 801(d)(2), and such compensation relates to services performed as an employee of the S corporation in a previous tax year, then the individual must instead use the method for employees to determine the amount of nonqualified deferred compensation related to that past employment that must be included in New York source income (see *Employee* on page 2).

**Note:** A TSB-M is an informational statement of existing department policies or of changes to the law, regulations, or department policies. It is accurate on the date issued. Subsequent changes in the law or regulations, judicial decisions, Tax Appeals Tribunal decisions, or changes in department policies could affect the validity of the information presented in a TSB-M.

# RELEARNING CORPORATE TRANSACTIONS


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**Report No. 1388**

**NEW YORK STATE BAR ASSOCIATION TAX SECTION**

**REPORT ON SECTION 965**

**February 6, 2018**

PLEASE SEE PANEL ONE MATERIALS
OR ACCESS REPORT 1388 ONLINE AT:

http://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Section_Reports_2018/1388_Report.html

**NEW YORK STATE BAR ASSOCIATION TAX SECTION**

**REPORT ON THE GILTI PROVISIONS OF THE CODE**

**May 4, 2018**

PLEASE SEE PANEL ONE MATERIALS
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Guidance under Section 965

Notice 2018-07

## SECTION 1. OVERVIEW

This notice announces that the Department of the Treasury ("Treasury Department") and the Internal Revenue Service ("IRS") intend to issue regulations for determining amounts included in gross income by a United States shareholder under section 951(a)(1) by reason of section 965 of the Internal Revenue Code ("Code") as amended by "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," P.L. 115-97 (the "Act"), which was enacted on December 22, 2017. Section 2 of this notice provides background on section 965. Section 3 of this notice describes regulations that the Treasury Department and the IRS intend to issue. Section 4 of this notice describes the effective dates of those regulations. Section 5 of this notice requests comments and provides contact information.

## SECTION 2. BACKGROUND

*.01 Treatment of Accumulated Post-1986 Deferred Foreign Income as Subpart F Income*

Section 965(a) provides that for the last taxable year of a deferred foreign income corporation ("DFIC") that begins before January 1, 2018 (such year of the DFIC, the "inclusion year"), the subpart F income of the corporation (as otherwise determined for such taxable year under section 952) shall be increased by the greater of (1) the accumulated post-1986 deferred foreign income of such corporation determined as of November 2, 2017, or (2) the accumulated post-1986 deferred foreign income of such corporation determined as of December 31, 2017 (each such date, a "measurement date," and the greater of the accumulated post-1986 deferred foreign income of the corporation as of the measurement dates, the "section 965(a) earnings amount"). Furthermore, under section 965(b)(1), the section 965(a) earnings amount which would otherwise be taken into account under section 951(a)(1) by a United States shareholder with respect to a DFIC is reduced by the amount of such United States shareholder's aggregate foreign E&P deficit which is allocated to such DFIC under section 965(b)(2). The section 965(a) earnings amount reduced as described in the preceding sentence is referred to in this notice as the "section 965(a) inclusion amount." Neither the section 965(a) earnings amount nor the section 965(a) inclusion amount is subject to the rules or limitations in section 952 or limited by the accumulated earnings and profits of the DFIC on the date of the inclusion.

*.02 Application of the Participation Exemption*

Section 965(c)(1) provides that there shall be allowed as a deduction for the taxable year of a United States shareholder in which a section 965(a) inclusion amount is included in the gross income of such United States shareholder an amount equal to the sum of (A) the United States shareholder's 8 percent rate equivalent percentage (as defined in section 965(c)(2)(A)) of the excess (if any) of (i) the section 965(a) inclusion amount, over (ii) the amount of such United States shareholder's aggregate foreign cash position, plus (B) the United States shareholder's 15.5 percent rate equivalent percentage (as defined in section 965(c)(2)(B)) of so much of such United States shareholder's aggregate foreign cash position as does not exceed the section 965(a) inclusion amount.

Section 965(c)(3)(A) provides that the term "aggregate foreign cash position" means, with respect to any United States shareholder, the greater of (i) the aggregate of such United States shareholder's pro rata share of the cash position of each specified foreign corporation of such United States shareholder determined as of the close of the inclusion year, or (ii) one half of the sum of (I) the aggregate described in clause (i) determined as of the close of the last taxable year of each such specified foreign corporation that ends before November 2, 2017, plus (II) the aggregate described in clause (i) determined as of the close of the taxable year of each such specified foreign corporation which precedes the taxable year referred to in subclause (I). Each date referred to in the preceding sentence is referred to in this notice as a "cash measurement date."

The cash position of any specified foreign corporation is the sum of (i) cash held by such corporation, (ii) the net accounts receivable of such corporation, and (iii) the fair market value of the following assets held by such corporation: (I) personal property which is of a type that is actively traded and for which there is an established financial market ("actively traded property"); (II) commercial paper, certificates of deposit, the securities of the Federal government and of any State or foreign government; (III) any foreign currency; (IV) any obligation with a term of less than one year ("short-term obligation"); and (V) any asset which the Secretary identifies as being economically equivalent to any asset described in section 965(c)(3)(B). Section 965(c)(3)(B). Also, for purposes of section 965(c), the term "net accounts receivable" means, with respect to any specified foreign corporation, the excess (if any) of (i) such corporation's accounts receivable, over (ii) such corporation's accounts payable (determined consistent with the rules of section 461). Section 965(c)(3)(C).

Section 965(c)(3)(D) provides that net accounts receivable, actively traded property, and short-term obligations shall not be taken into account by a United States shareholder in determining its aggregate foreign cash position to the extent that such United States shareholder demonstrates to the satisfaction of the Secretary that such amount is so taken into account by such United States shareholder with respect to another specified foreign corporation.

Section 965(c)(3)(F) provides that if the Secretary determines that a principal purpose of any transaction was to reduce the aggregate foreign cash position taken into account under section 965(c), such transaction shall be disregarded for purposes of section 965(c).

*.03 Definition of DFIC and Accumulated Post-1986 Deferred Foreign Income*

For purposes of section 965, a DFIC is, with respect to any United States shareholder, any specified foreign corporation of such United States shareholder that has accumulated post-1986 deferred foreign income (as of a measurement date) greater than zero. Section 965(d)(1). The term "accumulated post-1986 deferred foreign income" means the post-1986 earnings and profits of the specified foreign corporation except to the extent such earnings and profits (A) are attributable to income of the specified foreign corporation that is effectively connected with the conduct of a trade or business within the United States and subject to tax under Chapter 1 ("effectively connected income"), or (B) in the case of a controlled foreign corporation ("CFC"), if distributed, would be excluded from the gross income of a United States shareholder under section 959 ("previously taxed income"). Section 965(d)(2).

Section 965(d)(2) further provides that, to the extent provided in regulations or other guidance prescribed by the Secretary, in the case of any CFC that has shareholders that are not United States shareholders, accumulated post-1986 deferred foreign income shall be appropriately reduced by amounts which would be previously taxed income if such shareholders were United States shareholders.

Section 965(d)(3) provides that the term "post-1986 earnings and profits" means the earnings and profits of the foreign corporation (computed in accordance with sections 964(a) and 986, and by only taking into account periods when the foreign corporation was a specified foreign corporation) accumulated in taxable years beginning after December 31, 1986, and determined (A) as of the measurement date that is applicable with respect to such foreign corporation, and (B) without diminution by reason of dividends distributed during the inclusion year other than dividends distributed to another specified foreign corporation. Accordingly, under section 965(d)(3)(B), dividends paid by a specified foreign corporation in the inclusion year before a measurement date generally reduce the post-1986 earnings and profits of the corporation as determined on such measurement date, except for dividends paid to a person other than a specified foreign corporation (for example, a United States shareholder).

*.04 Specified Foreign Corporation*

Section 965(e)(1) provides that the term "specified foreign corporation" means (A) any CFC, and (B) any foreign corporation with respect to which one or more domestic corporations is a United States shareholder (10-percent corporation). For purposes of sections 951 and 961, a 10-percent corporation is treated as a CFC solely for purposes of taking into account the subpart F income of such corporation under section 965(a). Section 965(e)(2). However, if a passive foreign investment company (as defined in section 1297) with respect to the shareholder is not a CFC, then such corporation is not a specified foreign corporation. Section 965(e)(3).

*.05 Determinations of Pro Rata Share*

Section 965(f)(1) provides that the determination of any United States shareholder's pro rata share of any amount with respect to any specified foreign corporation shall be determined under rules similar to the rules of section 951(a)(2) by treating such amount in the same manner as subpart F income (and by treating such specified foreign corporation as a CFC).

*.06 Regulations or Other Guidance*

Section 965(o) provides that the Secretary shall prescribe such regulations or other guidance as may be necessary or appropriate to carry out the provisions of section 965, including regulations or other guidance to provide appropriate basis adjustments, and regulations or other guidance to prevent the avoidance of the purposes of this section, including through a reduction in earnings and profits, through changes in entity classification or accounting methods, or otherwise.

## SECTION 3. REGULATIONS TO BE ISSUED ADDRESSING THE APPLICATION OF SECTION 965

### *.01 Determination of Aggregate Foreign Cash Position*

(a) Allocation Between Multiple Inclusion Years

The Treasury Department and the IRS are aware that in cases where specified foreign corporations have inclusion years that end in or with different taxable years of the same United States shareholder, section 965 could result in double-counting such shareholder's aggregate foreign cash position for purposes of determining the shareholder's deduction under section 965(c). For example, assume USP, a calendar year taxpayer, wholly owns CFC1, which has an inclusion year ending December 31, 2017, and CFC2, which has an inclusion year ending November 30, 2018. In addition, assume that USP's pro rata share of the cash position of each of CFC1 and CFC2 on all relevant cash measurement dates is $100, with the result that USP's aggregate foreign cash position is $200. Under section 965(c), the amount allowed as a deduction in the taxable year of a United States shareholder for which the United States shareholder takes a section 965(a) inclusion amount into gross income is based on the aggregate foreign cash position of the United States shareholder. One interpretation of section 965(c) could result in the 15.5 percent rate equivalent percentage applying to as much as $400 of the aggregate section 965(a) inclusion amounts of CFC1 and CFC2 taken into account by USP, because USP's aggregate foreign cash position for its 2017 taxable year (in which CFC1's section 965(a) inclusion amount is taken into account) is $200 and its aggregate foreign cash position for its 2018 taxable year (in which CFC2's section 965(a) inclusion amount is taken into account) is also $200.

The Treasury Department and the IRS intend to issue regulations providing that in the case of a United States shareholder that has a section 965(a) inclusion amount in more than one taxable year, the aggregate foreign cash position taken into account in the first taxable year will equal the lesser of the United States shareholder's aggregate foreign cash position or the aggregate of the section 965(a) inclusion amounts taken into account by the United States shareholder in that taxable year. Furthermore, the amount of the United States shareholder's aggregate foreign cash position taken into account in any succeeding taxable year will be its aggregate foreign cash position reduced by the amount of its aggregate foreign cash position taken into account in any preceding taxable year.

Example. (i) Facts. USP, a domestic corporation, owns all of the stock of CFC1, a foreign corporation, which owns all of the stock of CFC2, also a foreign corporation. USP is a calendar year taxpayer. CFC1's inclusion year ends December 31, 2017, and CFC2's inclusion year ends November 30, 2018. The cash position of each of CFC1 and CFC2 on all relevant cash measurement dates is $200, with the result that USP has an aggregate foreign cash position of $400. For its 2017 taxable year, USP takes into account CFC1's section 965(a) inclusion amount of $300, and for its 2018 taxable year, USP takes into account CFC2's section 965(a) inclusion amount of $300.

(ii) Analysis. USP's aggregate foreign cash position taken into account in 2017 is $300, the lesser of USP's aggregate foreign cash position ($400) or the section 965(a) inclusion amount ($300) that USP takes into account in 2017. The amount of USP's aggregate foreign cash position taken into account in 2018 is $100, USP's aggregate foreign cash position ($400) reduced by the amount of its aggregate foreign cash position taken into account in 2017 ($300).

In addition, in cases in which, for example, a calendar year United States shareholder owns specified foreign corporations with inclusion years that end in or with different taxable years of the United States shareholder, at least one specified foreign corporation of such United States shareholder will have a final cash measurement date in 2017 (for example, December 31, 2017) and at least one other such specified foreign corporation will have a final cash measurement date in 2018 (for example, November 30, 2018). The Treasury Department and the IRS are aware that a United States shareholder in this situation may not be able to determine its aggregate foreign cash position for purposes of calculating its deduction under section 965(c) for its 2017 taxable year by the date that its return for such taxable year must be filed (including extensions).

For purposes of determining the aggregate foreign cash position of a United States shareholder for a taxable year in which it takes into account a section 965(a) inclusion amount, future regulations will provide that the United States shareholder can assume that its pro rata share of the cash position of any specified foreign corporation with an inclusion year ending after the date the return for such taxable year of such United States shareholder is timely filed (including extensions, if any) will be zero as of the cash measurement date with which the inclusion year ends. If a United States shareholder's pro rata share of the cash position of a specified foreign corporation was treated as zero pursuant to the preceding sentence, and the amount described in section 965(c)(3)(A)(i) in fact exceeds the amount described in section 965(c)(3)(A)(ii) with respect to such United States shareholder, the United States shareholder must make appropriate adjustments to reflect that the 15.5 percent rate equivalent percentage applies to a greater amount of the aggregate section 965(a) inclusion amounts taken into account. The Treasury Department and the IRS expect to issue future guidance regarding the appropriate method for making such an adjustment.

<u>Example</u>. (i) <u>Facts</u>. USP, a domestic corporation, owns all of the stock of CFC1, a foreign corporation, which owns all of the stock of CFC2, also a foreign corporation. USP is a calendar year taxpayer. CFC1's inclusion year ends December 31, 2017, and CFC2's inclusion year ends November 30, 2018. The cash position of CFC1 on each of December 31, 2015, December 31, 2016, and December 31, 2017, is $100. The cash position of CFC2 on each of November 30, 2015, and November 30, 2016, is $200. CFC1 has a section 965(a) inclusion amount.

(ii) Analysis. In determining its aggregate foreign cash position for its 2017 taxable year, USP may assume that its pro rata share of the cash position of CFC2 will be zero as of November 30, 2018, for purposes of filing its U.S. federal income tax return due on April 15, 2018 (or due on October 15, 2018, with extension). Therefore, USP's aggregate foreign cash position is treated as $300, which is the greater of (a) $300, 50% of the sum of USP's pro rata shares of the cash position of CFC1 as of December 31, 2015, and December 31, 2016, and of the cash position of CFC2 as of November 30, 2015, and November 30, 2016, and (b) $100, USP's pro rata share of the cash position of CFC1 as of December 31, 2017. If USP's pro rata share of the cash position of CFC2 as of November 30, 2018, in fact exceeds $200, which would result in USP's aggregate foreign cash position being greater than $300, USP must make appropriate adjustments to reflect a higher aggregate foreign cash position, under future guidance to be issued by the Treasury Department and the IRS.

(b) Treatment of Related-Party Transactions for Purposes of Determination of Cash Position

Net accounts receivables and short-term obligations between related specified foreign corporations may inflate the aggregate foreign cash position of a United States shareholder relative to the actual aggregate amount of liquid assets (other than the intercompany receivables) owned by the specified foreign corporations of the United States shareholder. For example, if a United States shareholder wholly owns two specified foreign corporations and one specified foreign corporation makes a short-term loan to the other specified foreign corporation, the borrowing corporation may invest the proceeds of such financing in illiquid assets or may spend the cash on operating expenses. The resulting intercompany receivable would be included in the United States shareholder's aggregate foreign cash position, notwithstanding that, if the specified foreign corporations were treated as a single corporation, the liquid assets of the specified foreign corporations would have been reduced by the amount of the borrowed proceeds.

Accordingly, for purposes of determining the cash position of a specified foreign corporation with respect to net accounts receivable and short-term obligations, the Treasury Department and the IRS intend to issue regulations providing that, with respect to a United States shareholder, any receivable or payable of a specified foreign corporation from or to a related specified foreign corporation will be disregarded to the extent of the common ownership of such specified foreign corporations by the United States shareholder.  For this purpose, a specified foreign corporation will be treated as related to another specified foreign corporation to the extent that the specified foreign corporations are related persons within the meaning of section 954(d)(3), substituting the term “specified foreign corporation” for “controlled foreign corporation” in each place that it appears.

(c) Treatment of Derivative Financial Instruments and Hedging Transactions for Purposes of Determination of Cash Position

Under section 965(c)(3)(B)(iii)(V), the Secretary may identify any asset as being economically equivalent to any asset described in section 965(c)(3)(B).  The Treasury Department and the IRS intend to issue regulations that address the treatment of derivative financial instruments for purposes of measuring the cash position of a specified foreign corporation.  Derivative financial instruments include notional principal contracts, options contracts, forward contracts, futures contracts, short positions in securities and commodities, and any similar financial instruments.  These regulations will provide that the cash position of any specified foreign corporation will include the fair market value of each derivative financial instrument held by the specified foreign corporation that is not a “bona fide hedging transaction” (as defined in this section 3.01(c)).  The Treasury Department and the IRS are considering whether future guidance should exclude derivative financial instruments that are not actively traded or that do not reference an asset described in section 965(c)(3)(B) (a “cash-equivalent asset”) from the definition of cash position.  The value of each derivative financial instrument that must be taken into account in determining the cash position of a specified foreign corporation may be positive or negative; however, the aggregate amount taken into account for all derivative financial instruments (excluding bona fide hedging transactions) of a specified foreign corporation cannot be less than zero. Furthermore, derivative financial instruments between related specified foreign corporations will be disregarded on the same terms as receivables and payables described in section 3.01(b) of this notice.

For purposes of this section 3.01(c), a bona fide hedging transaction means a hedging transaction that meets the requirements of a bona fide hedging transaction described in §1.954-2(a)(4)(ii) and that is properly identified as such in accordance with the requirements of that subparagraph. Consistent with the definition of a bona fide hedging transaction in §1.954-2(a)(4)(ii), in the case of an asset hedging transaction, the risk being hedged may be with respect to ordinary property, section 1231 property, or a section 988 transaction. Because the identification requirements of §1.954-2(a)(4)(ii) are generally relevant only to CFCs whereas section 965 applies to all specified foreign corporations, the Treasury Department and the IRS will provide guidance in the future on identifying bona fide hedging transactions of specified foreign corporations that are not CFCs.

If a derivative financial transaction is a bona fide hedging transaction that is used to hedge a cash-equivalent asset, the value of the cash-equivalent asset identified on the taxpayer's books and records as the asset being hedged must be adjusted by the fair market value of the bona fide hedging transaction that is used to hedge such cash-equivalent asset (such hedging transaction, a "cash-equivalent asset hedging transaction"). The value of a cash-equivalent asset hedging transaction must be taken into account in determining the cash position of a specified foreign corporation whether the cash-equivalent asset hedging transaction has positive or negative value, but only to the extent that the cash-equivalent asset hedging transaction (or transactions) does not reduce the fair market value of the asset being hedged below zero.

Finally, a bona fide hedging transaction with respect to an asset that is not a cash-equivalent asset or with respect to a liability (as described in §1.1221-2(b)(2)) is not included in a specified foreign corporation's cash position for purposes of section 965(c)(3)(B).

*.02 Determination of Accumulated Post-1986 Deferred Foreign Income*

(a) Adjustments to Post-1986 Earnings and Profits to Account for Certain Amounts Paid or Incurred Between Specified Foreign Corporations Between Measurement Dates

Certain transactions between specified foreign corporations may result in earnings and profits of a specified foreign corporation being taken into account more than once or not at all by a United States shareholder under section 965(a). In this regard, the Conference Report accompanying the Act states:

> In order to avoid double-counting and double non-counting of earnings, the Secretary may provide guidance to adjust the amount of post-1986 earnings and profits of a specified foreign corporation to ensure that a single item of a specified foreign corporation is taken into account only once in determining the income of a United States shareholder subject to this provision. Such an adjustment may be necessary, for example, when there is a deductible payment (e.g., interest or royalties) from one specified foreign corporation to another specified foreign corporation between measurement dates.

H.R. Rep. No. 115-466, at 619 (2017). Consistent with congressional intent, the Treasury Department and the IRS intend to issue regulations to address the possibility of double-counting or double non-counting in the computation of post-1986 earnings and profits arising from amounts paid or incurred (including certain dividends) between related specified foreign corporations of a United States shareholder that occur between measurement dates and that would otherwise reduce the post-1986 earnings and profits as of December 31, 2017, of the specified foreign corporation that paid or incurred such amounts. For purposes of this section 3.02(a), the term "related" has the same meaning as given in section 3.01(b) of this notice.

The following examples illustrate fact patterns involving double-counting or double non-counting that will be addressed by future regulations.

Example 1. (i) Facts. USP, a domestic corporation, owns all of the stock of CFC1, a foreign corporation, which owns all of the stock of CFC2, also a foreign corporation. USP, CFC1, and CFC2 have calendar year taxable years. On November 2, 2017, each of CFC1 and CFC2 has post-1986 earnings and profits of 100u. Neither CFC1 nor CFC2 has previously taxed income or effectively connected income for any taxable year, and therefore each of CFC1's and CFC2's accumulated post-1986 deferred foreign income is equal to such corporation's post-1986 earnings and profits. On November 3, 2017, CFC2 makes a deductible payment of 10u to CFC1. The payment does not constitute subpart F income. CFC1 and CFC2 have no other items of income or deduction.

(ii) Analysis. Absent any adjustments, on December 31, 2017, CFC1 has post-1986 earnings and profits of 110u (100u plus 10u income from the deductible payment), and CFC2 has post-1986 earnings and profits of 90u (100u minus 10u deductible expense). The section 965(a) earnings amount with respect to CFC1 would be 110u, the greater of 100u accumulated post-1986 deferred foreign income on November 2, 2017, and 110u accumulated post-1986 deferred foreign income on December 31, 2017, and the section 965(a) earnings amount with respect to CFC2 would be 100u, the greater of 100u accumulated post-1986 deferred foreign income on November 2, 2017, and 90u accumulated post-1986 deferred foreign income on December 31, 2017. Disregarding the intercompany deductible payment, CFC1 and CFC2 would have, in the aggregate, section 965(a) earnings amounts of 200u. However, taking the deductible payment into account, CFC1 and CFC2 would have, in the aggregate, section 965(a) earnings amounts of 210u, because the 10u of income from the deductible payment would increase the post-1986 earnings and profits of CFC1 as of December 31, 2017, but the 10u of deductible expense would not decrease the post-1986 earnings and profits of CFC2 as of November 2, 2017. Under regulations to be issued by the Treasury Department and the IRS, an adjustment would be made with the result that CFC1 and CFC2 would have, in the aggregate, section 965(a) earnings amounts of 200u.

Example 2. (i) Facts. Assume the same facts as in Example 1, except instead of a deductible payment to CFC1, CFC2 makes a 10u distribution on November 3, 2017. The distribution increases CFC1's post-1986 earnings and profits as of December 31, 2017, by 10u and reduces CFC2's post-1986 earnings and profits as of December 31, 2017, by the same amount under section 965(d)(3)(B).

(ii) Analysis. Similar to the analysis in Example 1, the section 965(a) earnings amount with respect to CFC1 would be 110u, and the section 965(a) earnings amount with respect to CFC2 would be 100u, resulting in aggregate section 965(a) earnings amounts of 210u. Under regulations to be issued by the Treasury Department and the IRS, an adjustment would be made with the result that CFC1 and CFC2 would have, in the aggregate, section 965(a) earnings amounts of 200u. For an additional rule relating to dividends paid by one specified foreign corporation to another specified foreign corporation, see section 3.02(b) of this notice.

Example 3. (i) Facts. Assume the same facts as in Example 1, except that CFC2 does not make a deductible payment to CFC1, and, between measurement dates, CFC2 accrues gross income of 20u from a person that is not related to CFC2, and CFC1 incurs a deductible expense of 20u to a person that is not related to CFC1.

(ii) Analysis. Absent any adjustments, on December 31, 2017, CFC1 has post-1986 earnings and profits of 80u (100u minus 20u deductible expense), and CFC2 has post-1986 earnings and profits of 120u (100u plus 20u gross income). The section 965(a) earnings amount with respect to CFC1 would be 100u, the greater of 100u accumulated post-1986 deferred foreign income on November 2, 2017, and 80u accumulated post-1986 deferred foreign income on December 31, 2017, and the section 965(a) earnings amount with respect to CFC2 would be 120u, the greater of 100u accumulated post-1986 deferred foreign income on November 2, 2017, and 120u accumulated post-1986 deferred foreign income on December 31, 2017. CFC1 and CFC2 have, in the aggregate, section 965(a) earnings amounts of 220u. The section 965(a) earnings amounts, in the aggregate, are 20u greater than in Example 1, notwithstanding that CFC1 and CFC2 have, in the aggregate, earned no additional income. However, the additional 20u of section 965(a) earnings amount does not arise from an amount paid or incurred between specified foreign corporations that are related. The regulations to be issued by the Treasury Department and the IRS will not adjust the aggregate section 965(a) earnings amounts of CFC1 and CFC2.

Example 4. (i) Facts. Assume the same facts as in Example 3, except that CFC2 also makes a deductible payment of 10u to CFC1 on November 3, 2017.

(ii) Analysis. Absent any adjustments, on December 31, 2017, CFC1 has post-1986 earnings and profits of 90u (100u minus 20u deductible expense plus 10u intercompany income from the deductible payment), and CFC2 has post-1986 earnings and profits of 110u (100u plus 20u gross income minus10u intercompany deductible expense). The section 965(a) earnings amount with respect to CFC1 would be 100u, the greater of 100u accumulated post-1986 deferred foreign income on November 2, 2017, and 90u accumulated post-1986 deferred foreign income on December 31, 2017, and the section 965(a) earnings amount with respect to CFC2 would be 110u, the greater of 100u accumulated post-1986 deferred foreign income on November 2, 2017, and 110u accumulated post-1986 deferred foreign income on December 31, 2017. Taking the intercompany deductible payment into account, CFC1 and CFC2 would have, in the aggregate, section 965(a) earnings amounts of 210u, because the 10u of income from the deductible payment would not increase the post-1986 earnings and profits of CFC1 as of November 2, 2017, but the 10u of deductible expense would decrease the post-1986 earnings and profits of CFC2 as of December 31, 2017. However, disregarding the intercompany deductible payment, CFC1 and CFC2 would have, in the aggregate, section 965(a) earnings amounts of 220u. Under regulations to be issued by the Treasury Department and the IRS, an adjustment would be made with the result that CFC1 and CFC2 would have, in the aggregate, section 965(a) earnings amounts of 220u.

(b) Determination of Amount of Diminution by Reason of Distributions to Specified Foreign Corporations

The post-1986 earnings and profits of a specified foreign corporation are reduced to reflect dividends distributed during the corporation's inclusion year to another specified foreign corporation ("the dividend reduction rule"). Section 965(d)(3)(B). As a result, a dividend paid by a specified foreign corporation to another specified foreign corporation (whether in an inclusion year or a prior taxable year, including a prior taxable year that includes a measurement date) generally reduces the corporation's post-1986 earnings and profits with respect to any measurement date that such dividend precedes.

The dividend reduction rule is intended to address the potential double-counting of the earnings and profits of the distributing specified foreign corporation in calculating the section 965(a) inclusion amounts taken into account by a United States shareholder with respect to the distributing specified foreign corporation and the distributee specified foreign corporation. (See Example 2 in section 3.02(a) of this notice illustrating double-counting arising from dividends paid between measurement dates notwithstanding the application of the dividend reduction rule.) To the extent that a portion of a distribution reduces the post-1986 earnings and profits of a distributing specified foreign corporation (for example, by reason of a reduction pursuant to section 312(a)(3)) in an amount in excess of the increase in the post-1986 earnings and profits of the distributee specified foreign corporation, such reduction would not relieve double-counting and thus would be inconsistent with the purpose of the rule.

Accordingly, the Treasury Department and the IRS intend to issue regulations to clarify that the amount by which the post-1986 earnings and profits of a specified foreign corporation is reduced under section 965(d)(3)(B) as a result of a distribution made to a specified foreign corporation in the inclusion year may not exceed the amount by which the post-1986 earnings and profits of the distributee corporation is increased as a result of the distribution.

(c) Determination of Accumulated Post-1986 Deferred Foreign Income in the Case of a Controlled Foreign Corporation with Non-United States Shareholders

In the case of a CFC that has shareholders that are not United States shareholders on a measurement date, the Treasury Department and the IRS intend to issue regulations providing that the accumulated post-1986 deferred foreign income of the CFC on such measurement date will be reduced by amounts that would be described in section 965(d)(2)(B) if such shareholders were United States shareholders. In such cases, the regulations will follow the principles of Revenue Ruling 82-16, 1982-1 C.B. 106, in order to determine the amounts by which accumulated post-1986 deferred foreign income is reduced.

Example. (i) Facts. USP, a domestic corporation, and FP, a foreign corporation unrelated to USP, have owned 70% and 30% respectively, by vote and value, of the only class of stock of FS, a foreign corporation, from January 1, 2016, until December 31, 2017. USP and FS both have a calendar year taxable year. FS had no income until its taxable year ending December 31, 2016, in which it had 100u of income, all of which constituted subpart F income, and USP included 70u in income with respect to FS under section 951(a)(1) for such year. FS earned no income in 2017. Therefore, FS's post-1986 earnings and profits are 100u as of both of the measurement dates.

(ii) Analysis. Because USP included 70u in income with respect to FS under section 951(a)(1), 70u of such post-1986 earnings and profits is previously taxed income and, if distributed, would be excluded from the gross income of USP under section 959. Thus, FS's accumulated post-1986 deferred foreign income would be reduced by 70u pursuant to section 965(d)(2)(B). Furthermore, the accumulated post-1986 deferred foreign income of FS is reduced by amounts that would be described in section 965(d)(2)(B) if FP were a United States shareholder, consistent with the principles of Revenue Ruling 82-16. Accordingly, FS's accumulated post-1986 deferred foreign income would be reduced by the remaining 30u of the 100u of post-1986 earnings and profits to which USP's 70u of section 951(a)(1) income inclusions were attributable. Accordingly, FS's accumulated post-1986 deferred foreign income is 0u (100u minus 70u minus 30u).

(d) Coordination Between Sections 959 and 965 in the Inclusion Year

The accumulated post-1986 deferred foreign income of a specified foreign corporation that is a CFC excludes earnings to the extent that they would, if distributed, be excluded from the gross income of a United States shareholder under section 959 (that is, previously taxed income). Section 965(d)(2)(B). Post-1986 earnings and profits of a specified foreign corporation are determined without diminution by reason of dividends distributed during the inclusion year, other than dividends distributed to another specified foreign corporation. Section 965(d)(3)(B).

In general, earnings and profits of a foreign corporation attributable to amounts which are, or have been, included in the gross income of a United States shareholder under section 951(a) are not again included in the gross income of such United States shareholder when distributed (or when they would but for section 959(a) be included under section 951(a)(1)(B)). Section 959(a). For purposes of applying section 959(a), a distribution from a foreign corporation is treated as attributable first to earnings and profits included in gross income under section 951(a)(1)(B), then to earnings and profits included in gross income under section 951(a)(1)(A), and then to other earnings and profits. Section 959(c). A distribution excluded from gross income under section 959(a) is treated, for purposes of Chapter 1, as a distribution which is not a dividend, except that such distributions immediately reduce earnings and profits. Section 959(d). Actual distributions are taken into account before amounts that would be included under section 951(a)(1)(B). Section 959(f)(2).

The Treasury Department and the IRS intend to issue regulations to clarify the interaction between the rules under sections 959 and 965 in the inclusion year of a DFIC and the taxable year of a United States shareholder of the DFIC in which or with which such inclusion year ends. Such regulations will describe the following steps for determining the section 965(a) inclusion amount of a DFIC, the treatment of distributions under section 959, and the amount of an inclusion under sections 951(a)(1)(B) and 956 with respect to a DFIC:

(1) First, the subpart F income of the DFIC is determined without regard to section 965(a), and the United States shareholder's inclusion under section 951(a)(1)(A) by reason of such amount is taken into account.

(2) Second, the treatment of a distribution from the DFIC to another specified foreign corporation that is made before January 1, 2018, is determined under section 959.

(3) Third, the section 965(a) inclusion amount of the DFIC is determined, and the United States shareholder's inclusion under section 951(a)(1)(A) by reason of such amount is taken into account.

(4) Fourth, the treatment of all distributions from the DFIC other than those described in step 2 is determined under section 959.

(5) Fifth, an amount is determined under section 956 with respect to the DFIC and the United States shareholder, and the United States shareholder's inclusion under section 951(a)(1)(B) is taken into account.

Example. (i) Facts. USP, a domestic corporation, owns all of the stock of CFC1, a foreign corporation, which owns all of the stock of CFC2, also a foreign corporation. USP, CFC1, and CFC2 all have taxable years ending December 31, 2017. As of January 1, 2017, CFC1 has no earnings and profits, and CFC2 has 100u of earnings and profits described in section 959(c)(3) that were accumulated in taxable years beginning after December 31, 1986, while CFC2 was a specified foreign corporation. On March 1, 2017, CFC1 earns 30u of subpart F income (as defined in section 952), and CFC2 earns 20u of subpart F income. On July 1, 2017, CFC2 distributes 40u to CFC1, and the exception described in section 954(c)(6)(A) applies to such distribution. On November 1, 2017, CFC1 distributes 60u to USP.

(ii) Analysis. (A) Application of section 959 without regard to section 965. USP determines its inclusion under section 951(a)(1)(A) without regard to section 965(a), which is 30u with respect to CFC1 and 20u with respect to CFC2 for their taxable years ending December 31, 2017. As a result of the inclusions under section 951(a)(1)(A), CFC1 and CFC2 increase their earnings and profits described in section 959(c)(2) by 30u and 20u, respectively.

(B) Distributions between specified foreign corporations before January 1, 2018. The distribution of 40u from CFC2 to CFC1 is treated as a distribution of 20u out of earnings and profits described in section 959(c)(2) (attributable to inclusions under section 951(a)(1)(A) that are not by reason of section 965(a)) and 20u out of earnings and profits described in section 959(c)(3).

(C) Section 965(a) inclusion amount. USP determines CFC1's and CFC2's section 965(a) inclusion amounts. Because there are no aggregate foreign E&P deficits to be allocated to CFC1 and CFC2, the section 965(a) inclusion amount of CFC1 and CFC2 equals the section 965(a) earnings amount with respect to CFC1 and CFC2, respectively.

(1) CFC1 section 965(a) earnings amount. The section 965(a) earnings amount with respect to CFC1 is 20u, the amount of its accumulated post-1986 deferred foreign income as of both November 2, 2017, and December 31, 2017, which is equal to 70u of post-1986 earnings and profits (30u earned and 40u attributable to the CFC2 distribution) reduced by 50u of previously taxed income described in section 959(c)(2) (30u earned and 20u attributable to the CFC2 distribution) under section 965(d)(2)(B). Under section 965(d)(3)(B), the post-1986 earnings and profits of CFC1 are not reduced by the 60u distribution to USP.

(2) CFC2 section 965(a) earnings amount. The section 965(a) earnings amount with respect to CFC2 is 80u, the amount of its accumulated post-1986 deferred foreign income as of both November 2, 2017, and December 31, 2017, which is equal to the amount of CFC2's post-1986 earnings and profits of 80u. For purposes of calculating CFC2's accumulated post-1986 deferred foreign income, CFC2 has no previously taxed income and therefore no adjustment is made under section 965(d)(2)(B). CFC2's 80u of post-1986 earnings and profits consists of 120u of earnings and profits that it earned, reduced by the 40u distribution to CFC1 under section 965(d)(3)(B). The amount of the reduction to the post-1986 earnings and profits of CFC2 for the 40u distribution is not limited by the rules described in section 3.02(b) of this notice because CFC1's post-1986 earnings and profits are increased by 40u as a result of the distribution. Furthermore, because the 40u distribution was made on July 1, 2017, which is prior to any measurement date, section 3.02(a) of this notice is not relevant.

(3) Effect on previously taxed income. CFC1 and CFC2 increase their previously taxed income described in section 959(c)(2) by their section 965(a) inclusion amounts taken into account by USP, 20u and 80u, respectively, and reduce their earnings and profits described in section 959(c)(3) by an equivalent amount.

(D) Distribution to United States shareholder. The distribution from CFC1 to USP is treated as a distribution of 60u out of the earnings and profits of CFC1 described in section 959(c)(2), which include earnings and profits attributable to the section 965(a) inclusion amount taken into account by USP.

*.03 Application of Section 961 to Amounts Treated as Subpart F Income Under Section 965*

Section 965(o) authorizes the Treasury Department and the IRS to issue regulations or other guidance to provide appropriate basis adjustments in order to carry out the provisions of section 965. In order to provide certainty regarding the application of the rules described in section 961 with respect to amounts included under section 965, the Treasury Department and the IRS intend to issue regulations providing that if a United States shareholder receives distributions from a DFIC during the inclusion year that are attributable to previously taxed income described in section 959(c)(2) by reason of section 965(a), the amount of gain recognized by the United States shareholder with respect to the stock of the DFIC under section 961(b)(2) will be reduced (but not below zero) by the section 965(a) inclusion amount.

*.04 Treatment of Affiliated Group Making a Consolidated Return For Purposes of Section 965*

Pursuant to the Secretary's authority under sections 965(o) and 1502, the Treasury Department and the IRS intend to issue regulations providing that, solely with respect to the calculation of the amount included in gross income by a consolidated group (as defined in §1.1502-1(h)) under section 951(a)(1) by reason of section 965(a), all of the members of a consolidated group that are United States shareholders of one or more specified foreign corporations will be treated as a single United States shareholder. Thus, for example, all members of a consolidated group that are United States shareholders will be treated as a single United States shareholder for purposes of determining the aggregate foreign cash position of the consolidated group and for purposes of taking such aggregate foreign cash position into account under section 965(c)(1).

These regulations will provide that, consistent with the consolidated return regulations (and notwithstanding the calculation of the amount described in the prior paragraph), appropriate adjustments, for example, adjustments under §1.1502-32 to the basis of the stock of each member that is a United States shareholder, will be made to reflect the impact of amounts included in gross income under section 951(a)(1) by reason of section 965(a), and the impact of other attributes of each member on this calculation, such as the ownership of E&P deficit foreign corporations by particular members and the cash position of specified foreign corporations held by particular members. These regulations will also provide that taxpayers must make appropriate adjustments reflecting minority ownership interests in a member of the consolidated group that are owned by a person that is not a member of the consolidated group.

*.05 Determination of Foreign Currency Gain or Loss under Section 986(c)*

The Treasury Department and the IRS intend to issue regulations providing that any gain or loss recognized under section 986(c) with respect to distributions of previously taxed income described in section 959(c)(2) by reason of section 965(a) will be diminished proportionately to the diminution of the taxable income resulting from section 965(a) by reason of the deduction allowed under section 965(c). <u>See</u> H.R. Rep. No. 115-466, at 620.

The adjustments with respect to section 986(c) must be made so as to apply solely with respect to distributions of previously taxed income described in section 959(c)(2) by reason of section 965(a). Accordingly, future regulations will also provide ordering rules for determining the portion of a distribution that will be treated as previously taxed income described in section 959(c)(2) by reason of section 965(a).

SECTION 4. EFFECTIVE DATES

Section 965 is effective for the last taxable years of foreign corporations that begin before January 1, 2018, and with respect to United States shareholders, for the taxable years in which or with which such taxable years of the foreign corporations end. The Treasury Department and the IRS intend to provide that the regulations described in section 3 of this notice are effective beginning the first taxable year of a foreign corporation (and with respect to United States shareholders, the taxable years in which or with which such taxable years of the foreign corporations end) to which section 965 applies. Before the issuance of the regulations described in this notice, taxpayers may rely on the rules described in section 3.

SECTION 5. REQUEST FOR COMMENTS AND CONTACT INFORMATION

The Treasury Department and the IRS request comments on the rules described in this notice. In addition, the Treasury Department and the IRS expect to issue additional guidance under section 965, and the Treasury Department and the IRS request comments on what additional guidance should be issued to assist taxpayers in applying section 965.

Written comments may be submitted to the Office of Associate Chief Counsel (International), Attention: Leni C. Perkins, Internal Revenue Service, IR-4549, 1111 Constitution Avenue, NW, Washington, DC 20224. Alternatively, taxpayers may submit comments electronically to Notice.comments@irscounsel.treas.gov. Comments will be available for public inspection and copying.

The principal author of this notice is Ms. Perkins of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact Ms. Perkins at (202) 317-6934 (not a toll free call).

Additional Guidance Under Section 965 and Guidance Under Sections 863 and 6038 in Connection with the Repeal of Section 958(b)(4)

Notice 2018-13

SECTION 1. OVERVIEW

This notice announces that the Department of the Treasury ("Treasury Department") and the Internal Revenue Service ("IRS") intend to issue regulations for determining amounts included in gross income by a United States shareholder under section 951(a)(1) by reason of section 965 of the Internal Revenue Code ("Code") as amended by "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," P.L. 115-97 (the "Act"), which was enacted on December 22, 2017. See Notice 2018-07, 2018-4 I.R.B. 317, for prior guidance issued under section 965. In addition, this notice provides guidance in connection with the repeal of section 958(b)(4) by the Act.

Section 2 of this notice provides background on section 965 and the repeal of section 958(b)(4) by the Act. Section 3 of this notice describes regulations that the Treasury Department and the IRS intend to issue with respect to section 965. Section 4 of this notice describes a modification that the Treasury Department and the IRS intend to make with respect to regulations under section 965 that were described in section 3.03 of Notice 2018-07. Section 5 of this notice provides guidance under section 863 in connection with the repeal of section 958(b)(4) by the Act and announces the IRS's intention to update the Instructions for Form 5471 as a result of such repeal. Section 6 of this notice describes the effective dates of the regulations and other guidance described in this notice. Section 7 of this notice requests comments and provides contact information.

## SECTION 2. BACKGROUND

### *.01 Treatment of Accumulated Post-1986 Deferred Foreign Income as Subpart F Income*

Section 965(a) provides that for the last taxable year of a deferred foreign income corporation ("DFIC") that begins before January 1, 2018 (such year of the DFIC, the "inclusion year"), the subpart F income of the corporation (as otherwise determined for such taxable year under section 952) shall be increased by the greater of (1) the accumulated post-1986 deferred foreign income of such corporation determined as of November 2, 2017, or (2) the accumulated post-1986 deferred foreign income of such corporation determined as of December 31, 2017 (each such date, a "measurement date," and the greater of the accumulated post-1986 deferred foreign income of the corporation as of the measurement dates, the "section 965(a) earnings amount").

The section 965(a) earnings amount is not subject to the rules or limitations in section 952 and is not limited by the accumulated earnings and profits of the DFIC as of the close of the inclusion year.

*.02 Determination of United States Shareholder's Section 951(a)(1) Inclusion By Reason of Section 965*

Section 965(b)(1) provides that, if a taxpayer is a United States shareholder with respect to at least one DFIC and at least one E&P deficit foreign corporation, then the portion of the section 965(a) earnings amount which would otherwise be taken into account under section 951(a)(1) by a United States shareholder with respect to each DFIC is reduced by the amount of such United States shareholder's aggregate foreign E&P deficit that is allocated to such DFIC. The portion of the section 965(a) earnings amount that is taken into account under section 951(a)(1) by a United States shareholder, taking into account the reduction described in the preceding sentence, is referred to in this notice as the "section 965(a) inclusion amount."[1]

*.03 Allocation of Aggregate Foreign E&P Deficit and Definition of E&P Deficit Foreign Corporation*

The aggregate foreign E&P deficit of any United States shareholder is allocated to each DFIC of the United States shareholder in an amount that bears the same proportion to such aggregate as (A) such United States shareholder's pro rata share of the section 965(a) earnings amount of each such DFIC bears to (B) the aggregate of

[1] In contrast to Notice 2018-07, this notice uses the term "section 965(a) inclusion amount" to refer to an amount included in the gross income of the United States shareholder with respect to a DFIC, rather than an amount of the DFIC.

such United States shareholder's pro rata shares of the section 965(a) earnings amounts of all DFICs of such United States shareholder.  Section 965(b)(2).  The term "aggregate foreign E&P deficit" means, with respect to any United States shareholder, the lesser of (I) the aggregate of such shareholder's pro rata shares of the specified E&P deficits of the E&P deficit foreign corporations of such shareholder or (II) the aggregate of such shareholder's pro rata shares of the section 965(a) earnings amounts of all DFICs of such shareholder.  Section 965(b)(3)(A)(i).

The term "E&P deficit foreign corporation" means, with respect to any taxpayer, any specified foreign corporation with respect to which such taxpayer is a United States shareholder, if, as of November 2, 2017, (i) such specified foreign corporation has a deficit in post-1986 earnings and profits, (ii) such corporation was a specified foreign corporation, and (iii) such taxpayer was a United States shareholder of such corporation.  Section 965(b)(3)(B).  The term "specified E&P deficit" means, with respect to an E&P deficit foreign corporation, the amount of such corporation's deficit in post-1986 earnings and profits as of November 2, 2017.  See section 965(b)(3)(C).  A specified foreign corporation that is a DFIC cannot also be an E&P deficit foreign corporation.  See H.R. Rep. No. 115-466, at 618 (2017) (Conf. Rep.) ("Deferred earnings of a U.S. shareholder are reduced (but not below zero) by the shareholder's share of deficits as of November 2, 2017, from a specified foreign corporation that is not a [DFIC] . . . .").

*.04 Application of the Participation Exemption*

Section 965(c)(1) provides that there shall be allowed as a deduction for the taxable year of a United States shareholder in which a section 965(a) inclusion amount is included in the gross income of such United States shareholder an amount equal to the sum of (A) the United States shareholder's 8 percent rate equivalent percentage (as defined in section 965(c)(2)(A)) of the excess (if any) of (i) the section 965(a) inclusion amount, over (ii) the amount of such United States shareholder's aggregate foreign cash position, plus (B) the United States shareholder's 15.5 percent rate equivalent percentage (as defined in section 965(c)(2)(B)) of so much of such United States shareholder's aggregate foreign cash position as does not exceed the section 965(a) inclusion amount.

Section 965(c)(3)(A) provides that the term "aggregate foreign cash position" means, with respect to any United States shareholder, the greater of (i) the aggregate of such United States shareholder's pro rata share of the cash position of each specified foreign corporation of such United States shareholder determined as of the close of the inclusion year, or (ii) one half of the sum of (I) the aggregate described in clause (i) determined as of the close of the last taxable year of each such specified foreign corporation that ends before November 2, 2017, plus (II) the aggregate described in clause (i) determined as of the close of the taxable year of each such specified foreign corporation which precedes the taxable year referred to in subclause (I). Each date referred to in the preceding sentence is referred to in this notice as a "cash measurement date."

The cash position of any specified foreign corporation is the sum of (i) cash held by such corporation, (ii) the net accounts receivable of such corporation, and (iii) the fair market value of the following assets held by such corporation: (I) personal property which is of a type that is actively traded and for which there is an established financial market; (II) commercial paper, certificates of deposit, the securities of the Federal government and of any State or foreign government; (III) any foreign currency; (IV) any obligation with a term of less than one year ("short-term obligation"); and (V) any asset which the Secretary identifies as being economically equivalent to any asset described in section 965(c)(3)(B). Section 965(c)(3)(B). For purposes of section 965(c)(3), the term "net accounts receivable" means, with respect to any specified foreign corporation, the excess (if any) of (i) such corporation's accounts receivable, over (ii) such corporation's accounts payable (determined consistent with the rules of section 461). Section 965(c)(3)(C).

*.05 Definition of DFIC and Accumulated Post-1986 Deferred Foreign Income*

For purposes of section 965, a DFIC is, with respect to any United States shareholder, any specified foreign corporation of such United States shareholder that has accumulated post-1986 deferred foreign income (as of a measurement date) greater than zero. Section 965(d)(1). The term "accumulated post-1986 deferred foreign income" means the post-1986 earnings and profits of the specified foreign corporation except to the extent such earnings and profits (A) are attributable to income of the specified foreign corporation that is effectively connected with the conduct of a trade or business within the United States and subject to tax under chapter 1 ("effectively connected income"), or (B) in the case of a controlled foreign corporation ("CFC"), if distributed, would be excluded from the gross income of a United States shareholder under section 959 ("previously taxed income"). Section 965(d)(2).

Section 965(d)(3) provides that the term "post-1986 earnings and profits" means the earnings and profits of the foreign corporation (computed in accordance with sections 964(a) and 986, and by only taking into account periods when the foreign corporation was a specified foreign corporation) accumulated in taxable years beginning after December 31, 1986, and determined (A) as of the measurement date that is applicable with respect to such foreign corporation, and (B) without diminution by reason of dividends distributed during the inclusion year other than dividends distributed to another specified foreign corporation.

*.06 Specified Foreign Corporation*

Section 965(e)(1) provides that the term "specified foreign corporation" means (A) any CFC and (B) any foreign corporation with respect to which one or more domestic corporations is a United States shareholder (10-percent corporation). For purposes of sections 951 and 961, a 10-percent corporation is treated as a CFC solely for purposes of taking into account the subpart F income of such corporation under section 965(a). Section 965(e)(2). However, if a passive foreign investment company (as defined in section 1297) with respect to the shareholder is not a CFC, then such corporation is not a specified foreign corporation. Section 965(e)(3).

*.07 Determination of Pro Rata Share*

Section 965(f)(1) provides that the determination of any United States shareholder's pro rata share of any amount with respect to any specified foreign corporation shall be determined under rules similar to the rules of section 951(a)(2) by treating such amount in the same manner as subpart F income (and by treating such specified foreign corporation as a CFC).

*.08 Repeal of Section 958(b)(4)*

Section 958 provides rules for determining stock ownership of a foreign corporation for purposes of sections 951 through 965. Section 958(b) provides, in relevant part, that section 318(a) (relating to the constructive ownership of stock) applies, subject to certain modifications, to the extent that the effect is to treat any United States person as a United States shareholder within the meaning of section 951(b) or to treat a foreign corporation as a CFC under section 957. Effective for the last taxable year of foreign corporations beginning before January 1, 2018, and each subsequent year of such foreign corporations, and for the taxable years of United States shareholders in which or with which such taxable years of foreign corporations end, the Act repeals section 958(b)(4). As in effect prior to repeal, section 958(b)(4) provided that subparagraphs (A), (B), and (C) of section 318(a)(3) were not to be applied so as to consider a United States person as owning stock which is owned by a person who is not a United States person. The subparagraphs of section 318(a)(3) generally attribute stock owned by a person to a partnership, estate, trust, or corporation in which such person has an interest (so-called "downward attribution"). For example, stock of a corporation owned by a person that owns 50 percent or more in value of the stock of another corporation is treated as owned by such other corporation. See section 318(a)(3)(C).

## SECTION 3. REGULATIONS TO BE ISSUED ADDRESSING THE APPLICATION OF SECTION 965

### *.01 Determination of Status of a Specified Foreign Corporation as a DFIC or an E&P Deficit Foreign Corporation*

The Treasury Department and the IRS intend to issue regulations providing that, for purposes of determining the status of a specified foreign corporation as a DFIC or an E&P deficit foreign corporation, it must first be determined whether the specified foreign corporation is a DFIC. If the specified foreign corporation meets the definition of a DFIC, it is classified solely as a DFIC and not also as an E&P deficit foreign corporation, even if such specified foreign corporation otherwise satisfies the requirements of section 965(b)(3)(B). If a specified foreign corporation does not meet the definition of a DFIC, the United States shareholder must then determine whether it is an E&P deficit foreign corporation. In some cases, as illustrated in Example 2, a specified foreign corporation may be classified as neither a DFIC nor an E&P deficit foreign corporation, despite having post-1986 earnings and profits greater than zero or a deficit in accumulated post-1986 deferred foreign income.

Example 1. (i) Facts. USP, a domestic corporation, owns all of the stock of FS, a foreign corporation. As of November 2, 2017, FS has a deficit in post-1986 earnings and profits of 150u. As of December 31, 2017, FS has 200u of post-1986 earnings and profits. FS does not have previously taxed income or effectively connected income for any taxable year.

(ii) Analysis. Because FS, a specified foreign corporation, does not have previously taxed income or effectively connected income for any taxable year, FS's accumulated post-1986 deferred foreign income is equal to its post-1986 earnings and profits. Because FS has accumulated post-1986 deferred foreign income as of December 31, 2017, FS is a DFIC. See section 965(d)(1). Accordingly, FS is not an E&P deficit foreign corporation.

Example 2. (i) Facts. USP, a domestic corporation, owns all of the stock of FS, a foreign corporation. As of both November 2, 2017, and December 31, 2017, FS has 100u of previously taxed income described in section 959(c)(2) and a deficit of 90u in earnings and profits described in section 959(c)(3), all of which were accumulated in taxable years beginning after December 31, 1986, while FS was a specified foreign corporation. Accordingly, as of both November 2, 2017, and December 31, 2017, FS has 10u of post-1986 earnings and profits.

(ii) Analysis. (A) Determination of status as a DFIC. For purposes of determining whether FS is a DFIC, a determination must be made whether FS has accumulated post-1986 deferred foreign income greater than zero as of either November 2, 2017, or December 31, 2017. Under section 965(d)(2), FS's accumulated post-1986 deferred foreign income is its post-1986 earnings and profits, except to the extent such earnings are effectively connected income or previously taxed income. Disregarding FS's 100u of previously taxed income, FS has a 90u deficit in accumulated post-1986 deferred foreign income as of both November 2, 2017, and December 31, 2017. Accordingly, FS does not have accumulated post-1986 deferred foreign income greater than zero as of either measurement date and therefore FS is not a DFIC.

(B) Determination of status as an E&P deficit foreign corporation. For purposes of determining whether FS is an E&P deficit foreign corporation, a determination must be made whether FS has a deficit in post-1986 earnings and profits as of November 2, 2017. As described in paragraph (i) of this Example 2, FS has 10u of post-1986 earnings and profits as of both November 2, 2017, and December 31, 2017. As a result, FS does not have a deficit in post-1986 earnings and profits as of November 2, 2017, and therefore FS is not an E&P deficit foreign corporation. Accordingly, FS is neither a DFIC nor an E&P deficit foreign corporation.

*.02 Alternative Method for Calculating Post-1986 Earnings and Profits*

The Act provides that the earnings and profits of a specified foreign corporation must be determined as of two measurement dates and "in accordance with sections 964(a) and 986." See section 965(a) and (d)(3). Consistent with this requirement, the Treasury Department and the IRS have determined that, for purposes of measuring the post-1986 earnings and profits of a specified foreign corporation as of a measurement date, the extent to which an item of income, deduction, gain, or loss is taken into account as of such measurement date must generally be determined under principles applicable to the calculation of earnings and profits, including the application of sections 312 and 964.

For purposes of determining whether a specified foreign corporation is a DFIC and for purposes of determining a DFIC's section 965(a) earnings amount, the actual post-1986 earnings and profits of the specified foreign corporation must be determined as of the close of both November 2, 2017, and December 31, 2017. In addition, for purposes of determining whether a specified foreign corporation is an E&P deficit foreign corporation and for purposes of determining the amount of the specified E&P deficit of an E&P deficit foreign corporation, the actual post-1986 earnings and profits (including a deficit) of the specified foreign corporation must be determined as the close of November 2, 2017.

However, the Treasury Department and the IRS recognize that it may be impractical for taxpayers to determine the post-1986 earnings and profits of a specified foreign corporation as of a measurement date that does not fall on the last day of a month. Therefore, the Treasury Department and the IRS intend to issue regulations providing that an election may be made to determine a specified foreign corporation's post-1986 earnings and profits as of a measurement date based on the amount of post-1986 earnings and profits (including a deficit) as of another date as provided in this section 3.02 (the “alternative method”).  If an election to use the alternative method is made, the amount of the post-1986 earnings and profits (including a deficit) of a specified foreign corporation (other than a specified foreign corporation with a 52-53-week taxable year described in §1.441-2(a)(1)) as of November 2, 2017, will equal the sum of (1) the corporation’s post-1986 earnings and profits as of October 31, 2017, and (2) the corporation’s annualized earnings and profits amount.  For this purpose, the term “annualized earnings and profits amount” means, with respect to a specified foreign corporation, the amount equal to the product of two (the number of days after October 31, 2017, and on or before the measurement date on November 2, 2017) multiplied by the daily earnings amount of the specified foreign corporation.  The term “daily earnings amount” means, with respect to a specified foreign corporation, the post-1986 earnings and profits (including a deficit) of the specified foreign corporation as of the close of October 31, 2017, that were earned (or incurred) during the specified foreign corporation’s taxable year that includes October 31, 2017, divided by the number of days that have elapsed in such taxable year as of the close of October 31, 2017.  A specified foreign corporation that does not have a 52-53-week taxable year described in

§1.441-2(a)(1) may not determine its post-1986 earnings and profits under the alternative method with respect to the measurement date on December 31, 2017.

In the case of a specified foreign corporation that has a 52-53-week taxable year described in §1.441-2(a)(1), an election may be made to use the alternative method to determine its post-1986 earnings and profits as of both measurement dates based on the amount of post-1986 earnings and profits (including a deficit) as of the closest end of a fiscal month to each measurement date consistent with the principles of the preceding paragraph. For example, if the closest end of a fiscal month of a specified foreign corporation that has a 52-53-week taxable year occurs after an applicable measurement date, the annualized earnings amount will be subtracted from (rather than added to) the post-1986 earnings and profits of the specific foreign corporation as of such fiscal month end. For a specified foreign corporation with a 52-53-week taxable year, in order to use the alternative method for any measurement date, the election must be made for both measurement dates.

The IRS intends to issue forms, publications, regulations, or other guidance that will specify the manner and timing of an election to use the alternative method.

Example. (i) Facts. FS, a foreign corporation, has a calendar year taxable year and as of October 31, 2017, FS has post-1986 earnings and profits of 10,000u, 3,040u of which were earned during the taxable year that includes October 31, 2017. An election is made for FS to determine its post-1986 earnings and profits under the alternative method.

(ii) Analysis. As of the close of October 31, 2017, 304 days have elapsed in the taxable year of FS that includes October 31, 2017. Therefore, FS's daily earnings amount is 10u (3,040u divided by 304), and FS's annualized earnings and profits amount is 20u (10u multiplied by 2). Accordingly, FS's post-1986 earnings and profits as of November 2, 2017, are 10,020u (its post-1986 earnings and profits as of October 31, 2017 (10,000u), plus its annualized earnings and profits amount (20u)).

*.03 Treatment of Deficits*

(a) Allocation of Deficits to Different Classes of Stock

For purposes of determining the amount of a United States shareholder's aggregate foreign E&P deficit, the aggregate of such shareholder's pro rata shares of the specified E&P deficits of the E&P deficit foreign corporations of such shareholder must be determined. Section 965(f)(1) provides that, in determining a United States shareholder's pro rata share of "any amount with respect to any specified foreign corporation," rules similar to section 951(a)(2) shall be applied. Section 1.951-1(e) provides guidance with respect to allocating subpart F income among multiple classes of stock but does not address deficits.

The Treasury Department and the IRS intend to issue regulations providing that, for purposes of determining a United States shareholder's pro rata share of the specified E&P deficit of an E&P deficit foreign corporation that has multiple classes of stock outstanding, the specified E&P deficit is allocated first among the shareholders of the corporation's common stock and in proportion to the value of the common stock held by such shareholders.

(b) Treatment of Hovering Deficits

The Conference Report accompanying the Act provides that "the amount of post-1986 earnings and profits of a specified foreign corporation is the amount of positive earnings and profits accumulated as of the measurement date reduced by any deficit in earnings and profits of the specified foreign corporation as of the measurement date, without regard to the limitation category of the earnings or deficit." H.R. Rep. No. 115-466, at 618. The Conference Report clarifies that, for this purpose, the term "deficit" includes a hovering deficit (as defined in §1.367(b)-7(d)(2)(i)), with the following example:

> For example, assume that a foreign corporation organized after December 31, 1986 has $100 of accumulated earnings and profits as of November 2, 2017, and December 31, 2017 . . . which consist of $120 general limitation earnings and profits and a $20 passive limitation deficit, the foreign corporation's post-1986 earnings and profits would be $100, even if the $20 passive limitation deficit was a hovering deficit.

Id. at 619. Consistent with the Conference Report, the Treasury Department and the IRS intend to issue regulations clarifying that all deficits related to post-1986 earnings and profits, including hovering deficits, are taken into account for purposes of determining the post-1986 earnings and profits (including a deficit) of a specified foreign corporation.

*.04 Determination of Aggregate Foreign Cash Position*

(a) Definitions for Determining Net Accounts Receivable

Section 965(c)(3)(C) does not define the term “accounts receivable” for purposes of the term “net accounts receivable.” The Treasury Department and the IRS intend to issue regulations providing that, for purposes of section 965(c)(3)(C), the term “accounts receivable” means receivables described in section 1221(a)(4), and the term “accounts payable” means payables arising from the purchase of property described in section 1221(a)(1) or 1221(a)(8) or the receipt of services from vendors or suppliers. Receivables that are treated as accounts receivable within the meaning of section 965(c)(3)(C)(i) will not also be treated as short-term obligations.

(b) Treatment of Demand Obligations

Section 965(c)(3)(B) provides that the “cash position” of a specified foreign corporation includes the fair market value of any short-term obligation. The Treasury Department and the IRS intend to issue regulations providing that, for purposes of determining a specified foreign corporation’s cash position, a loan that must be repaid on the demand of the lender (or that must be repaid within one year of such demand) will be treated as a short-term obligation, regardless of the stated term of the instrument.

*.05 Translation Rules*

(a) Comparison of Accumulated Post-1986 Deferred Foreign Income as of the Measurement Dates

Generally, determinations made under subtitle A of the Code must be made in a taxpayer's functional currency. See section 985(a). For purposes of determining the tax under subtitle A of the Code of any shareholder of a foreign corporation, the earnings and profits of such corporation must be determined in the corporation's functional currency. See section 986(b)(1). Accordingly, the Treasury Department and the IRS intend to issue regulations providing that, for purposes of determining the section 965(a) earnings amount of a specified foreign corporation, the accumulated post-1986 deferred foreign income of the specified foreign corporation as of each of the measurement dates must be compared in the functional currency of the specified foreign corporation. If the functional currency of a specified foreign corporation changes between the two measurement dates, the comparison must be made in the functional currency of the specified foreign corporation as of December 31, 2017, by translating the specified foreign corporation's earnings and profits as of November 2, 2017, into the new functional currency using the spot rate on November 2, 2017. For purposes of this notice, the term "spot rate" has the meaning described in §1.988-1(d).

(b) Determination of the Amount of Inclusion Under Section 951(a)(1) by Reason of Section 965

In the case of any United States person, the earnings and profits determined under section 986(b)(1) when distributed, deemed distributed, or otherwise taken into account are translated into U.S. dollars using the appropriate exchange rate for purposes of determining the tax on such earnings under subtitle A of the Code. See section 986(b)(2). Generally, except as provided in regulations, section 989(b) sets forth the appropriate exchange rate. In the case of an actual distribution of earnings and profits or an actual or deemed sale or exchange of stock in a foreign corporation treated as a dividend under section 1248, the appropriate exchange rate is the spot rate on the date such distribution or deemed dividend is included into income. Section 989(b)(1) and (2). In the case of subpart F income included in income by a United States shareholder under section 951(a)(1)(A), the appropriate exchange rate is the average exchange rate for the taxable year of the foreign corporation. Section 989(b)(3). Any amounts included in income under section 951(a)(1)(B) (inclusions under section 956) are treated for this purpose as distributions made on the last day of the taxable year for which such amounts were so included, and accordingly translated at the spot rate on the last day of such taxable year. Section 989(b).

In order to calculate the section 965(a) inclusion amount of a United States shareholder with respect to a DFIC, the United States shareholder’s pro rata shares of the section 965(a) earnings amounts of its DFICs and the specified E&P deficits of its

E&P deficit foreign corporations must be translated into U.S. dollars. The Treasury Department and the IRS have determined that the spot rate on December 31, 2017, is the appropriate exchange rate for purposes of translating these amounts, regardless of a specified foreign corporation's taxable year or the applicable measurement date, because it is the date on which a specified foreign corporation's post-1986 earnings and profits becomes fixed and immediately precedes the transition to the participation exemption under section 245A. Furthermore, a single spot rate on December 31, 2017, is more administrable for the IRS and less burdensome for taxpayers than the yearly average approach of section 989(b)(3) because under the yearly average approach, certain amounts required for the determination of the section 965(a) inclusion amount of a United States shareholder (for example, the United States shareholder's aggregate foreign E&P deficit) would not be determinable until the last closing of an inclusion year of a specified foreign corporation of the United States shareholder.

Accordingly, the Treasury Department and the IRS intend to issue regulations providing that the appropriate exchange rate under section 989(b) for translating the section 965(a) earnings amount will be the spot rate on December 31, 2017. The regulations will also provide that the spot rate on December 31, 2017, will apply for purposes of translating other amounts necessary for the application of section 965(b), including (1) translating a section 965(a) earnings amount into U.S. dollars in computing amounts described in section 965(b)(2)(A) and (B), (2) translating a specified E&P deficit into U.S. dollars in order to determine a United States shareholder's aggregate foreign E&P deficit under section 965(b)(3)(A), (3) translating a section 965(a) inclusion amount with respect to a DFIC (if such amount was reduced by an aggregate foreign E&P deficit under section 965(b)(1)) back into the functional currency of the DFIC for purposes of determining the previously taxed income of the DFIC, and (4) translating the portion of the U.S. dollar-denominated aggregate foreign E&P deficit allocated to a DFIC under section 965(b)(2) into the functional currency of the DFIC for purposes of determining its previously taxed income under section 965(b)(4)(A).

The regulations will also provide that, for purposes of section 986(c), foreign currency gain or loss with respect to distributions of previously taxed income described in section 959(c)(2) by reason of section 965 will be determined based on movements in the exchange rate between December 31, 2017, and the date on which such previously taxed earnings and profits are actually distributed.

Example. (i) Facts. As of November 2, 2017, and December 31, 2017, USP, a domestic corporation, owns all of the stock of CFC1, an E&P deficit foreign corporation with the "u" as its functional currency; CFC2, an E&P deficit foreign corporation with the "v" as its functional currency; CFC3, a DFIC with the "y" as its functional currency; and CFC4, a DFIC with the "z" as its functional currency. USP, CFC1, CFC2, CFC3, and CFC4 each have a calendar year taxable year. As of December 31, 2017, 1u=$1, .75v=$1, .50y=$1, and .25z=$1. CFC1 has a specified E&P deficit of 100u, CFC2 has a specified E&P deficit of 120v, CFC3 has a section 965(a) earnings amount of 50y, and CFC4 has a section 965(a) earnings amount of 75z.

(ii) Analysis. (A) For purposes of applying section 965(b), the section 965(a) earnings amount of each of CFC3 and CFC4 translated into U.S. dollars at the spot rate on December 31, 2017, is $100 (50y at .50y=$1) and $300 (75z at .25z=$1), respectively. Furthermore, USP's pro rata share of the section 965(a) earnings amounts, as translated, is $100 and $300, respectively, or 100% of each section 965(a) earnings amount.

(B) For purposes of applying section 965(b), the specified E&P deficit of each of CFC1 and CFC2 translated into U.S. dollars at the spot rate on December 31, 2017, is $100 (100u at 1u=$1) and $160 (120v at .75v=$1), respectively. Furthermore USP's pro rata share of each specified E&P deficit, as translated, is $100 and $160, respectively, or 100% of each specified E&P deficit. Therefore, USP's aggregate foreign E&P deficit is $260.

(C) For purposes of applying section 965(b), USP's aggregate foreign E&P deficit of $260 is allocated $65 to reduce the amount that USP would otherwise take into account under section 951(a)(1) by reason of section 965 with respect to CFC3 ($260 x ($100/$400)) and allocated $195 to reduce the amount that USP would otherwise take into account under section 951(a)(1) by reason of section 965 with respect to CFC4 ($260 x ($300/400)). After reduction under section 965(b)(1), the section 965(a) inclusion amount of USP with respect to CFC3 is $35 ($100 – $65) and the section 965(a) inclusion amount of USP with respect to CFC4 is $105 ($300 – $195). The previously taxed income of CFC3 and CFC4 resulting from the section 965(a) inclusion amounts included in gross income by USP, translated into the respective functional currencies of CFC3 and CFC4 at the spot rate on December 31, 2017, are 17.5y ($35 at .50y=$1) and 26.25z ($105 at .25z=$1), respectively.

(D) For purposes of determining the previously taxed income of each of CFC3 and CFC4 under section 965(b)(4)(A) as a result of the reduction to USP's section 965(a) inclusion amounts with respect to CFC3 and CFC4, the amounts of the aggregate foreign E&P deficit of USP are allocated to each of CFC3 and CFC4 under section 965(b)(2), which translated into the respective functional currencies of CFC3 and CFC4 at the spot rate on December 31, 2017, are 32.5y ($65 at .50y=$1) and 48.75z ($195 at .25z=$1), respectively.

(c) Determination of Cash Positions as of Cash Measurement Dates

The Treasury Department and the IRS intend to issue regulations providing that the cash position of a specified foreign corporation with respect to any cash measurement date must be expressed in U.S. dollars. Therefore, the amount of a United States shareholder's aggregate foreign cash position will be the greater of the U.S. dollar-denominated aggregate amounts on each cash measurement date described in section 965(c)(3)(A).

In determining the cash position attributable to net accounts receivable, the amount of accounts receivables and accounts payables (in each case, if not otherwise denominated in U.S. dollars) must be translated into U.S. dollars at the spot rate on the relevant cash measurement date. The fair market value of assets described in section 965(c)(3)(B)(iii) must also be determined in U.S. dollars on the relevant cash measurement date. For example, in the case of foreign currency, the fair market value will equal the currency amount translated at the spot rate on the relevant cash measurement date.

## SECTION 4. MODIFICATION TO RULE DESCRIBED IN SECTION 3.03 OF NOTICE 2018-07 RELATING TO DISTRIBUTIONS OF PREVIOUSLY TAXED INCOME

Section 3.03 of Notice 2018-07 announced that the Treasury Department and the IRS intend to issue regulations providing that if a United States shareholder receives distributions from a DFIC during the inclusion year that are attributable to previously taxed income described in section 959(c)(2) by reason of section 965(a), the amount of gain recognized by the United States shareholder with respect to the stock of the DFIC under section 961(b)(2) will be reduced (but not below zero) by the section 965(a) inclusion amount (the "gain-reduction rule"). Notice 2018-07 does not expressly apply the gain-reduction rule to distributions to a United States shareholder from an entity (an "upper-tier entity") that is not a DFIC (for instance, an E&P deficit foreign corporation) that has received distributions from a DFIC (a "lower-tier DFIC") attributable to previously taxed income described in section 959(c)(2) by reason of section 965(a). Moreover, Notice 2018-07 could be interpreted to provide that even when the upper-tier entity is a DFIC, the amount of gain recognized by the United States shareholder that is reduced by reason of the gain-reduction rule is limited solely to the section 965(a) inclusion amount of the United States shareholder with respect to the upper-tier entity, rather than also including the section 965(a) inclusion amount with respect to the lower-tier DFIC from which such upper-tier entity has received distributions attributable to previously taxed income described in section 959(c)(2) by reason of section 965(a).

The Treasury Department and the IRS intend to issue regulations that provide that the gain-reduction rule also applies to distributions received from a DFIC through a chain of ownership described in section 958(a). Specifically, regulations will provide that if a United States shareholder receives distributions through a chain of ownership described under section 958(a) from a DFIC during the inclusion year that are attributable to previously taxed income described in section 959(c)(2) by reason of section 965(a), the amount of gain recognized under section 961(b)(2) by the United States shareholder with respect to the stock or property of any entity in the ownership chain described in section 958(a) through which the distribution is made will be reduced (but not below zero) by the section 965(a) inclusion amount of the United States shareholder with respect to such DFIC. The gain-reduction rule will apply similarly to reduce the amount of gain that would otherwise be recognized under section 961(c) by any controlled foreign corporation in the ownership chain described in section 958(a) through which the distribution is made to a United States shareholder for purposes of determining the amount included under section 951(a)(1) in the gross income of the United States shareholder.

Example. (i) Facts. USP, a domestic corporation, owns all of the stock of CFC1, a specified foreign corporation that has no post-1986 earnings and profits (or deficit), and CFC1 owns all the stock of CFC2, a DFIC. USP is a calendar year taxpayer. CFC1 and CFC2 have inclusion years that end on November 30, 2018. The functional currency of CFC1 and CFC2 is the U.S. dollar. USP's adjusted basis in the stock of CFC1 is zero, and CFC1's adjusted basis in the stock of CFC2 is zero. On January 1, 2018, CFC2 distributes $100 to CFC1, and CFC1 distributes $100 to USP. USP has a section 965(a) inclusion amount of $100 with respect to CFC2. CFC2 has no other earnings and profits described in section 959(c)(1) or (2), other than earnings and profits described in section 959(c)(2) by reason of section 965(a).

(ii) Analysis. USP receives a distribution from CFC2, a lower-tier DFIC, through a chain of ownership described in section 958(a) during the inclusion year of CFC2 that is attributable to $100 of previously taxed income described in section 959(c)(2) by reason of section 965(a). The amount of gain that USP would otherwise recognize with respect to the stock of CFC1 under section 961(b)(2) and the amount of gain that CFC1 would otherwise recognize with respect to the stock of CFC2 under section 961(c) for purposes of determining CFC1's subpart F income is reduced (but not below zero) in each case by $100, USP's section 965(a) inclusion amount with respect to CFC2.

## SECTION 5. GUIDANCE IN CONNECTION WITH THE REPEAL OF SECTION 958(b)(4)

### *.01 Application of Section 863*

Section 863 and the regulations thereunder provide special rules for determining the source of certain items of gross income, including gross income from space and ocean activities and international communications income. Section 863(d) provides that, except as provided in regulations, any income derived from a space or ocean activity ("space and ocean income") by a United States person is sourced in the United States (such income, "U.S. source income") and that any space and ocean income derived by a foreign person is sourced outside the United States (such income, "foreign source income"). Regulations under section 863(d) include an exception from the statutory provision regarding space and ocean income derived by a foreign person if the foreign person is a CFC. Specifically, space and ocean income derived by a CFC is treated as U.S. source income, except to the extent that the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country. See §1.863-8(b)(2)(ii).

In the case of any United States person, 50 percent of any international communications income (as defined in section 863(e)(2)) is treated as U.S. source income and 50 percent of such income is treated as foreign source income. Section 863(e)(1)(A). Subject to certain exceptions, including exceptions set forth in regulations, international communications income derived by a foreign person is treated as foreign source income. Regulations under section 863(e) provide that international communications income derived by a CFC is treated as one-half U.S. source and one-half foreign source. See §1.863-9(b)(2)(ii).

As a result of the repeal of section 958(b)(4) by the Act, stock of a foreign corporation owned by a foreign person can be attributed to a United States person under section 318(a)(3) for purposes of determining whether such United States person is a United States shareholder of the foreign corporation and, therefore, whether the foreign corporation is a CFC. In other words, as a result of the repeal of section 958(b)(4), section 958(b) now provides for “downward attribution” from a foreign person to a United States person in circumstances in which section 958(b), before the Act, did not so provide. As a result, foreign corporations that were not previously treated as CFCs may be treated as CFCs.

The Treasury Department and the IRS have determined that, in light of the change to the constructive ownership rules in section 958(b), further study is necessary to determine whether it is appropriate for the source of income described in section 863(d) and (e) to be determined by reference to the status of the recipient as a CFC. Accordingly, for purposes of applying §§1.863-8 and 1.863-9, taxpayers may determine whether a foreign corporation is a CFC without regard to the repeal of section 958(b)(4) pending further guidance (which will be prospective, as described in section 6 of this notice).

*.02 Elimination of Form 5471 Filing Obligation for Certain Constructive Owners*

Pursuant to section 6038(a)(4), the IRS may require any United States person treated as a United States shareholder of a CFC to file an information return on Form 5471, "Information Return of U.S. Persons with Respect to Certain Foreign Corporations," with respect to its ownership in such CFC. For this purpose, a United States shareholder is defined in section 951(b), and the United States shareholder's ownership in a CFC is determined based on direct and indirect ownership under section 958(a) and constructive ownership under section 958(b). Under the Instructions for Form 5471 (Rev. Dec. 2017), a United States shareholder who owns stock in a CFC for an uninterrupted period of 30 or more days during the CFC's tax year and owned the stock on the last day of that year is a Category 5 Filer and must file Form 5471.

As discussed in section 5.01 of this notice, as a result of the Act, section 958(b) now provides for "downward attribution" from a foreign person under section 318(a)(3) to a United States person in circumstances in which section 958(b), before the Act, did not so provide. A United States shareholder's pro rata share of a CFC's subpart F income and the amount determined under section 956 that a United States shareholder is required to include in gross income, however, continue to be determined based on direct and indirect ownership of the CFC under section 958(a), which does not take into account such downward attribution.

The IRS intends to amend the Instructions for Form 5471 to provide an exception from Category 5 filing for a United States person that is a United States shareholder with respect to a CFC if no United States shareholder (including such United States person) owns, within the meaning of section 958(a), stock in such CFC, and the foreign corporation is a CFC solely because such United States person is considered to own the stock of the CFC owned by a foreign person under section 318(a)(3).

SECTION 6. EFFECTIVE DATES

Section 965 is effective for the last taxable years of foreign corporations that begin before January 1, 2018, and with respect to United States shareholders, for the taxable years in which or with which such taxable years of the foreign corporations end. The Treasury Department and the IRS intend to provide that the regulations described in sections 3 and 4 of this notice are effective beginning the first taxable year of a foreign corporation (and with respect to United States shareholders, the taxable years in which or with which such taxable years of the foreign corporations end) to which section 965 applies. Before the issuance of the regulations described in this notice, taxpayers may rely on the rules described in sections 3 and 4 of this notice.

The repeal of section 958(b)(4) is effective for the last taxable year of foreign corporations beginning before January 1, 2018, and each subsequent year of such foreign corporations and for the taxable years of United States shareholders in which or with which such taxable years of foreign corporations end. Taxpayers may rely on section 5.01 of this notice with respect to the last taxable year of foreign corporations beginning before January 1, 2018, and for the taxable years of United States shareholders in which or with which such taxable years of foreign corporations end, pending the issuance of further guidance (the application of which will be prospective). Before the change to instructions described in section 5.02 of this notice, taxpayers may also rely on the exception described in section 5.02 of this notice for the last taxable year of foreign corporations beginning before January 1, 2018, and each subsequent year of such foreign corporations and for the taxable years of United States shareholders in which or with which such taxable years of foreign corporations end.

## SECTION 7. REQUEST FOR COMMENTS AND CONTACT INFORMATION

The Treasury Department and the IRS request comments on the rules described in this notice. The Treasury Department and the IRS expect to issue additional guidance under section 965, and the Treasury Department and the IRS request comments on what additional guidance should be issued to assist taxpayers in applying section 965. In addition, comments are requested as to whether, in light of the repeal of section 958(b)(4), it would be appropriate for the Treasury Department and the IRS to reconsider the provisions of any form, publication, regulation, or other guidance that reference CFCs, and if so, what revisions may be appropriate.

Written comments may be submitted to the Office of Associate Chief Counsel (International), Attention: Leni C. Perkins, Internal Revenue Service, IR-4549, 1111 Constitution Avenue, NW, Washington, DC 20224. Alternatively, taxpayers may submit comments electronically to Notice.comments@irscounsel.treas.gov. Comments will be available for public inspection and copying.

The principal author of this notice is Ms. Perkins of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact Ms. Perkins at (202) 317-6934 (not a toll free call).

Additional Guidance Under Section 965; Guidance Under Sections 62, 962, and 6081 in Connection With Section 965; and Penalty Relief Under Sections 6654 and 6655 in Connection with Section 965 and Repeal of Section 958(b)(4)

Notice 2018-26

SECTION 1. OVERVIEW

This notice announces that the Department of the Treasury ("Treasury Department") and the Internal Revenue Service ("IRS") intend to issue regulations in connection with section 965 of the Internal Revenue Code ("Code") as amended by "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," P.L. 115-97 (the "Act"), which was enacted on December 22, 2017. For prior guidance issued under section 965, see Notice 2018-07, 2018-4 I.R.B. 317; Notice 2018-13, 2018-6 I.R.B. 341; and Rev. Proc. 2018-17, 2018-9 I.R.B. 384. In addition, this notice announces relief from estimated tax penalties in connection with the amendment of section 965 and the repeal of section 958(b)(4) by the Act.

Section 2 of this notice provides background on section 965 and other relevant provisions of the Code. Section 3 of this notice describes regulations that the Treasury Department and the IRS intend to issue in connection with section 965 and announces the IRS's intent to modify certain form instructions as a result of section 965. Section 4 of this notice describes a modification that the Treasury Department and the IRS intend to make with respect to regulations under section 965 that were described in section 3.04(a) of Notice 2018-13. Section 5 of this notice provides guidance under section 962 in connection with section 965. Section 6 of this notice provides guidance concerning the application of the estimated tax rules in sections 6654 and 6655 and a waiver from the penalty imposed under those sections with respect to estimated taxes in connection with section 965 and the repeal of section 958(b)(4). Section 7 of this notice describes the effective dates of the regulations and other guidance described in this notice, as well as a clarification to the effective date provided in section 6 of Notice 2018-13 for the rule described in section 5.01 of Notice 2018-13. Section 8 of this notice requests comments and provides contact information.

SECTION 2. BACKGROUND

*.01 Treatment of Accumulated Post-1986 Deferred Foreign Income as Subpart F Income*

Section 965(a) provides that for the last taxable year of a deferred foreign income corporation ("DFIC") that begins before January 1, 2018 (such year of the DFIC, the "inclusion year"), the subpart F income of the corporation (as otherwise determined for such taxable year under section 952) shall be increased by the greater of (1) the accumulated post-1986 deferred foreign income of such corporation determined as of November 2, 2017, or (2) the accumulated post-1986 deferred foreign income of such corporation determined as of December 31, 2017 (each such date, a "measurement date," and the greater of the accumulated post-1986 deferred foreign income of the corporation as of the measurement dates, the "section 965(a) earnings amount").The section 965(a) earnings amount is not subject to the rules or limitations in section 952 and is not limited by the accumulated earnings and profits of the DFIC as of the close of the inclusion year.

*.02 Determination of United States Shareholder's Section 951(a)(1) Inclusion by Reason of Section 965*

Section 965(b)(1) provides that, if a taxpayer is a United States shareholder with respect to at least one DFIC and at least one E&P deficit foreign corporation, then the portion of the section 965(a) earnings amount which would otherwise be taken into account under section 951(a)(1) by a United States shareholder with respect to each DFIC is reduced by the amount of such United States shareholder's aggregate foreign E&P deficit that is allocated to such DFIC. The portion of the section 965(a) earnings amount that is taken into account under section 951(a)(1) by a United States shareholder, taking into account the reduction described in the preceding sentence, is referred to in this notice as the "section 965(a) inclusion amount."

*.03 Allocation of Aggregate Foreign E&P Deficit and Definition of E&P Deficit Foreign Corporation*

The aggregate foreign E&P deficit of any United States shareholder is allocated to each DFIC of the United States shareholder in an amount that bears the same proportion to such aggregate as (A) such United States shareholder's pro rata share of the section 965(a) earnings amount of each such DFIC bears to (B) the aggregate of such United States shareholder's pro rata shares of the section 965(a) earnings amounts of all DFICs of such United States shareholder. Section 965(b)(2). The term "aggregate foreign E&P deficit" means, with respect to any United States shareholder, the lesser of (I) the aggregate of such shareholder's pro rata shares of the specified E&P deficits of the E&P deficit foreign corporations of such shareholder or (II) the aggregate of such shareholder's pro rata shares of the section 965(a) earnings amounts of all DFICs of such shareholder. Section 965(b)(3)(A)(i).

The term "E&P deficit foreign corporation" means, with respect to any taxpayer, any specified foreign corporation with respect to which such taxpayer is a United States shareholder, if, as of November 2, 2017, (i) such specified foreign corporation has a deficit in post-1986 earnings and profits, (ii) such corporation was a specified foreign corporation, and (iii) such taxpayer was a United States shareholder of such corporation. Section 965(b)(3)(B). The term "specified E&P deficit" means, with respect to an E&P deficit foreign corporation, the amount of such corporation's deficit in post-1986 earnings and profits as of November 2, 2017. <u>See</u> section 965(b)(3)(C).

*.04 Application of the Participation Exemption*

Section 965(c)(1) provides that there shall be allowed as a deduction for the taxable year of a United States shareholder in which a section 965(a) inclusion amount is included in the gross income of such United States shareholder an amount equal to the sum of (A) the United States shareholder's 8 percent rate equivalent percentage (as defined in section 965(c)(2)(A)) of the excess (if any) of (i) the section 965(a) inclusion amount, over (ii) the amount of such United States shareholder's aggregate foreign cash position, plus (B) the United States shareholder's 15.5 percent rate equivalent percentage (as defined in section 965(c)(2)(B)) of so much of such United States shareholder's aggregate foreign cash position as does not exceed the section 965(a) inclusion amount. The deduction allowed to a United States shareholder under section 965(c) with respect to a section 965(a) inclusion amount of the United States shareholder is referred to in this notice as a "section 965(c) deduction."

Section 965(c)(3)(A) provides that the term "aggregate foreign cash position" means, with respect to any United States shareholder, the greater of (i) the aggregate of such United States shareholder's pro rata share of the cash position of each specified foreign corporation of such United States shareholder determined as of the close of the last taxable year of such specified foreign corporation that begins before January 1, 2018 ("final cash measurement date"),[1] or (ii) one half of the sum of (I) the aggregate described in clause (i) determined as of the close of the last taxable year of each such specified foreign corporation that ends before November 2, 2017 (the "second cash measurement date"), plus (II) the aggregate described in clause (i) determined as of the close of the taxable year of each such specified foreign corporation that precedes the taxable year referred to in subclause (I) ("first cash measurement date"). Each date referred to in the preceding sentence is referred to in this notice as a "cash measurement date."

The cash position of any specified foreign corporation is the sum of (i) cash held by such corporation, (ii) the net accounts receivable of such corporation, and (iii) the fair market value of the following assets held by such corporation (each asset, a "cash equivalent asset"): (I) personal property which is of a type that is actively traded and for which there is an established financial market; (II) commercial paper, certificates of deposit, the securities of the Federal government and of any State or foreign

[1] Notice 2018-07 and Notice 2018-13 referred to the year that includes the final cash measurement date as the "inclusion year" of such specified foreign corporation. However, only a DFIC can have an inclusion year, and therefore the final cash measurement date of a specified foreign corporation, which can be a DFIC, an E&P deficit foreign corporation, or neither, will not necessarily be the close of an inclusion year. The regulations described in Notice 2018-07 and Notice 2018-13 will describe the final cash measurement date consistently with section 965(c)(3)(A) and this notice. Any reference to an "inclusion year" for a specified foreign corporation that is not a DFIC will describe the last year of the specified foreign corporation that begins before January 1, 2018.

government; (III) any foreign currency; (IV) any obligation with a term of less than one year ("short-term obligation"); and (V) any asset which the Secretary identifies as being economically equivalent to any asset described in section 965(c)(3)(B). Section 965(c)(3)(B). For purposes of determining the aggregate foreign cash position of a United States shareholder, the term "net accounts receivable" means, with respect to any specified foreign corporation, the excess (if any) of (i) such corporation's accounts receivable, over (ii) such corporation's accounts payable (determined consistent with the rules of section 461). Section 965(c)(3)(C).

Section 965(c)(3)(D) provides that net accounts receivable, actively traded property, and short-term obligations shall not be taken into account by a United States shareholder in determining its aggregate foreign cash position to the extent that such United States shareholder demonstrates to the satisfaction of the Secretary that such amount is so taken into account by such United States shareholder with respect to another specified foreign corporation.

Section 965(c)(3)(F) provides that if the Secretary determines that a principal purpose of any transaction was to reduce the aggregate foreign cash position taken into account under section 965(c), such transaction shall be disregarded for purposes of section 965(c).

*.05 Definition of DFIC and Accumulated Post-1986 Deferred Foreign Income*

For purposes of section 965, a DFIC is, with respect to any United States shareholder, any specified foreign corporation of such United States shareholder that has accumulated post-1986 deferred foreign income (as of a measurement date) greater than zero. Section 965(d)(1). The term "accumulated post-1986 deferred foreign income" means the post-1986 earnings and profits of the specified foreign corporation except to the extent such earnings and profits (A) are attributable to income of the specified foreign corporation that is effectively connected with the conduct of a trade or business within the United States and subject to tax under chapter 1 ("effectively connected income"), or (B) in the case of a controlled foreign corporation ("CFC"), if distributed, would be excluded from the gross income of a United States shareholder under section 959 ("previously taxed income"). Section 965(d)(2).

Section 965(d)(3) provides that the term "post-1986 earnings and profits" means the earnings and profits of the foreign corporation (computed in accordance with sections 964(a) and 986, and by taking into account only periods when the foreign corporation was a specified foreign corporation) accumulated in taxable years beginning after December 31, 1986, and determined (A) as of the measurement date that is applicable with respect to such foreign corporation, and (B) without diminution by reason of dividends distributed during the inclusion year other than dividends distributed to another specified foreign corporation.

*.06 Specified Foreign Corporation*

Section 965(e)(1) provides that the term "specified foreign corporation" means (A) any CFC and (B) any foreign corporation with respect to which one or more domestic corporations is a United States shareholder. For purposes of sections 951 and 961, a specified foreign corporation described in section 965(e)(1)(B) is treated as a CFC solely for purposes of taking into account the subpart F income of such corporation under section 965(a) (and for purposes of determining a United States shareholder's pro rata share of any amount with respect to a specified foreign corporation under section 965(f)). Section 965(e)(2). However, if a passive foreign investment company (as defined in section 1297) with respect to the shareholder is not a CFC, then such corporation is not a specified foreign corporation. Section 965(e)(3).

*.07 Determination of Pro Rata Share*

Section 965(f)(1) provides that the determination of any United States shareholder's pro rata share of any amount with respect to any specified foreign corporation shall be determined under rules similar to the rules of section 951(a)(2) by treating such amount in the same manner as subpart F income (and by treating such specified foreign corporation as a CFC).

*.08 Election Under Section 965(h) Concerning Payment of Net Tax Liability Under Section 965*

Section 965(h)(1) provides that in the case of a United States shareholder of a DFIC, such United States shareholder may elect to pay the net tax liability under section 965 in eight installments. Section 965(h)(5) provides that any election under section 965(h)(1) must be made not later than the due date for the return of tax for the year of the United States shareholder in which or with which the inclusion year of the DFIC ends and must be made in such manner as the Secretary provides.

If an election is made under section 965(h)(1), the first installment must be paid on the due date (determined without regard to any extension of time for filing the return) for the return of tax for the year of the United States shareholder in which or with which the inclusion year of the DFIC ends, and each succeeding installment must be paid on the due date (determined without regard to any extension of time for filing the return) for the return of tax for the taxable year following the taxable year with respect to which the preceding installment was made. Section 965(h)(2).

Section 965(h)(6) defines the net tax liability under section 965 with respect to any United States shareholder as the excess (if any) of (i) such taxpayer's net income tax for the taxable year in which an amount is included in the gross income of such United States shareholder under section 951(a)(1) by reason of section 965, over (ii) such taxpayer's net income tax for such taxable year determined (I) without regard to section 965, and (II) without regard to any income or deduction properly attributable to a dividend received by such United States shareholder from any DFIC. For this purpose, the term "net income tax" means the regular tax liability reduced by the credits allowed under subparts A, B, and D of part IV of subchapter A.

*.09 Election Under Section 965(i) Concerning Payment of Net Tax Liability Under Section 965 by S Corporation Shareholder and Related Reporting Requirements*

Section 965(i)(1) provides that in the case of any S corporation that is a United States shareholder of a DFIC, each shareholder of such S corporation may elect to defer payment of such shareholder's net tax liability under section 965 with respect to such S corporation until the shareholder's taxable year which includes the triggering event with respect to such liability.

Under section 965(i)(1), any net tax liability, payment of which is deferred under section 965(i)(1), will be assessed on the return of tax as an addition to tax in the shareholder's taxable year which includes the triggering event with respect to such liability. As defined in section 965(i)(2), in the case of any shareholder's net tax liability under section 965 with respect to any S corporation, the triggering event with respect to such liability is whichever of the following occurs first: (i) such corporation ceases to be an S corporation (determined as of the first day of the first taxable year that such corporation is not an S corporation); (ii) a liquidation or sale of substantially all the assets of such S corporation (including in a title 11 or similar case), a cessation of business by such S corporation, such S corporation ceases to exist, or any similar circumstance; or (iii) a transfer of any share of stock in such S corporation by the taxpayer (including by reason of death, or otherwise). In the case of a transfer of less than all of the taxpayer's shares of stock in the S corporation, such transfer shall only be a triggering event with respect to so much of the taxpayer's net tax liability under section 965 with respect to such S corporation as is properly allocable to such stock. Section 965(i)(2)(B).

Section 965(i)(3) defines a shareholder's net tax liability under section 965 with respect to any S corporation as the net tax liability under section 965 which would be determined under section 965(h)(6) if the only amounts taken into account under section 951(a)(1) by reason of section 965 by such shareholder were allocations from such S corporation.

*.10 Election Under Section 965(m) Concerning Inclusions of Amounts Under Section 965*

Under section 965(m)(1)(B), a real estate investment trust (REIT) may elect, in lieu of including any amount required to be taken into account under section 951(a)(1) by reason of section 965 in the taxable year in which it would otherwise be included in gross income (for purposes of the computation of REIT taxable income under section 857(b)), to include such amount in gross income in eight installments.

*.11 Election Under Section 965(n) Not to Apply Net Operating Loss Deduction*

Under section 965(n)(1), a United States shareholder of a DFIC may make an election pursuant to which the amount described in section 965(n)(2) shall not be taken into account (A) in determining the amount of the net operating loss deduction under section 172 of such shareholder for such taxable year, or (B) in determining the amount of taxable income for such taxable year which may be reduced by net operating loss carryovers or carrybacks to such taxable year under section 172. The amount described in section 965(n)(2) is the sum of (A) the amount required to be taken into account under section 951(a)(1) by reason of section 965 (determined after the application of section 965(c)), plus (B) in the case of a domestic corporation which chooses to have the benefits of subpart A of part III of subchapter N for the taxable year, the taxes deemed to be paid by such corporation under subsections (a) and (b) of section 960 for such taxable year with respect to the amount described in section 965(n)(2)(A) which are treated as a dividends under section 78.

*.12 Regulations or Other Guidance Under Section 965*

Section 965(o) provides that the Secretary shall prescribe such regulations or other guidance as may be necessary or appropriate to carry out the provisions of section 965, including regulations or other guidance to provide appropriate basis adjustments, and regulations or other guidance to prevent the avoidance of the purposes of section 965, including through a reduction in earnings and profits, through changes in entity classification or accounting methods, or otherwise.

*.13 Definition of United States Shareholder*

For taxable years of foreign corporations beginning before January 1, 2018, under section 951(b), a United States shareholder is a United States person (within the meaning of section 957(c)) that owns within the meaning of section 958(a), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of the stock of a foreign corporation. Under section 957(c), a United States person generally has the meaning assigned to it by section 7701(a)(30), which includes a domestic partnership or domestic trust. But see Notice 2010-41, 2010-22 I.R.B. 715 (announcing that the Treasury Department and the IRS intend to issue regulations treating certain domestic partnerships as foreign partnerships for purposes of identifying which United States shareholders are required to include amounts in gross income under section 951(a)). Moreover, an S corporation is treated as a partnership for purposes of sections 951 through 965. See section 1373(a).

*.14 Attribution Rules in Section 958(b) and Section 318(a)*

Section 958 provides rules for determining direct, indirect, and constructive stock ownership. Under section 958(a)(1), stock is considered owned by a person if it is owned directly or is owned indirectly through certain foreign entities under section 958(a)(2). Under section 958(b), section 318 applies, with certain modifications, to the extent that the effect is to treat any United States person as a United States shareholder within the meaning of section 951(b), to treat a person as a related person within the meaning of section 954(d)(3), to treat the stock of a domestic corporation as owned by a United States shareholder of a CFC for purposes of section 956(c)(2), or to treat a foreign corporation as a CFC under section 957.

Section 318 provides rules that attribute the ownership of stock to certain family members, between certain entities and their owners, and to holders of options to acquire stock. Section 318(a)(1) provides rules attributing stock ownership among members of a family. Section 318(a)(2) provides rules attributing stock ownership "upward" from partnerships, estates, trusts, and corporations to partners, beneficiaries, owners, and shareholders. In addition, section 318(a)(3) provides specific rules that attribute the ownership of stock "downward" from partners, beneficiaries, owners, and shareholders to partnerships, estates, trusts, and corporations. In particular, section 318(a)(3)(A) provides that stock owned, directly or indirectly, by or for a partner in a partnership or a beneficiary of an estate is considered as owned by the partnership or estate. This provision applies to all partners and beneficiaries without regard to the size of their interest in the partnership or estate. Section 318(a)(3)(B) similarly provides, subject to certain exceptions, that stock owned, directly or indirectly, by or for a beneficiary of a trust (or a person who is considered an owner of a trust) is considered owned by the trust. In comparison, section 318(a)(3)(C) provides that stock owned, directly or indirectly, by or for a shareholder in a corporation is considered owned by the corporation only if 50 percent or more in value of the stock in the corporation is owned, directly or indirectly, by such person.

Effective for the last taxable year of foreign corporations beginning before January 1, 2018, and each subsequent year of such foreign corporations, and for the taxable years of United States shareholders in which or with which such taxable years of foreign corporations end, the Act repeals section 958(b)(4). As in effect prior to repeal, section 958(b)(4) provided that subparagraphs (A), (B), and (C) of section 318(a)(3) (providing for "downward" attribution) were not to be applied so as to consider a United States person as owning stock that is owned by a person who is not a United States person.

*.15 Estimated Taxes Under Sections 6654 and 6655*

Taxpayers who fail to make sufficient and timely payments of estimated taxes are liable for additions to tax under sections 6654(a), for individuals, and 6655(a), for corporations. Generally, the addition to tax is calculated by applying the underpayment interest rate under section 6621 to the unpaid portion of any required installment for the period that portion goes unpaid.

*.16 Miscellaneous Itemized Deductions*

Under section 67(a), miscellaneous itemized deductions are allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income (the “2-percent floor”). As amended by the Act, section 67(g) provides that for taxable years beginning after December 31, 2017, and before January 1, 2026, no miscellaneous itemized deductions are allowable under section 67(a). In addition, under section 56(b)(1)(A)(i), an individual subject to the alternative minimum tax (“AMT”) in 2017 is not allowed a deduction for any miscellaneous itemized deduction. Under section 63(d), itemized deductions generally mean all allowable deductions except for the deductions allowable in arriving at adjusted gross income pursuant to section 62(a), the deduction provided by section 151, and the deduction provided in section 199A (added by the Act). Miscellaneous itemized deductions include all itemized deductions other than those listed in section 67(b), which does not reference the deduction under section 965(c).

*.17 Election Under Section 962 for Individual to be Subject to Tax at Corporate Rates*

As amended by the Act, section 962 provides that an individual who is a United States shareholder may elect to have the tax imposed under chapter 1 on amounts that are included in the individual’s gross income under section 951(a) be an amount equal to the tax that would be imposed under section 11 if the amounts were received by a domestic corporation. In addition, if such election is made, the amounts included in the individual’s gross income under section 951(a) are treated as if they were received by a domestic corporation for purposes of applying section 960 (relating to foreign tax credits).  See §1.962-1(a).  However, the taxable income determined for purposes of applying section 11 is not reduced by any deduction of the United States shareholder. See §1.962-1(b)(1)(i).  An election under section 962 does not affect tax imposed under other chapters, including under chapter 2A.

*.18 Extensions of Time for Filing Income Tax Returns and Paying Tax for Certain Citizens and Residents Abroad*

In relevant part, regulations under section 6081 provide an extension of time to the fifteenth day of the sixth month following the close of the taxable year for filing returns of income and for paying any tax shown on the return in the case of United States citizens or residents whose tax homes and abodes, in a real and substantial sense, are outside the United States and Puerto Rico, and United States citizens and residents in military or naval service on duty, including non-permanent or short term duty, outside the United States and Puerto Rico ("specified individuals").  See §1.6081-5(a)(5) and (6).

SECTION 3.  REGULATIONS TO BE ISSUED ADDRESSING THE APPLICATION OF SECTION 965

*.01 Application of Section 318(a)(3)(A) to Treat a Foreign Corporation as a Specified Foreign Corporation*

As a result of the application of the constructive ownership rule in section 318(a)(3)(A) (providing for downward attribution of stock from a partner to a partnership), it may be difficult to determine if a foreign corporation is a specified foreign corporation under certain circumstances.  Assume, for example, that a person, A, owns 100 percent of the stock of a domestic corporation, DC, and 1 percent of the interests in a partnership, PS.  Assume further that a United States citizen, USI, owns 10 percent of the interests in PS and 10 percent by vote and value of the stock of a foreign corporation, FC. The remaining 90 percent by vote and value of the stock of FC is owned by non-U.S. persons that are unrelated to A, USI, DC, and PS. Absent the application of sections 958(b), 318(a)(3)(A), and 318(a)(3)(C), FC would not be a specified foreign corporation, because FC is not a CFC and there would be no domestic corporation that is a United States shareholder of FC.

Under sections 958(b) and 318(a)(3)(A), PS would be treated as owning 100 percent of the stock of DC and 10 percent of the stock of FC. As a result, under sections 958(b), 318(a)(5)(A), and 318(a)(3)(C), DC would be treated as owning the stock of FC treated as owned by PS, and thus DC would be a United States shareholder with respect to FC, causing FC to be a specified foreign corporation within the meaning of section 965(e)(1)(B). USI is a United States shareholder with respect to FC and thus, absent an exception, would be required to include amounts in gross income under section 951(a)(1) by reason of section 965 with respect to FC. The results are the same whether A or PS or both are domestic or foreign persons.

The Treasury Department and the IRS have determined that it would pose compliance difficulties for taxpayers and administrative difficulties for the IRS to require a United States person to determine whether a foreign corporation with respect to which it is a United States shareholder is a specified foreign corporation if such foreign corporation may be a specified foreign corporation solely by reason of downward attribution under section 318(a)(3)(A) of stock from a partner to a partnership when such partner has only a de minimis interest in such partnership. Accordingly, the Treasury Department and the IRS intend to issue regulations, pursuant to the grant of authority under section 965(o), providing that, solely for purposes of determining whether a foreign corporation is a specified foreign corporation within the meaning of section 965(e)(1)(B), stock owned, directly or indirectly, by or for a partner (tested partner) will not be considered as being owned by a partnership under sections 958(b) and 318(a)(3)(A) if such partner owns less than five percent of the interests in the partnership's capital and profits. For purposes of the preceding sentence, an interest in the partnership owned by another partner will be considered as being owned by the tested partner under the principles of sections 958(b) and 318, as modified by this notice, as if the interest in the partnership were stock.

Thus, for example, assume the same facts as in the example above, except that A is a corporation wholly owned by B, and B directly owns 4 percent of the interests in PS. For purposes of the rule in this section 3.01, applying the principles of sections 958(b) and 318, as modified by this notice, as if the interest in PS were stock, A is treated as owning the interests in PS owned by B (in addition to the 1 percent interest in PS that A owns directly), and thus A is not treated as owning less than five percent of the interests in PS's capital and profits. Accordingly, the rule in this section 3.01 does not apply, and PS is treated as owning A's stock in DC for purposes of determining whether FC is a specified foreign corporation within the meaning of section 965(e)(1)(B).

*.02 Determination of Cash Measurement Dates of a Specified Foreign Corporation with Respect to a United States Shareholder*

In certain cases, a specified foreign corporation may not be owned by a particular United States shareholder on all of the cash measurement dates, whether because the specified foreign corporation goes out of existence before the final cash measurement date or because its stock is acquired or disposed of between cash measurement dates.

The Treasury Department and the IRS understand that section 965(c)(3)(A)(i) could be interpreted to treat the close of the final taxable year of a specified foreign corporation that ceased to exist before November 2, 2017, as the final cash measurement date of such specified foreign corporation. Additionally, if a United States shareholder acquires or disposes of stock of a specified foreign corporation between cash measurement dates of the specified foreign corporation, questions have been raised as to whether the United States shareholder's pro rata share of the cash position of such specified foreign corporation as of an earlier or subsequent cash measurement date should be taken into account for purposes of determining the United States shareholder's aggregate foreign cash position.

The Treasury Department and the IRS intend to issue regulations providing that (i) the final cash measurement date of a specified foreign corporation is the close of the last taxable year of the specified foreign corporation that begins before January 1, 2018, and ends on or after November 2, 2017, if any; (ii) the second cash measurement date of a specified foreign corporation is the close of the last taxable year of the specified foreign corporation that ends after November 1, 2016, and before November 2, 2017, if any; (iii) the first cash measurement date of a specified foreign corporation is the close of the last taxable year of the specified foreign corporation that ends after November 1, 2015, and before November 2, 2016, if any; and (iv) a United States shareholder takes into account its pro rata share of the cash position of a specified foreign corporation as of any cash measurement date of the specified foreign corporation on which such United States shareholder is a United States shareholder of such specified foreign corporation, regardless of whether such United States shareholder is a United States shareholder of such specified foreign corporation as of any other cash measurement date, including the final cash measurement date of such specified foreign corporation. For purposes of applying this paragraph, a 52-53-week taxable year is deemed to begin on the first day of the calendar month nearest to the first day of the 52-53-week taxable year, and is deemed to end or close on the last day of the calendar month nearest to the last day of the 52-53-week taxable year, as the case may be. See §1.441-2(c).

Example. (i) Facts. Except as otherwise provided, for all relevant periods, USP, a domestic corporation, has owned directly at least 10 percent of the stock of CFC1, CFC2, CFC3, and CFC4, each a foreign corporation. CFC1 and CFC2 have calendar year U.S. taxable years. CFC3 and CFC4 have U.S. taxable years that end on November 30. No entity has a short taxable year, except as a result of the transactions described below.

(a) USP transferred all of its stock of CFC2 to an unrelated person on June 30, 2016, at which point USP ceased to be a United States shareholder with respect to CFC2.

(b) CFC4 dissolved on December 30, 2010, and, as a result, its final taxable year ended on December 30, 2010.

(ii) Analysis. Each of CFC1, CFC2, CFC3, and CFC4 is a specified foreign corporation. Taking into account the regulations described in this section 3.02, the cash measurement dates of the specified foreign corporations to be taken into account by USP in determining its aggregate foreign cash position are summarized in the following table:

| | Cash Measurement Dates | | |
|---|---|---|---|
| | Final | Second | First |
| CFC1 | December 31, 2017 | December 31, 2016 | December 31, 2015 |
| CFC2 | N/A | N/A | December 31, 2015 |
| CFC3 | November 30, 2018 | November 30, 2016 | November 30, 2015 |
| CFC4 | N/A | N/A | N/A |

*.03 Treatment of Certain Accrued Foreign Income Taxes for Purposes of Determining Post-1986 Earnings and Profits*

Post-1986 earnings and profits are defined, in relevant part, as the earnings and profits of a specified foreign corporation determined as of each of the two measurement dates described in section 965(a) and “computed in accordance with sections 964(a) and 986.” Section 965(d)(3). In general, section 964(a) provides that, under regulations prescribed by the Secretary, the earnings and profits of any foreign corporation, and the deficit in earnings and profits of any foreign corporation, for any taxable year shall be determined according to rules substantially similar to those applicable to domestic corporations. As described in section 3.02 of Notice 2018-13, for purposes of measuring the post-1986 earnings and profits of a specified foreign corporation as of a measurement date, the extent to which an item of income, deduction, gain, or loss is taken into account as of such measurement date must be determined under principles generally applicable to the calculation of the earnings and profits of a domestic corporation. Section 3.02(a) of Notice 2018-13 provided a limited exception to this general rule in order to reduce taxpayer compliance burdens. Section 3.02(a) of Notice 2018-07 also announced the intention to issue regulations that may provide exceptions to this general rule in limited cases that are contemplated by section 965 or the legislative history to the Act, such as to address double counting or double non-counting.

The Treasury Department and the IRS have determined that an additional limited exception to the general rule is appropriate for certain foreign income taxes that accrue between measurement dates. Accordingly, the Treasury Department and the IRS intend to issue regulations providing that, for purposes of determining a specified foreign corporation’s post-1986 earnings and profits as of the measurement date on November 2, 2017, any foreign income tax (as defined in section 901(m)(5)) that accrues (i) within the specified foreign corporation’s U.S. taxable year that includes

November 2, 2017, and (ii) after November 2, 2017, but on or before December 31, 2017, will be allocated between the respective portions of the foreign tax base on which the accrued foreign taxes are determined that are attributable to the part of the U.S. taxable year ending on November 2, 2017, and the part of the U.S. taxable year beginning after November 2, 2017.

The Treasury Department and the IRS have determined that it is appropriate to limit the scope of the regulations to foreign income taxes that accrue on or before December 31, 2017, in order to allow for the section 965(a) earnings amounts of each specified foreign corporation to be determined as of the final measurement date, December 31, 2017.

The regulations announced in this section 3.03 are relevant solely for purposes of determining a specified foreign corporation's post-1986 earnings and profits (including a deficit) within the meaning of section 965(d)(3). Therefore, the regulations to be issued will not affect, for example, the computation of credits for taxes deemed paid under sections 902 and 960.

*.04 Prevention of the Reduction of the Section 965 Tax Liability of a United States Shareholder*

(a) <u>Anti-Avoidance Rule</u>

*(i) Transactions Undertaken with a Principal Purpose of Reducing Section 965 Tax Liability*

The Treasury Department and the IRS intend to issue regulations under sections 965(c)(3)(F) and 965(o) providing that a transaction will be disregarded for purposes of determining a United States shareholder's section 965 tax liability if each of the following conditions is satisfied: (i) such transaction occurs, in whole or in part, on or after November 2, 2017 (the "specified date"); (ii) such transaction is undertaken with a principal purpose of reducing the section 965 tax liability of such United States shareholder; and (iii) such transaction would, without regard to this sentence, reduce the section 965 tax liability of such United States shareholder (the “anti-avoidance rule”).

For purposes of this section 3.04(a) and section 3.04(b) of this notice, a transaction (or change in method of accounting or election described in section 3.04(b) of this notice) reduces the section 965 tax liability of a United States shareholder if such transaction (i) reduces a section 965(a) inclusion amount of such United States shareholder with respect to any specified foreign corporation, (ii) reduces the aggregate foreign cash position of such United States shareholder, or (iii) increases the amount of foreign income taxes of any specified foreign corporation deemed paid by such United States shareholder under section 960 as a result of an inclusion under section 951(a) by reason of section 965. Also for purposes of this section 3.04(a) and section 3.04(b) of this notice, in the case of a United States shareholder that is a domestic pass-through entity, a domestic pass-through owner of such domestic pass-through entity is also treated as a United States shareholder. For the definition of domestic pass-through entity and domestic pass-through owner, see section 3.05(b) of this notice.

Under section 3.04(a)(ii) through (iv) of this notice, certain transactions are presumed to be undertaken with a principal purpose of reducing the section 965 tax liability of a United States shareholder for purposes of the anti-avoidance rule. The presumption described in the preceding sentence may be rebutted only if facts and circumstances clearly establish that the transaction was not undertaken with a principal purpose of reducing the section 965 tax liability of a United States shareholder. The regulations will provide that a taxpayer that takes the position that the presumption is rebutted must attach a statement to its income tax return for its taxable year in which or with which the relevant taxable year of the relevant specified foreign corporation ends disclosing that it has rebutted the presumption.  In the case of a transaction described in section 3.04(a)(ii) and (iii), if the presumption does not apply because such transaction occurs in the ordinary course of business, whether such transaction was undertaken with a principal purpose of reducing the section 965 tax liability of a United States shareholder must be determined under all the facts and circumstances.  Under section 3.04(a)(ii) through (iv) of this notice, certain transactions are also treated per se as being undertaken with a principal purpose of reducing the section 965 tax liability of a United States shareholder.  Further, under section 3.04(a)(ii), certain distributions are treated per se as not being undertaken with a principal purpose of reducing the section 965 tax liability of such United States shareholder and therefore are not subject to the anti-avoidance rule.

For purposes of the rules described in section 3.04(a)(ii) through (iv) of this notice, a person is treated as related to a United States shareholder if (i) the person bears a relationship to the United States shareholder described in section 267(b) or section 707(b) and (ii) the relationship described in clause (i) of this sentence is satisfied either immediately before or immediately after the transaction.  Furthermore, for purposes of the rules described in section 3.04(a)(ii) and (iv) of this notice, the term “transfer” includes any disposition, exchange, contribution, distribution, issuance, redemption, recapitalization, or loan, and includes an indirect transfer (for example, a transfer of an interest in a partnership is a transfer of the assets of such partnership).

No inference is intended as to the treatment, under general tax law, of transactions that occurred before the specified date. The IRS may, where appropriate, challenge such transactions under the Code, regulations, or judicial doctrines such as the step transaction doctrine or the economic substance doctrine.

*(ii) Application of the Anti-Avoidance Rule to Cash Reduction Transactions*

For purposes of applying the anti-avoidance rule, a cash reduction transaction is presumed to be undertaken with a principal purpose of reducing the section 965 tax liability of a United States shareholder. For this purpose, the term "cash reduction transaction" means (i) a transfer of cash, accounts receivable, or cash equivalent assets by a specified foreign corporation to a United States shareholder of such specified foreign corporation or a person related to a United States shareholder of such specified foreign corporation, or (ii) an assumption by a specified foreign corporation of an accounts payable of a United States shareholder of such specified foreign corporation or a person related to a United States shareholder of such specified foreign corporation, if such transfer or assumption would, without regard to the anti-avoidance rule, reduce the aggregate foreign cash position of such United States shareholder. The presumption described in this paragraph does not apply to a cash reduction transaction that occurs in the ordinary course of business.

Notwithstanding the presumption described in the preceding paragraph, except in the case of a specified distribution, a cash reduction transaction that is a distribution by a specified foreign corporation to a United States shareholder of such specified foreign corporation will be treated per se as not being undertaken with a principal purpose of reducing the section 965 tax liability of such United States shareholder for purposes of the anti-avoidance rule. A specified distribution will be treated per se as being undertaken with a principal purpose of reducing the section 965 tax liability of a United States shareholder for purposes of the anti-avoidance rule. For purposes of this section 3.04(a)(ii), the term “specified distribution” means a cash reduction transaction that is a distribution by a specified foreign corporation of a United States shareholder if (i) at the time of the distribution, there was a plan or intention for the distributee to transfer, directly or indirectly, cash, accounts receivable, or cash equivalent assets to any specified foreign corporation of such United States shareholder, or (ii) the distribution is a non pro rata distribution to a foreign person that is related to such United States shareholder. For purpose of clause (i) of the preceding sentence, an indirect transfer includes, for example, a transfer of cash to a partnership if a specified foreign corporation of such United States shareholder is a partner.

*(iii) Application of the Anti-Avoidance Rule to E&P Reduction Transactions*

For purposes of applying the anti-avoidance rule, an E&P reduction transaction is presumed to be undertaken with a principal purpose of reducing the section 965 tax liability of a United States shareholder. For this purpose, the term “E&P reduction transaction” means a transaction between a specified foreign corporation and any of (i) a United States shareholder of such specified foreign corporation, (ii) another specified foreign corporation of a United States shareholder of such specified foreign corporation, or (iii) any person related to a United States shareholder of such specified foreign corporation, if such transaction would, without regard to the anti-avoidance rule, reduce the accumulated post-1986 deferred foreign income or the post-1986 undistributed earnings (as defined in section 902(c)(1) as in effect before the date of the enactment of the Act) of such specified foreign corporation or another specified foreign corporation of any United States shareholder of such specified foreign corporation. The presumption described in this paragraph does not apply to an E&P reduction transaction that occurs in the ordinary course of business.

Notwithstanding the presumption described in the preceding paragraph, a specified transaction will be treated per se as being undertaken with a principal purpose of reducing the section 965 tax liability of a United States shareholder for purposes of the anti-avoidance rule. For purposes of the preceding sentence, the term "specified transaction" means an E&P reduction transaction that involves one or more of the following: (i) a complete liquidation of a specified foreign corporation to which section 331 applies; (ii) a sale or other disposition of stock by a specified foreign corporation, or (iii) a distribution by a specified foreign corporation that reduces the earnings and profits of such specified foreign corporation pursuant to section 312(a)(3).

*(iv) Application of the Anti-Avoidance Rule to Pro Rata Share Transactions*

For purposes of applying the anti-avoidance rule, a pro rata share transaction is presumed to be undertaken with a principal purpose of reducing the section 965 tax liability of a United States shareholder. For this purpose, the term "pro rata share transaction" means a transfer of the stock of a specified foreign corporation to a United States shareholder of the specified foreign corporation or a person related to a United States shareholder of such specified foreign corporation if such transfer would, without regard to the anti-avoidance rule, (i) reduce such United States shareholder's pro rata share of the section 965(a) earnings amount of such specified foreign corporation if it is a DFIC; (ii) increase such United States shareholder's pro rata share of the specified E&P deficit of such specified foreign corporation if it is an E&P deficit foreign corporation; or (iii) reduce such United States shareholder's pro rata share of the cash position of such specified foreign corporation.

Notwithstanding the presumption described in the preceding paragraph, an internal group transaction will be treated per se as being undertaken with a principal purpose of reducing the section 965 tax liability of a United States shareholder for purposes of the anti-avoidance rule. For purposes of the preceding sentence, the term "internal group transaction" means a pro rata share transaction if, immediately before or after the transfer, the transferor of the stock of the specified foreign corporation and the transferee of such stock are members of an affiliated group in which the United States shareholder is a member. For this purpose, the term "affiliated group" has the meaning set forth in section 1504(a), determined without regard to paragraphs (1) through (8) of section 1504(b), and the term "members of an affiliated group" means entities included in the same affiliated group. For purposes of identifying an affiliated group and the members of such group, (i) each partner in a partnership, as determined without regard to clause (ii) of this sentence, is treated as holding its proportionate share of the stock held by the partnership, as determined under the rules and principles of sections 701 through 777, and (ii) if one or more members of an affiliated group own, in the aggregate, at least 80 percent of the interests in a partnership's capital or profits, the partnership will be treated as a corporation that is a member of the affiliated group.

Example. (i) Facts. FP, a foreign corporation, owns all of the stock of USP, a domestic corporation. USP owns all of the stock of FS, a foreign corporation. USP has held the stock of FS for more than one year. USP has a calendar year taxable year; FS's taxable year ends November 30. On January 2, 2018, USP transfers all of the stock of FS to FP in exchange for cash. On January 3, 2018, FS makes a distribution with respect to the stock transferred to FP. USP treats the transaction as a taxable sale of the FS stock and claims a dividends received deduction under section 245A with respect to its deemed dividend under section 1248(j) as a result of the sale. FS has post-1986 earnings and profits as of December 31, 2017, and no previously taxed income or effectively connected income for any previous taxable year.

(ii) Analysis. The transfer of the stock of FS is a pro rata share transaction because such transfer is to a person related to USP, and the transfer would, without regard to the anti-avoidance rule, reduce USP's pro rata share of FS's section 965(a) earnings amount. Because USP and FP are also members of an affiliated group within the meaning of this section 3.04(a)(iv), the transfer of the stock of FS is also an internal group transaction and is treated per se as being undertaken with a principal purpose of reducing the section 965 tax liability of USP. Accordingly, the transfer will be disregarded for purposes of determining USP's section 965 tax liability with the result that, among other things, USP's pro rata share of FS's section 965(a) earnings amount is determined as if USP owned (within the meaning of section 958(a)) 100 percent of the stock of FS on the last day of FS's inclusion year and no other person received a distribution with respect to such stock during such year. See section 951(a)(2)(A) and (B).

(b) Disregard of Certain Changes in Method of Accounting and Entity Classification Elections

The Treasury Department and the IRS also intend to issue regulations, pursuant to the grant of authority under section 965(o), providing that any change in method of accounting made for a taxable year of a specified foreign corporation that ends in 2017 or 2018 will be disregarded for purposes of determining the section 965 tax liability of a United States shareholder if such change in method of accounting would otherwise reduce the section 965 tax liability of such United States shareholder. The rule described in this section 3.04(b) will apply whether or not such change in method of accounting was made in accordance with the procedures described in Rev. Proc. 2015-13, 2015-5 I.R.B. 419 (or successor), and whether or not such change in method of accounting was properly made. These regulations will not apply to a change in method of accounting for which the original and/or duplicate copy of any Form 3115, Application for Change in Accounting Method, requesting the change was filed before the specified date, November 2, 2017.

The regulations will also provide that any entity classification election under §301.7701-3 that is filed on or after the specified date will be disregarded for purposes of determining the section 965 tax liability of such United States shareholder if such entity classification election would otherwise reduce the section 965 tax liability of any United States shareholder.  An entity classification election filed on or after the specified date will be subject to these regulations even if such entity classification election was effective on a date before the specified date.

The regulations described in this section 3.04(b) will apply regardless of whether such change in method of accounting or change of entity classification election is made with a principal purpose of reducing the section 965 tax liability of a United States shareholder.

*.05 Rules Related to Elections, Reporting, and Payment*

(a) Documentation of Cash Position

Section 965(c)(3)(D) provides that net accounts receivable, actively traded property, and short-term obligations shall not be taken into account by a United States shareholder in determining its aggregate foreign cash position to the extent that such United States shareholder demonstrates to the satisfaction of the Secretary that such amount is so taken into account by such United States shareholder with respect to another specified foreign corporation.  The IRS intends to issue forms, publications, regulations, or other guidance that will specify the documentation that a United States shareholder must maintain or provide, and the time and manner for providing any such documentation, in order to make the required demonstration to the Secretary.

(b) United States Persons Eligible to Make Elections Under Section 965 in the Case of a United States Shareholder that is a Domestic Pass-Through Entity

Section 965 increases the amount included in the gross income of a United States shareholder under section 951(a)(1) only if such United States shareholder owns (within the meaning of section 958(a)) stock in one or more specified foreign corporations. See section 951(a)(2)(A). For purposes of this notice, the term "section 958(a) stock" means, with respect to a United States shareholder of a DFIC, the stock of the DFIC owned by the United States shareholder within the meaning of section 958(a).

The Treasury Department and IRS have determined that if a domestic pass-through entity is a United States shareholder of a DFIC and owns section 958(a) stock in such DFIC, the section 965(a) inclusion amount with respect to such section 958(a) stock and the section 965(c) deduction with respect to such amount should be determined at the level of the domestic pass-through entity. However, the domestic pass-through owners of the domestic pass-through entity are subject to federal income tax on their share of the section 965(a) inclusion amount with respect to the section 958(a) stock of the domestic pass-through entity. Accordingly, in the case of a domestic pass-through entity that is a United States shareholder, the regulations will provide that each domestic pass-through owner takes into account its share of the section 965(a) inclusion amount with respect to section 958(a) stock of a DFIC of the domestic pass-through entity and the section 965(c) deduction with respect to such amount, regardless of whether such domestic pass-through owner is also a United States shareholder with respect to such DFIC. In this case, the section 965(a) inclusion amount and the related section 965(c) deduction must be allocated in the same proportion. For example, if a domestic pass-through owner is allocated 50 percent of the section 965(a) inclusion amount with respect to section 958(a) stock of a domestic pass-through entity, such domestic pass-through owner must be allocated 50 percent of the related section 965(c) deduction. If the domestic pass-through owner is also a United States shareholder with respect to such DFIC that owns section 958(a) stock of such DFIC, regulations will provide that the section 965(a) inclusion amount with respect to such section 958(a) stock of such domestic pass-through owner and the section 965(c) deduction with respect to such amount are determined separately from its share of the section 965(a) inclusion amount and section 965(c) deduction of the domestic pass-through entity.

For purposes of this notice, the term “domestic pass-through entity” means a pass-through entity that is a United States person (as defined in section 7701(a)(30)). Also for purposes of this notice, a “pass-through entity” means a partnership, S corporation, or any other person to the extent that the income or deductions of such person are included in the income of one or more direct or indirect owners or beneficiaries of the person. Accordingly, if, for example, a domestic trust is subject to federal income tax on a portion of its section 965(a) inclusion amount and its domestic pass-through owners are subject to tax on the remaining portion, the domestic trust is treated as a domestic pass-through entity with respect to such remaining portion. Also for purposes of this notice, the term “domestic pass-through owner” means a United States person that is a partner, shareholder, beneficiary, grantor, or owner, as the case may be, in a domestic pass-through entity, except that, in the case of tiered pass-through entities, the term does not include a partner, shareholder, beneficiary, or owner that is itself a domestic pass-through entity. In the case of tiered pass-through entities, a reference in this notice to a domestic pass-through owner includes a United States person that is an indirect partner, shareholder, beneficiary, or owner through one or more other pass-through entities, and a reference to a domestic pass-through owner’s share of the section 965(a) inclusion amount and section 965(c) deduction of a domestic pass-through entity includes such domestic pass-through owner's share of the section 965(a) inclusion amount and section 965(c) deduction of a domestic pass-through entity owned indirectly by such domestic pass-through owner through one or more other pass-through entities.

The elections under section 965(h), (m), and (n) ("specified elections") are described in section 965 as available to a United States shareholder of a DFIC. However, because a domestic pass-through owner includes in income a share of the section 965(a) inclusion amount with respect to section 958(a) stock of a DFIC of a domestic pass-through entity, the Treasury Department and the IRS intend to issue regulations, pursuant to the grant of regulatory authority under section 965(o), allowing such domestic pass-through owner to make a specified election that applies to its share of the section 965(a) inclusion amount with respect to section 958(a) stock of a DFIC of the domestic pass-through entity.  Such a domestic pass-through owner will be permitted to make a specified election regardless of whether the domestic pass-through owner is itself a United States shareholder of the DFIC.  If a domestic pass-through owner makes a specified election for its taxable year, such election will be applicable to all section 965(a) inclusion amounts included in the gross income of such domestic pass-through owner for such taxable year (other than amounts with respect to which elections under section 965(i) are effective), whether included directly by reason of owning section 958(a) stock in a DFIC or indirectly by reason of being a domestic pass-through owner.

If an S corporation is, directly or indirectly, a partner, beneficiary, or owner of a domestic pass-through entity and takes into account a share of the section 965(a) inclusion amount of a domestic pass-through entity with respect to a DFIC, and the S corporation is a United States shareholder of the DFIC, the regulations will provide that shareholders of the S corporation will be permitted to make an election under section 965(i) to defer the shareholder's net tax liability under section 965 with respect to the S corporation. However, in such a case, if the S corporation is not itself a United States shareholder of a DFIC, the net tax liability under section 965 of a shareholder with respect to the S corporation for purposes of the election under section 965(i) will not include the shareholder's share of the domestic pass-through entity's section 965(a) inclusion amount with respect to the DFIC or section 965(c) deduction with respect to such amount.

(c) Determination of Amount of Net Tax Liability Under Section 965 for Purposes of Section 965(h)

As discussed in section 3.05(b) of this notice, if a domestic pass-through entity is a United States shareholder that has a section 965(a) inclusion amount with respect to section 958(a) stock in a DFIC, a United States person that is a domestic pass-through owner, directly or indirectly, in such domestic pass-through entity is subject to net income tax on its share of the section 965(a) inclusion amount. Accordingly, the Treasury Department and the IRS intend to issue regulations providing that for purposes of determining the net tax liability under section 965 of a domestic pass-through owner, the domestic pass-through owner will be treated as a United States shareholder. See, however, section 5 of this notice, which provides that a domestic pass-through owner that is not itself a United States shareholder is not permitted to make an election under section 962.

Furthermore, the regulations will provide that, in the case of a taxpayer that has made one or more elections under section 965(i) for a taxable year, the taxpayer's net tax liability under section 965 for purposes of section 965(h) is the taxpayer's net tax liability under section 965 as determined under section 965(h)(6) (taking into account the rules in this section 3.05(c)) reduced by the aggregate amount of the taxpayer's net tax liabilities under section 965 as determined under section 965(i)(3) (taking into account the rule provided in section 3.05(b) of this notice) with respect to which elections under section 965(i) are effective.

(d) Application of Section 965(n) to Losses Arising in the Year in Which the Inclusion Year of a DFIC Ends

A United States shareholder of a DFIC may elect the application of section 965(n) for the taxable year of the United States shareholder in which, or with which, the inclusion year of the DFIC ends. If such an election is made, the United States shareholder does not take into account the amount described in section 965(n)(2) in determining the amount of the net operating loss deduction under section 172 of such shareholder for such taxable year or in determining the amount of taxable income for such taxable year which may be reduced by net operating loss carryovers or carrybacks to such taxable year under section 172.

Questions have arisen regarding the scope of the election under section 965(n) due to the use of the term "deduction" in section 965(n)(1)(A). A net operating loss "deduction" for a taxable year generally refers to the amount of a net operating loss carried to such taxable year from a prior or subsequent year rather than the net operating loss arising from such year. Compare section 172(a) and (c). However, interpreting "deduction" in section 965(n)(1)(A) to refer to carryovers or carrybacks (and not to the net operating loss for the taxable year) would cause that paragraph to be duplicative of section 965(n)(1)(B), which already provides that amounts described in section 965(n)(2) are disregarded for purposes of applying net operating loss carryovers or carrybacks to such taxable year under section 172. The Treasury Department and the IRS have determined that section 965(n)(1)(A) was intended to apply to a different set of losses than those to which section 965(n)(1)(B) applies. Therefore, the Treasury Department and the IRS intend to issue regulations providing that, if an election under section 965(n) is made with respect to a taxable year in which or with which the inclusion year of a DFIC ends, the amount of a net operating loss for such taxable year will be determined without taking into account as gross income the amount described in section 965(n)(2). The regulations will also clarify that an election made under section 965(n) will be treated as made with respect to both the amount of a net operating loss for such taxable year and the net operating loss carryovers or carrybacks for such taxable year.

(e) Filing and Payment Due Date for Specified Individuals

A specified individual (as defined in section 2.18 of this notice) who does not make the election under section 965(h)(1) or (i)(1) is considered to have timely filed such person's return and paid the net tax liability under section 965 if the filing and payment are made on or before the fifteenth day of the sixth month following the close of the taxable year, and the specified individual attaches a statement to the return showing that the person for whom the return is made is a person described in §1.6081-5(a). See §1.6081-5(a)(5)-(6), and (b). For a specified individual who makes the election under section 965(h)(1), section 965(h)(2) provides that the installments must be paid on the due dates for the relevant returns (determined without regard to any extension of time for filing the return).

The question has arisen whether the disregarding of extensions of time to file in section 965(h)(2) applies to negate the extension of time to pay that is otherwise available under §1.6081-5 for a specified individual that does not make the election under section 965(h)(1). The Treasury Department and the IRS intend to issue regulations providing that, if a specified individual receives an extension of time to file and pay under §1.6081-5(a)(5) or (6), then the individual’s due date for an installment payment under section 965(h) is also the fifteenth day of the sixth month following the close of a taxable year.

*.06 Treatment of Section 965(c) Deduction for Purposes of Sections 62(a) and 63(d)*

Questions have arisen as to whether the section 965(c) deduction is a miscellaneous itemized deduction as defined in section 67(b). The Treasury Department and the IRS have determined that an individual’s section 965(c) deduction was not intended to be subject to the 2-percent floor under section 67 or the deduction disallowance under the AMT, or, in the case of a taxable year beginning after December 31, 2017, the deduction disallowance under section 67 as modified by the Act. Therefore, the Treasury Department and the IRS intend to issue regulations, pursuant to the grant of authority under section 965(o), providing that a section 965(c) deduction will not be treated as an itemized deduction, including for purposes of sections 56 and 67.

SECTION 4. MODIFICATION OF RULE DESCRIBED IN SECTION 3.04(a) OF NOTICE 2018-13

Section 3.04(a) of Notice 2018-13 announced that the Treasury Department and the IRS intend to issue regulations providing that, for purposes of calculating the net accounts receivable of a specified foreign corporation, the term "accounts receivable" means receivables described in section 1221(a)(4), and the term "accounts payable" means payables arising from the purchase of property described in section 1221(a)(1) or 1221(a)(8) or the receipt of services from vendors or suppliers. The Treasury Department and the IRS have determined that it is appropriate to exclude any receivable or payable with an initial term of one year or more for purposes of calculating a specified foreign corporation's net accounts receivable. Cf. section 965(c)(3)(B)(iii)(IV) (short-term obligations). Accordingly, the Treasury Department and the IRS intend to issue regulations providing that the terms "accounts receivable" and "accounts payable" will include only receivables or payables with a term of less than one year.

SECTION 5. REGULATIONS TO BE ISSUED ADDRESSING ELECTIONS UNDER SECTION 962

As discussed in section 3.05(b) of this notice, if a domestic pass-through entity is a United States shareholder that has a section 965(a) inclusion amount with respect to section 958(a) stock in a DFIC, a domestic pass-through owner of such entity is subject to net income tax on its share of the section 965(a) inclusion amount. The Treasury Department and the IRS intend to issue regulations clarifying that a domestic pass-through owner who is an individual (including, as provided in §1.962-2(a), a trust or estate) and a United States shareholder with respect to a DFIC may make an election under section 962 with respect to the individual's share of the section 965(a) inclusion amount of a domestic pass-through entity with respect to such DFIC. However, an individual who is not a United States shareholder of a DFIC is not permitted to make an election under section 962 with respect to the individual's share of a section 965(a) inclusion amount of a domestic pass-through entity with respect to such DFIC notwithstanding the rules in section 3.05(b) and (c) of this notice. See section 962(b). The regulations will clarify that the same principles apply to inclusions under section 951(a) other than by reason of section 965.

If an individual elects to have the provisions of section 962 apply for a taxable year, the tax imposed on amounts included in the individual's gross income under section 951(a) (directly by reason of owning section 958(a) stock or indirectly by reason of being a domestic pass-through owner), including by reason of section 965, is an amount equal to the tax that would be imposed under section 11 if the amounts were received by a domestic corporation. In addition, §1.962-1(b)(1)(i) provides that a deduction of a United States shareholder does not reduce the amount included in gross income under section 951(a) for purposes of computing the amount of tax that would be imposed under section 11.

The Treasury Department and the IRS have determined that in the case of a taxpayer making an election under section 962, Congress intended for the section 965(c) deduction (which is generally available to United States shareholders of DFICs, including individuals) to be allowed with respect to the tax imposed under section 11 rather than under section 1. See H.R. Rep. No. 115-466, at 620 (2017) (Conf. Rep.). Pursuant to the grant of authority under section 965(o), the Treasury Department and the IRS intend to modify §1.962-1(b)(1)(i) to provide that, in computing the amount of tax due as a result of a section 962 election, the section 965(c) deduction may be taken into account. Specifically, the regulations will provide that “taxable income” as used in section 11 shall be reduced by the section 965(c) deduction. These regulations will not apply to any other deductions, and therefore existing §1.962-1(b)(1)(i) will continue to provide that “taxable income” as used in section 11 shall not be reduced by any other deductions. Any section 965(c) deduction allowed in determining “taxable income” as used in section 11 for purposes of computing the tax due as a result of a section 962 election will not also be allowed for purposes of determining an individual’s actual taxable income.

Example. (i) Facts. USI, a United States citizen, owns 10% of the capital and profits of USPRS, a domestic partnership that has a calendar year taxable year, the remainder of which is owned by foreign persons unrelated to USI or USPRS. USPRS owns all of the stock of FS, a foreign corporation that is a CFC with a calendar year U.S. taxable year. USPRS has a section 965(a) inclusion amount with respect to FS of $1,000 and is allowed a section 965(c) deduction of $700. FS has no post-1986 foreign income taxes (as defined in section 902(c)(1) as in effect before the date of the enactment of the Act). USI makes a valid election under section 962 for 2017.

(ii) Analysis. USI’s “taxable income” described in §1.962-1(b)(1)(i) equals $100 (USI’s distributive share of USPRS’s section 965(a) inclusion amount) minus $70 (USI’s distributive share of USPRS’s allowable section 965(c) deduction), or $30. No other deductions are allowed in determining this amount. USI’s tax on such amount will be equal to the tax imposed under section 11 as if $30 were received by a domestic corporation. USI cannot deduct $70 for purposes of determining USI’s taxable income that is subject to tax under section 1.

## SECTION 6. PENALTY RELIEF UNDER SECTIONS 6654 AND 6655 IN CONNECTION WITH THE AMENDMENT OF SECTION 965 AND THE REPEAL OF SECTION 958(B)(4)

### *.01 Penalty Waiver with Respect to Section 965*

A United States shareholder that has a net tax liability under section 965 generally includes the amount of the net tax liability on its return for the year in which or with which the inclusion year of the DFIC ends.

Section 965(h)(1) provides that a United States shareholder of a DFIC may elect to pay the net tax liability under section 965 in eight annual installments, the first of which is due on the due date (without regard to any extension of time to file) of the return for the shareholder's taxable year in which or with which the inclusion year of the DFIC ends. Each successive installment is due on the due date (without regard to any extension of time to file) of the return for the taxable year following the taxable year the prior installment was made. Section 965(h)(2). The timely payment of an installment does not incur underpayment interest. See H.R. Rep. No. 115-466, at 611 (2017) (Conf. Rep.). Section 965(h), therefore, demonstrates Congress's intent to permit a taxpayer to pay its net tax liability under section 965 without incurring additional liability, including additions to tax. Consistent with this intent, and in the interest of sound tax administration, the IRS will waive underpayment penalties under sections 6654 and 6655 with respect to a taxpayer's net tax liability under section 965 for those taxpayers that make an election under section 965(h). In addition, the IRS will waive underpayment penalties under sections 6654 and 6655 with respect to a taxpayer's net tax liability under section 965 for those taxpayers who do not elect to pay their net tax liability under section 965 in installments. Accordingly, a taxpayer's required installments of estimated tax need not include amounts attributable to its net tax liability under section 965 to prevent the imposition of penalties under sections 6654(a) and 6655(a). If a taxpayer fails to timely pay its net tax liability under section 965 when due, other sections of the Code may apply; for example, additions to tax could result under section 6651, and installment payments could be accelerated under section 965(h)(3).

The instructions to estimated tax forms will be modified, as necessary, to clarify that no underpayment penalty will be imposed under section 6654 or section 6655 with respect to a taxpayer's net tax liability under section 965 and that the taxpayer may exclude such amounts when calculating the amount of its required installment.

*.02 Penalty Waiver for 2017 with Respect to Amendments to Sections 965 and 958(b) by the Act*

In addition, because the amendment to section 965 and the repeal of section 958(b)(4) could also affect tax liability (other than by way of the imposition of the net tax liability under section 965) for periods that end before or shortly after the enactment of the Act, the IRS has determined that additional penalty relief is appropriate. Therefore, the IRS has determined that if the amendment to section 965 or the amendment to section 958(b) by the Act causes an underpayment related to a required installment of estimated tax due on or before January 15, 2018, the estimated tax penalty under section 6654 or section 6655 will not apply to that underpayment.

SECTION 7. EFFECTIVE DATES

Section 965 is effective for the last taxable years of foreign corporations that begin before January 1, 2018, and with respect to United States shareholders, for the taxable years in which or with which such taxable years of the foreign corporations end. The Treasury Department and the IRS intend to provide that the regulations and instructions described in sections 3, 4, 5, and 6 of this notice are effective beginning for the first taxable year of a foreign corporation (and with respect to United States shareholders, the taxable years in which or with which such taxable years of the foreign corporations end) to which section 965 applies. Before the issuance of the regulations and instructions described in this notice, taxpayers may rely on the rules described in sections 3, 4, 5, and 6 of this notice.

This notice also clarifies one of the effective dates described in section 6 of Notice 2018-13, which provided that taxpayers could rely on the rules described in section 5.01 of Notice 2018-13 with respect to the last taxable year of foreign corporations beginning before January 1, 2018, and for the taxable years of United States shareholders in which or with which such taxable years of foreign corporations end, pending the issuance of further guidance. Taxpayers may rely on section 5.01 of Notice 2018-13 with respect to the last taxable year of foreign corporations beginning before January 1, 2018, and each subsequent year of such foreign corporations, and for the taxable years of United States shareholders in which or with which such taxable years of foreign corporations end, pending the issuance of further guidance (the application of which will be prospective).

## SECTION 8. REQUEST FOR COMMENTS AND CONTACT INFORMATION

The Treasury Department and the IRS request comments on the rules described in this notice. The Treasury Department and the IRS expect to issue additional guidance under section 965, and the Treasury Department and the IRS request comments on what additional guidance should be issued to assist taxpayers in applying section 965.

Written comments may be submitted to the Office of Associate Chief Counsel (International), Attention: Leni C. Perkins, Internal Revenue Service, IR-4579, 1111 Constitution Avenue, NW, Washington, DC 20224. Alternatively, taxpayers may submit comments electronically to Notice.comments@irscounsel.treas.gov. Comments will be available for public inspection and copying.

The principal author of this notice is Ms. Perkins of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact Ms. Perkins at (202) 317-6934 (not a toll free call).

# AGGREGATE VS. ENTITY THEORY AFTER TCJA

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Report No. 1387
February 2, 2018

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
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The Honorable David J. Kautter
Acting Commissioner
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1111 Constitution Avenue, NW
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The Honorable William M. Paul
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1111 Constitution Avenue, NW
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Re: *Request for Immediate Guidance under Sections 864(c)(8) and 1446(f)*

Dear Messrs. Kautter and Paul:

The New York State Bar Association Tax Section (the "Tax Section") is submitting this letter[1] to request immediate guidance under Sections 864(c)(8) and 1446(f) (collectively, the "Provisions") of the Internal Revenue Code of 1986, as amended (the "Code"), which were added to the Code pursuant to P.L. 115-97 (the "Act") on December 22, 2017.

[1] The principal drafters of this letter were Robert Cassanos and Michael Shulman with contributions from Stanley A. Barsky, Kimberly S. Blanchard, Charles W. Cope, Ze'ev Deutsch, Tim Devetski, Phillip J. Gall, Rafael Kariyev, Michael Karlin, Abraham Leitner, Michael Miller, Erika W. Nijenhuis, Harsha Reddy, Tyler Robbins, David R. Sicular, Michael Schler, Eric B. Sloan, Karen G. Sowell, Chaim Stern, and Gordon E. Warnke. This letter reflects solely the views of the Tax Section of the New York State Bar Association ("NYSBA") and not those of the NYSBA Executive Committee or the House of Delegates.

As discussed below, while the Provisions raise numerous technical and interpretative issues that should be addressed through regulations, there is a pressing need for immediate guidance regarding the Provisions, particularly in light of the current requirement to withhold tax under Section 1446(f) in connection with the transfer of certain partnership interests and the effect of Section 864(c)(8) on the structuring of certain transactions. Such guidance would allow affected transactions to proceed in a workable manner while the government considers how to address the broader set of issues raised by the Provisions.

## I. Background

Section 864(c)(8) provides that gain or loss recognized by a nonresident alien individual or foreign corporation from the sale, exchange or disposition of a directly or indirectly held partnership interest generally is treated as effectively connected with the conduct of a U.S. trade or business to the extent that such gain or loss does not exceed the gain or loss such person would have recognized as effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the transfer. Section 1446(f) provides that a transferee of such a partnership interest generally must withhold tax equal to 10% of the amount realized upon the disposition of a partnership interest if any gain on the transfer of such interest would be treated as effectively connected with the conduct of a U.S. trade or business under Section 864(c)(8). If the transferee fails to withhold the correct amount of tax under Section 1446(f), the obligation to collect is shifted to the partnership, which is required to withhold from distributions to the transferee partner any amount required to be, but not, withheld by the transferee.

The enactment of Section 864(c)(8) was intended to override the result in *Grecian Magnesite Mining Co. v. Commissioner*, 149 T.C. No. 3 (July 13, 2017) ("*Grecian Magnesite*"), and to codify the holding in Revenue Ruling 91-32, 1991-1 C.B. 107. In *Grecian Magnesite*, the Tax Court held that gain recognized on a sale or exchange by a foreign person of an interest in a partnership that is engaged in a U.S. trade or business generally does not constitute income that is effectively connected with a U.S. trade or business ("ECI"). In *Grecian Magnesite*, the court rejected the position of the Internal Revenue Service (the "Service") in Revenue Ruling 91-32 that gain or loss recognized by a foreign person upon its disposition of a partnership interest generally constitutes effectively connected gain or loss to the extent of the foreign person's distributive share of unrealized gain or loss of the partnership attributable to effectively connected property of the partnership.

The Provisions, however, go well beyond a codification of Revenue Ruling 91-32. Most notably, Section 1446(f) imposes a new withholding regime on transfers of partnership interests after December 31, 2017. As a result, partnership interest transfers occurring in 2018 are potentially subject to withholding tax without the benefit of much-needed guidance on the scope and manner of this new withholding regime.

Section 864(c)(8) also differs in certain important respects from the holding in Revenue Ruling 91-32 and is ambiguous in many respects. Moreover, Revenue Ruling 91-32 itself raised numerous interpretative questions, resulting in substantial commentary from practitioners, the issuance of a prior report by the Tax Section[2] and the initiation of a project at the Department of the Treasury ("Treasury") and the Service regarding the implementation of the ruling.[3] Most of these questions continue to apply to the application of Section 864(c)(8).

In response to concerns expressed by taxpayers and practitioners, Treasury and the Service issued Notice 2018-8, 2018-4 I.R.B. (Jan. 2, 2018), which suspended all withholding in connection with the sale or other disposition of publicly traded partnership ("PTP") interests under Section 1446(f) until regulations or other guidance under such section are issued. Notice 2018-8 also requested comments on whether a temporary suspension of Section 1446(f) withholding for partnership interests other than PTP interests is needed and what additional guidance may be needed to assist taxpayers in applying the Provisions.[4]

Part II of this letter recommends that immediate guidance be provided on certain critical issues in order for the withholding regime under Section 1446(f) to operate in a workable manner until more detailed guidance can be issued or, alternatively, that withholding be delayed until guidance is issued. Part III of this letter makes recommendations for immediate guidance under Section 864(c)(8) (regardless of whether withholding under Section 1446(f) is delayed) in order to clarify certain matters that could meaningfully affect the structuring of current transactions. Finally, in Part IV of this letter, we provide a brief summary of a number of other important issues raised by the Provisions that should be addressed through guidance.

## II. Recommendations Regarding Section 1446(f)

Although Section 1446(f) is currently in effect for partnerships that are not PTPs, applying its provisions as written in a sensible manner has proven to be challenging in a number of circumstances. In particular, the manner in which Section 1446(f) was drafted leaves many interpretative gaps. Ideally, guidance to address such gaps should be prompt but also thorough and workable. Given the need for thought and care in handling many of the difficult issues that arise under the statute, there is some tension between the goals of speed and thoroughness/workability. Accordingly, we recommend that the Service consider extending to all partnerships the delay in implementation of Section 1446(f) currently in effect for PTPs until practical guidance can be issued if Treasury and the Service conclude that they cannot provide workable guidance in a very short time frame.

The following two examples illustrate some of the many challenges withholding agents currently face in implementing the withholding regime under Section 1446(f) without further guidance.

[2] *See* N.Y. St. Ba. Ass'n, Tax Sec., *Report on Guidance Implementing Revenue Ruling 91-32* (Jan. 21, 2014).

[3] *See* Joint Treasury, IRS 2013-2014 Priority Guidance Plan.

[4] We understand that Treasury and the Service are presently crafting a procedure to implement Section 1446(f) withholding for PTPs and that this procedure may place the responsibility for withholding on the broker of the transferor of the partnership interest. In light of this ongoing process, we are not commenting further on issues specific to PTP withholding in this letter.

*Example 1:* Open-ended domestic fund classified as a partnership for U.S. federal income tax purposes ("PRS") periodically redeems interests of holders, each of whom has provided PRS with a Form W-9 certifying its status as a U.S. person. PRS has a U.S. trade or business ("USTB"), which constitutes less than 1% of its gross assets. As drafted, PRS apparently must either obtain affidavits from each redeeming partner or withhold 10% of the amount realized on the disposition by such redeeming partner because it is not clear that a Form W-9 is considered an "affidavit" for this purpose (and notwithstanding the fact that less than 1% of PRS's assets are used in a USTB).

*Example 2:* A foreign person ("FP") is a partner in a foreign partnership ("FPRS") that to the best knowledge of FP does not have a USTB. FP wishes to sell its partnership interest to another foreign person. Under the statutory provision, although there is in fact no withholding obligation, there is no practical procedure for the buyer in this transaction to avoid the requirement to withhold because there is no reasonable cause exemption. Even if FPRS were willing to certify that it has no USTB assets, the statute does not permit a buyer to rely on such certification to avoid withholding.

We make below two alternative recommendations concerning the effective and orderly implementation of Section 1446(f), given the lack of guidance. Specifically, we recommend that either (i) Treasury and the Service issue immediate guidance that addresses the most pressing issues regarding the manner in which withholding under Section 1446(f) is to be conducted or (ii) if workable guidance cannot be issued in a very short period of time, the application of withholding for all partnership interests be delayed until regulations or other guidance is issued. We believe that at a minimum such "workable guidance" should address the issues set forth in this letter with respect to both Section 864(c)(8) and Section 1446(f). We note that there are many other important interpretative issues to be addressed, some of which are briefly summarized in Part IV below.

A. <u>Alternative 1: Provide Immediate Guidance Allowing for Orderly Application of Withholding Rules until More Detailed Guidance Is Provided</u>

We recommend that the government provide immediate and temporary guidance (until further guidance is issued) that would provide basic and needed direction so that withholding may be done in a reasonable manner in advance of broader guidance being issued. As described below, we believe that such immediate guidance should provide that (i) no withholding is required if the effectively connected assets of the partnership do not constitute a substantial portion of the partnership's total assets, (ii) a transferee may rely on certification provided by the underlying partnership to determine whether withholding is required, (iii) a transferee of a partnership interest generally may rely on a Form W-9 to certify the U.S. status of the transferor, and (iv) nonrecognition transactions (with certain appropriate carve-outs) are exempt from withholding.

1. <u>No Withholding Where the Partnership's Effectively Connected Assets are Less than a Specified Percentage of the Partnership's Total Assets</u>

The statute by its terms appears to require withholding of 10% of the entire amount realized by a seller of a partnership interest if the seller recognizes any gain on the sale and there is even a dollar of gain that would be treated as ECI on a sale of partnership assets. The fact that withholding is required with respect to amounts not attributable to USTB assets can result in the withholding of tax in an amount that is grossly disproportionate to the amount of tax that will ultimately be due. Although Section 1446(f)(3) allows taxpayers to make an application to the Service to reduce the amount required to be withheld, there is presently no procedure in place to obtain such relief. Moreover, even if there were, such relief would have to be given on a case-by-case basis and, in any event, would in many cases be unnecessarily costly and burdensome to both taxpayers and the Service, particularly where the value of USTB assets held by the underlying partnership is relatively small.

Section 1446(f)(6) provides the Secretary with regulatory authority to provide exceptions from the requirement to withhold. We believe that this authority should be utilized to create an exception from the requirement to withhold in connection with the transfer of a partnership interest where the value of the partnership's USTB assets is less than a specified percentage of the value of the partnership's total assets. An application for relief from withholding should still be available under Section 1446(f)(3) to cover situations where the exception does not apply but the amount of tax due will be less than the amount required to be withheld.

For purposes of identifying a model for interim guidance, we considered the withholding regime for FIRPTA (the Foreign Investment in Real Property Tax Act of 1980), which generally provides that gain realized on the disposition of a U.S. real property interest ("USRPI") is considered effectively connected income, which in certain cases requires withholding upon the transfer of an interest in a partnership that holds a USRPI. Withholding under the FIRPTA regime is required upon the transfer of a partnership interest only if (i) 50% or more of the value of the gross assets of such partnership consists of USRPIs and (ii) 90% or more of the value of the gross assets of the partnership consists of USPRIs plus any cash or cash equivalents (the "50%/90% rule"). *See* Treas. Reg. §§ 1.897-7T(a) and 1.1445-11T(b). This is a ready-made rule that is familiar to both taxpayers and the Service, which could be adopted for Section 1446(f) by substituting USTB assets for USRPIs. We note that this standard would allow for withholding tax to be avoided even on the transfer of an interest in a partnership substantially more than half of whose assets consist of USTB assets. In that regard, the rule could be modified, if desired, to use only the 50% prong for purposes of Section 1446(f). Under this approach, withholding under Section 1446(f) would be required only if 50% or more of the value of the partnership's gross assets consists of USTB assets. With or without such a "de-coupling," using Section 1445 principles, at least on a temporary basis, would have certain benefits. First, as noted above, the framework for such an exception is already in place in the FIRPTA context and is familiar to both the Service and practitioners. Thus, using the framework in this context would allow for a smoother implementation of the new withholding regime than if a completely new approach were adopted. Second, using this framework for the new withholding regime might allow for easier coordination between the different withholding regimes under Section 1445 and Section 1446(f). For example, income and loss with respect to USRPIs often are effectively connected with a U.S. trade or business.

If the 50% threshold is lowered for this interim guidance, we recommend that the principles and procedures of the 50%/90% test be used. In considering which threshold to use, we would note the following factors: (i) the calculations required are extremely complex and burdensome; (ii) the higher the threshold, the more readily certification may be obtained; and (iii) a higher threshold serves to mitigate to a greater extent the difficulties of complying with the "amount realized" requirement discussed below.

Whether a 50% threshold is adopted, or a lower threshold is used, consideration should be given to integrating the procedures under Section 1445 relating to transfers of partnership interests with those under Section 1446(f) so that the two procedures can work in tandem even if the thresholds are different (*e.g.*, the Section 1446(f) regime should allow the use of the same forms and certification procedures as the Section 1445 withholding regime), although for the reasons set forth above, it would be preferable if the procedures were the same, at least for the immediate future.[5]

2. <u>Allow Transferees to Rely on Certifications</u>

Section 1446(f) does not by its terms permit certification as to the underlying partnership's USTB assets to be given or relied on by any person (either the transferee or the partnership itself) to avoid withholding under Section 1446(f). The absence of a reliable certification process can place transactions at risk since in many cases the buyer can only avoid liability by withholding and allowing the seller to file for a refund, which in many cases will be unduly burdensome since the amount of the tax may not have a strong relationship to the amount of withholding.

Section 1445 permits a transferee of a partnership interest to rely on certification from the underlying partnership to determine if the partnership satisfies the 50%/90% test. We recommend that discretionary certification by a partnership equivalent to that permitted for purposes of the 50/90% test under the FIRPTA regime be permitted to allow transferees to determine whether the underlying partnership is under the applicable threshold for USTB assets (as described in Part II.A.1 above) for purposes of determining whether withholding is required.

We note, however, that because Section 1446(f) imposes secondary liability on the partnership to withhold from distributions to the transferee if the transferee fails to withhold, partnerships may be reluctant or unwilling to provide such a certification because relieving the transferee of withholding responsibility causes the partnership to be potentially liable for any underwithholding if the certification were ultimately determined to be incorrect. This dynamic is part of a larger challenge created by the Provisions, which is that the proper calculation of whether tax is due under the Provisions, and the amount of any such tax, will require the underlying partnership to provide detailed information to the transaction parties (including the liabilities allocable to the transferred interest, the amount of net gain inherent in the partnership's USTB assets and the portion of any such gain allocable to the interest), each of which (except for the first) is a purely hypothetical calculation. The overall construction of the statute and, in particular, the potential secondary liability of the partnership for any under-withholding may make efforts of the affected parties to comply with the Provisions without undue burden or inefficiency more difficult precisely because the partnership (which is best positioned to provide accurate information) is incentivized not to cooperate in this process. To address this issue, the secondary withholding

[5] In this regard, we note that Section 1446(f) provides no direction on the timing or manner of remitting amounts withheld under that provision. Immediate guidance should address this by either directing withholding agents to use the same withholding remittance procedures set forth in Section 1445 or requiring the remittance of any tax withheld under Section 1446(f) no earlier than 30 days after guidance addressing such procedures is issued. In addition, Sections 1445 and 1446(f) should be coordinated to prevent the possibility that withholding of tax under both provisions may be required, for example, in the case of the transfer of an interest in a partnership whose assets principally consist of USRPIs but that also holds non-USRPI assets that comprise a USTB.

liability could be relieved in cases where the partnership provides a certification or other information under penalties of perjury and such certification or information was prepared reasonably and was consistent with the partnership's tax reporting.

Certification issues may also arise when partnerships make cash distributions to continuing partners. In that case, assuming the distribution is not part of a disguised sale of a partnership interest and there is no alteration in the distributee partner's share of Section 751(b) property, the distribution generally does not result in gain except to the extent that the amount of the distribution exceeds such partner's basis in its partnership interest. Such gain is treated as gain from the sale or exchange of the partnership interest of the distributee partner. Section 864(c)(8) requires a sale, exchange or disposition of a partnership interest in order to potentially characterize gain or loss as effectively connected with a U.S. trade or business; Section 1446(f) requires a disposition of a partnership interest in order to potentially impose a withholding obligation. Accordingly, to the extent a partnership cash distribution does not exceed the distributee partner's basis, there should be neither a substantive tax nor a requirement to withhold. The foregoing should be confirmed through immediate guidance.

Even though withholding should not be required where a cash distribution does not exceed the distributee partner's basis, the partnership may not have knowledge of sufficient facts to determine such partner's outside basis. As a result, because a partner's basis may be less than the partnership would expect as a result of facts not within the knowledge of the partnership, the partnership may decide to withhold on all distributions of cash (including operating cash flow distributions in the ordinary course) in order to avoid potential exposure to transferee liability if a cash distribution were found to exceed the distributee partner's basis. Accordingly, we recommend that, for purposes of Section 1446(f), a partnership be allowed to rely on its books and records to determine which portion, if any, of a distribution is in excess of a partner's basis, provided it does not know or have reason to know that such partner's basis is not accurately determined by such information. A partnership also should be allowed to rely for purposes of the withholding tax determination under Section 1446(f) on a certification received from a distributee partner as to such partner's basis, provided that the partnership does not know or have reason to know that the certification is incorrect. A partnership that meets either standard should be relieved of any liability for underwithholding. Failure to promulgate such a rule could result in partnerships with USTBs withholding on all cash distributions to foreign partners to avoid withholding liability.

> *Example*: PRS is engaged solely in a USTB. Based on its books and records, PRS determines that FP has a tax basis of $10X in its PRS interest, after taking into account FP's distributive share of income and loss for the current and prior periods and all prior distributions to FP. PRS makes a distribution of $8X of cash to FP. No withholding should be required in this case because PRS has determined, based on information within its control, that there has been no amount treated as gain from the sale or exchange of FP's interest. If, however, unbeknownst to PRS, FP's basis was in fact only $6X, FP would recognize $2X of gain, characterized as ECI under Section 864(c)(8). Nevertheless, because PRS did not know or have reason to know that the cash distribution exceeded FP's basis, PRS should be relieved of any liability for underwithholding with respect to the $2X of gain.

3. Treatment of Form W-9 as a Nonforeign Affidavit for Purposes of Section 1446(f)(2)

Section 1446(f)(2) provides that no withholding is required if the transferor furnishes to the transferee an affidavit stating, under penalty of perjury, the transferor's U.S. taxpayer identification number and that the transferor is not a foreign person. In many cases, the exception has limited efficacy, however, by placing undue compliance burdens on partners, partnerships and other withholding agents. For instance, in the case of domestic partnerships that periodically redeem the interests of their partners, all of the partners may be U.S. persons and have certified that fact under penalty of perjury on a Form W-9. However, if the partnership cannot rely on a Form W-9 to eliminate its withholding liability, the partnership will be required to either obtain separate affidavits from each of its partners (which may prove burdensome) or withhold with respect to each redemption, despite the fact that such redemptions are not subject to tax by virtue of Section 864(c)(8).

The Form W-9 requirements (*i.e.*, provision of a U.S. taxpayer identification number and certification that the person providing the Form W-9 is a U.S. citizen or other U.S. person, both under penalty of perjury) match the requirements set forth in the exception for a nonforeign affidavit. While the Form W-9 would therefore appear to meet the substantive requirements of Section 1446(f)(2), any uncertainty in this regard could frustrate the purpose of the exception. Thus, to achieve the intended objective of the nonforeign affidavit exception without requiring duplicative and burdensome documentation requirements, we recommend Treasury and the Service issue guidance that confirms that a duly certified Form W-9 is an acceptable certification for purposes of Section 1446(f)(2).

4. Provide for No Withholding in the Case of Nonrecognition Transfers

For the reasons discussed in Part III.A below, we believe that Section 864(c)(8) should not be interpreted to override nonrecognition treatment (except where recognition treatment is necessary in order to prevent the permanent elimination of gain through the use of a nonrecognition provision). We recommend that immediate guidance provide that, in the case of any partnership interest transfer that is eligible for nonrecognition treatment, other than a form of transfer that is specifically identified in such guidance, no withholding under Section 1446(f) is required. If desired, the transferor could be required to provide certification of nonrecognition treatment to the transferee and also to notify the Service.

B. Alternative 2: Delay Withholding on Transfers of Non-Publicly Traded Partnership Interests

We believe that, in the absence of guidance addressing the issues discussed in Alternative 1 and Part III below, implementation of the withholding tax regime under Section 1446(f) should be delayed until such guidance is released. As it currently operates, the application of the statutory withholding provision is overinclusive and imposes an undue burden on withholding agents. Without immediate guidance addressing the issues raised in this letter or a temporary delay in withholding, many partnership interest transfers may be delayed or abandoned in light of the many uncertainties associated with the Provisions.

In addition, we note that in many if not almost all cases, partners in non-traded partnerships which have a U.S. trade or business are already subject to "regular" withholding under Section 1446, and so are already in the U.S. tax filing system. This may reduce the risk to the U.S. tax system of a short-term delay in the implementation of Section 1446(f) withholding. Extending the delay set forth in Notice 2018-8 to the application of withholding under Section 1446(f) to all partnership interests would give practitioners and other interested parties the opportunity to identify issues and propose solutions and would provide the government with time to consider such comments in drafting guidance that is reasonable, workable and thorough. Such a delay would have no effect on the amount of U.S. tax ultimately owed by the foreign partner by virtue of Section 864(c)(8). We note, however, that even if withholding of tax under Section 1446(f) is delayed, it is critical that immediate guidance still be issued clarifying the application of Section 864(c)(8) to nonrecognition transactions and treaties, as discussed in Part III below.

## III. Recommendations Regarding Section 864(c)(8)

### A. Interaction of Section 864(c)(8) with Nonrecognition Provisions

By its terms, Section 864(c)(8) does not purport to override nonrecognition provisions, and instead merely characterizes gain or loss as effectively connected. Nevertheless, some practitioners have suggested that the statute could be read as requiring gain recognition in connection with a partnership interest transfer, even where a nonrecognition provision otherwise applies. We believe that the statute only characterizes gain or loss as effectively connected gain or loss and is not intended to change the determination of whether gain or loss is recognized. This view is consistent with the approach taken in Revenue Ruling 91-32, which provided a rule for characterizing recognized gain or loss, and did not itself require the recognition of gain or loss.

Given the apparent confusion on this point, however, we think it is important for immediate guidance to confirm that, except as provided in regulations (or other published guidance), the Provisions do not apply to transactions otherwise eligible for nonrecognition treatment. In this regard, we note that Section 864(c)(8)(E) provides the Secretary with regulatory authority in appropriate cases to require the recognition of gain or loss upon the transfer of a partnership interest even where nonrecognition treatment would otherwise be available. We briefly discuss below in what circumstances it might be appropriate for this authority to be used to override nonrecognition treatment.

One approach in evaluating whether Section 864(c)(8) should override a particular nonrecognition provision would be to align, where possible, the treatment of partnership interest transfers with the treatment of comparable transfers of U.S. branches holding the same assets (the "Branch Consistency Approach"). Under this approach, a nonrecognition provision would continue to apply to a foreign person's transfer of a partnership interest to the extent that a transfer of the partnership's underlying assets in a comparable transaction would be eligible for nonrecognition treatment. The focus of this approach would be on whether the gain that would have been subject to U.S. tax if the partnership interest at issue were sold is preserved in a manner that will continue to be subject to U.S. tax, such that there is no erosion of the U.S. tax base.[6]

6 A special rule might be necessary for a limited class of transactions, for example those involving certain provisions of Subchapter K where there is no ready analogy to a branch transaction, but no base erosion is present.

Another approach would be to provide that gain inherent in the foreign partner's interest that would be taxable under Section 864(c)(8) upon a sale would be triggered unless the interest is exchanged in a nonrecognition transaction for an interest that would be subject to U.S. tax in the hands of the transferor upon a subsequent sale to at least the same extent (the "Transferor Gain Approach"). Under this approach, the focus would be on ensuring that the foreign partner cannot escape U.S. tax with respect to its partnership interest even if the amount of income and gain that will ultimately be subject to U.S. tax has not changed and even if the identical transaction would not have been taxable had it been an asset transfer, rather than an interest transfer.

We consider below three types of nonrecognition transactions involving partnership interests and the extent to which it may be appropriate for any guidance to override nonrecognition treatment.

> *Section 721(a) Contributions*. FP contributes its interest in PRS1 to PRS2 in a transaction qualifying under Section 721(a). Assume PRS1 has a USTB. A contribution by a foreign person of the assets of a U.S. branch to a partnership generally does not give rise to the recognition of gain or loss. The same rule should apply in this case because Section 704(c) generally causes any pre-contribution gain or loss with respect to the PRS1 interest to be allocated to FP. Thus, using either approach outlined above, Section 864(c)(8) should not override nonrecognition treatment in this case.
>
> *Section 351(a) Contributions*. FP holds an interest in PRS, which it contributes to a newly formed U.S. corporation ("Corp") in a transfer qualifying for nonrecognition treatment under Section 351(a). A contribution by a foreign person of the assets of a U.S. branch to a corporation generally qualifies for nonrecognition treatment under Section 351(a), except with respect to the assumption of certain liabilities. Thus, under the Branch Consistency Approach, nonrecognition treatment should be available to the extent that, due to having a carryover basis of the PRS interest, Corp (whether it is domestic or foreign) will ultimately be taxed on (or otherwise take into account) all of the pre-contribution built-in gain in the PRS interest. Under the Transferor Gain Approach, however, even though the gain otherwise would remain subject to U.S. taxation in a modified form of ownership, the contribution would be taxable to FP because, after the contribution, FP would not be subject to U.S. tax on a subsequent disposition of its stock in Corp (unless Corp is a United States real property holding corporation). Appropriate adjustments would need to be made to the basis of Corp's assets to reflect the gain recognized.
>
> *Section 731(a) Distributions*. FP and a U.S. person ("USP") hold interests in PRS. PRS has a USTB and also holds non-USTB assets. In a transaction ordinarily qualifying as a nonrecognition transaction, PRS distributes the non-USTB assets to FP in complete redemption of its interest in PRS. In such a case, while USP remains fully subject to tax, FP has gone from partially subject to U.S. tax (because it indirectly held a share of the USTB through PRS) to not being subject to U.S. tax because it no longer holds any interest in PRS. In such case, under either approach, nonrecognition treatment may not be appropriate. Nevertheless, depending on the factual circumstances (*e.g.*, where the parties have a strong business purpose for causing FP to be redeemed for non-USTB assets), there may be

situations where nonrecognition may still be appropriate. We believe further study is warranted to determine the circumstances in which it is necessary to override the nonrecognition rule in Section 731, as we believe the determination may not be susceptible to a hard and fast rule.

The foregoing examples are intended to illustrate that the application of many nonrecognition provisions to transfers of interests in partnerships with a USTB do not create the potential for inappropriate results, but that there are circumstances where an override of otherwise-applicable nonrecognition provisions may be appropriate. Given the number of potential fact patterns and the complexity of these issues (as illustrated above), in an effort to provide near-term guidance, we recommend that any guidance confirm that the Provisions do not override nonrecognition provisions except as provided in future guidance, perhaps with a carve-out at least for transactions that would have the effect of causing gain that would have been subject to U.S. tax to no longer be subject to U.S. tax. If desired, the Tax Section would be happy to provide more detailed analysis and recommendations on this issue.

B. Interaction of Section 864(c)(8) and Treaty Provisions

The application of U.S. income tax treaties to transactions described in Section 864(c)(8) should be clarified. In particular, Treasury and the Service should confirm whether (i) Section 864(c)(8) is intended to override treaty provisions and other reciprocal agreements, given that such agreements are nowhere mentioned in the section, and (ii) the approach taken in Revenue Ruling 91-32 (Situation 3) will apply to the application of Section 864(c)(8).

In Revenue Ruling 91-32 (Situation 3), a foreign partner was eligible for the benefits of an income tax treaty which provided that gain recognized by a resident of the treaty partner from the disposition of movable property was exempt from U.S. tax except to the extent such gain is from the disposition of assets of a permanent establishment in the United States ("USPE"). The ruling then held that gain from the disposition of the foreign partner's partnership interest will be subject to U.S. tax only to the extent such gain is attributable to unrealized gain of the partnership's assets attributable to the partnership's USPE. We recommend that guidance confirm this approach, including nontaxation in cases where the relevant partnership has no USPE. In addition, we recommend that the withholding rules be coordinated to reflect this conclusion (for example, for purposes of calculating the threshold amount to determine if withholding is required).[7] We note that the interaction of treaties and the Provisions is a complex topic that will likely require further study and guidance.

[7] We also recommend that such guidance permit an exemption from withholding tax under Section 1446(f) to the extent that the treaty eligibility of the transferring partner will cause the gain from the sale to be fully exempt from U.S. tax (or the portion of the partnership's assets attributable to a USPE is less than the threshold percentage for withholding described above). *Cf.* Treas. Reg. § 1.1446-2(b)(2)(iii) (in determining the amount of effectively connected taxable income of a partnership subject to withholding tax under Section 1446(a), such income does include income or gain exempt from tax by operation of a U.S. income tax treaty or reciprocal agreement).

## IV. Other Issues to be Addressed

The issues addressed above are only a small subset of the significant issues raised by the Provisions. Other issues that Treasury and the Service should consider promptly addressing in subsequent guidance include:

- the fact that the mechanical application of Section 864(c)(8) may result in the taxation of the same items of unrealized gain in USTB assets more than once in the case of partial transfers of a partner's interest or multiple transfers of the same partnership interest,

- the effect, if any, of special allocations of income, gain, loss or deduction on the application of Section 864(c)(8), including the intended effect of the flush language following Section 864(c)(8)(B),

- how to make determinations necessary to apply the Provisions when partnership interest transfers occur during the middle of a tax accounting period,

- the manner of determining the source of effectively connected gain or loss recognized under Section 864(c)(8),

- the interaction of the Provisions with the FIRPTA tax and withholding regime of Sections 897 and 1445,

- the interaction of the Provisions with the partnership audit rules of the Bipartisan Budget Act of 2015,

- the application of the Provisions to tiered partnership arrangements,

- the effect of a shift in a foreign partner's share of USTB assets in a transaction not otherwise resulting in the recognition of gain or loss,

- the application of Section 1446(f) where proceeds are received by a partner in connection with a transaction treated as a disguised sale of a partnership interest,

- whether the secondary liability of a partnership to withhold tax under Section 1446(f) where the transferee failed to do so continues to apply after the transferee transfers the acquired interest to another party,

- the manner in which tax should be withheld under Section 1446(f) in the case of transfers of PTP interests,

- the manner in which a partnership with a USTB may confirm that tax has been withheld on a transfer of a partnership interest in order to eliminate its secondary obligation to withhold on distributions to the transferee, and

- definitional issues with respect to the defined terms provided in Section 1446(f), including the fact that (i) the "transferor" and "transferee" as used in Section 1446(f), by virtue of its cross-reference to Section 1445, appear to be limited to the persons who transfer or receive a "U.S. real property interest" (rather than the partnership interest) and (ii) a "qualified foreign pension fund" is apparently permitted to avoid withholding by providing a nonforeign affidavit (even though such a fund would still be subject to tax on a partnership interest transfer).

The Tax Section would be happy to issue a more detailed report addressing some or all of the issues listed above. We note that certain of these issues (such as the definitional issues under Section 1446(f)) may be more properly addressed through technical corrections.

* * *

We appreciate your consideration of our recommendations. If you have any questions or comments regarding this letter, please feel free to contact us and we will be glad to discuss or assist in any way.

Respectfully submitted,

Karen G. Sowell

Karen Gilbreath Sowell
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Report No. 1392
March 23, 2018

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Re: *Report No. 1392 on Section 199A Deduction*

Dear Messrs. Kautter and Paul:

I am pleased to submit Report No. 1392 adressing Section 199A of the Internal Revenue Code of 1986, as amended (the "**Code**"), which was added to the Code pursuant to P.L. 115-97 (the "**Act**") on December 22, 2017. As discussed in the Report, Section 199A raises numerous technical and interpretative issues that should be addressed. In particular, we believe that there is an immediate need for guidance with respect to (1) the identification of a "specified service trade or business," (2) the determination as to whether a given set of activities constitutes a single trade or business or multiple trades or businesses for purposes of Section 199A (including activities conducted through one or more pass-through entities), (3) the application of Section 199A's netting principles where a taxpayer is engaged in multiple "qualified trades or businesses," and (4) the measurement of "W-2 wages" for purposes of calculating certain limitations on the Section 199A deduction.

Given the scope of Section 199A, and in light of our uncertainty regarding Congressional intent with respect to the resolution of several of the technical ambiguities within the statute, this Report generally refrains from offering firm recommendations on the issues identified for immediate guidance. Rather, this Report notes a number of alternative approaches that could be considered by Treasury and the Service in crafting regulations under Section 199A. For example, with respect to the identification of a "specified service trade or business," the Report notes that Treasury and the Service may consider (i) "safe harbor" lists clarifying the status of certain trades or businesses, (ii) certain mechanical tests as the basis for a presumption, or (iii) certain principles in constructing a regulatory standard. Similar approaches are taken with respect to the identification and separation of multiple "qualified trades or businesses" and the application of the Section 199A netting rules. At the conclusion of the Report we have identified other technical areas in need of guidance, and where possible have offered firmer recommendations where we believe a given result is clearly warranted by the statutory framework of Section 199A.

If further elaboration on any of the points addressed in this Report would be useful to Treasury and the Service, we would be happy to provide additional commentary upon request.

Respectfully submitted,

Karen G. Sowell

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Enclosure

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**NEW YORK STATE BAR ASSOCIATION TAX SECTION**

**REPORT ON SECTION 199A**

**March 23, 2018**

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The New York State Bar Association Tax Section (the "***Tax Section***") is submitting this report[1] to request immediate guidance under Section 199A of the Internal Revenue Code of 1986, as amended (the "***Code***"), which was added to the Code pursuant to P.L. 115-97 (the ***"Act"***) on December 22, 2017. As discussed below, while Section 199A raises numerous technical and interpretative issues that should be addressed through regulations, there is a pressing need for immediate guidance regarding certain aspects of the guidance that go directly to whether taxpayers may access the benefits of Section 199A, and if so, how those benefits are calculated. This guidance is needed sooner rather than later so that taxpayers may pay accurate estimates of taxes owed and make appropriate choice of entity and planning decisions for business ventures.

## I. Background

Section 199A generally allows a non-corporate taxpayer an income tax deduction equal to up to 20% of its qualified business income (***"QBI"***) from pass-through businesses. The provision is of limited duration, and does not apply to taxable years beginning after December 31, 2025.[2] The deduction is based on a mechanical, if relatively complex calculation, as follows:

- First the taxpayer determines whether it (a) recognized QBI, either directly through operation of a sole proprietorship or indirectly through owning an equity interest in an entity classified as a partnership or S corporation, (b) received dividends from a REIT or cooperative or (c) recognized income with respect to an interest in a publicly traded partnership.

- QBI is generally the net amount of qualified items of income, gain, loss and deduction with respect to a "qualified trade or business" (***"QTB"***).[3] There are netting and loss carryforward provisions, which raise uncertainties in the case of multiple trades or businesses, discussed in further detail in Section II.C, below.

- A QTB is generally defined as any trade or business other than (i) a specified service trade or business (***"SSTB"***) or (ii) the trade or business of providing services as an employee; provided that taxpayers with income less than a threshold amount ($415,000 for joint filers and $207,500 for individual filers) are not subject to the SSTB exception.

- An SSTB is generally defined as a trade or business (i) which is described in Section 1202(e)(3)(A)[4], without regard to the words "engineering, architecture", or (ii) which

[1] The principal drafters of this report were Sara B. Zablotney, Adam Kool, Amanda Nussbaum, Lee Allison, and Brad Borden, with substantial contributions from Dario Arezzo, Stanley Barsky, Andy Braiterman, James R. Brown, Robert Cassanos, Phillip Gall, Rafael Kariyev Matthew Lay, Elliot Pisem, Michael Schler, Joel Scharfstein, David H. Schnabel, Eric Sloan, Martin Shenkman, Michael A. Shulman, Karen G. Sowell, Jonathan Talansky, and Willard Taylor. This letter reflects solely the views of the Tax Section of the New York State Bar Association (***"NYSBA"***) and not those of the NYSBA Executive Committee or the House of Delegates.

[2] Section 199A(i).

[3] Section 199A(c).

[4] All Section references herein are to the Code unless otherwise indicated.

involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests or commodities.[5] Uncertainties with respect to the QTB definition and the SSTB definition are discussed in greater detail in Sections II.A and II.B, below.

- The Section 199A deduction is calculated as the sum of (1) the lesser of (A) the "combined qualified business income" (***"Combined QBI"***) amount of the taxpayer or (B) 20% of the excess (if any) of (i) the taxpayer's taxable income over (ii) the sum of the taxpayer's net capital gain, plus the taxpayer's aggregate qualified cooperative dividends and (2) the lesser of (A) 20% of the taxpayer's aggregate qualified cooperative dividends or (B) the taxable income (reduced by the net capital gain) of the taxpayer, for the taxable year, with a cap of the taxpayer's taxable income.[6]

- Combined QBI is itself a complex calculation and is equal to the sum of (1) for each QTB, the lesser of (A) 20% of the taxpayer's QBI with respect to such trade or business or (B) the greater of (i) 50% of the W-2 wages with respect to such trade or business or (ii) the sum of 25% of the trade or business' W-2 wages and 2.5% of the "unadjusted basis" immediately after acquisition of "qualified property" of such trade or business and (2) 20% of the aggregate amount of qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year. The W-2 wage/basis limitations are phased in to apply only to taxpayers with income above a threshold amount ($415,000 for joint filers and $207,500 for individual filers). The deduction, and the components of the limitation, are to be determined at a partner or member level in the case of a partnership or S corporation.[7] Uncertainties with respect to these calculations are discussed in further detail in Section II.D, below.

- The deduction is only applicable, broadly, to income that would be treated as effectively connected income for a foreign person.[8]

## II. Request for Guidance Regarding Section 199A

### A. Guidance Regarding the Scope of a "Qualified Trade or Business" and a "Specified Service Trade or Business"

As a threshold matter, taxpayers involved in pass-through businesses whose income exceeds the threshold amount need immediate guidance regarding whether they are engaged in QTBs or SSTBs. Section 199A(d)(2) specifically prohibits high-income taxpayers from receiving the Section 199A deduction with respect to income from an SSTB. As described more generally above, an SSTB is either (i) a trade or business described in Section 1202(e)(3)(A), but without regard to the words "engineering" and "architecture" and substituting "owners or employees" for

[5] Section 199A(d).

[6] Section 199A(a).

[7] Section 199A(f).

[8] Section 199A(c)(3).

"employees" or (ii) a trade or business involving certain investment management activities. Thus, the definition of an SSTB would read:

> Any trade or business--
>
> > (A) involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its owners or employees, or
> >
> > (B) which involves the performance of services that consist of investing and investment management, trading or dealing in securities (as defined in Code section 457(c)(2)), partnership interests, or commodities (as defined in Code section 175(e)(2)).

The first part of this definition raises several uncertainties:

- The scope of the enumerated categories of SSTBs. As further discussed below, we recommend that Treasury and the Service look to Section 448 and the Treasury Regulations thereunder (as suggested in the Conference Report accompanying the Act (the ***"Conference Report"***[9]) for a framework for guidance.[10]

- The general application of the reputation or skill clause to other trades or businesses, which we believe turns, in part, on how broadly Congress intended the Section 199A deduction to be available. Because of our uncertainty regarding Congress' intent on this subject, and the limited duration of the provision, we recommend that Treasury and IRS in the short term publish a list of business types that are meant to be SSTBs (or meant not to be SSTBs), together with a clear articulation of the criteria that will be used to judge non-enumerated trades or businesses.[11] We have proposed a few possible frameworks for Treasury and the Service's consideration.

- Whether the last clause of the first part of the definition (the ***"reputation or skill clause"***) could be read to cause persons engaged in the specifically excluded trades or businesses of architecture and engineering to nonetheless be deemed to be engaged in an SSTB. Though it is possible that Congress intended engineering and architecture businesses to be *per se* QTBs, it is not clear that the statute as drafted achieves this result.

1. Uncertainties Regarding Enumerated SSTB Categories

[9] H. Rep. No.115-446 (2017).

[10] *Id.* at 215-16.

[11] Including, as discussed below, engineering and architecture.

In unpacking the statutory language addressing SSTBs, the first question raised relates to the scope of the enumerated categories of SSTBs. While in some instances the categories are relatively obvious (e.g., in the case of a doctor with a private general practice or a lawyer with a law firm), other categories are less obvious. For instance, the "health care" industry is potentially an enormous category that could encompass a wide variety of activities and services, including research, laboratory testing, payment processing, billing analysis and similar services. This is equally true in the legal arena (e.g., form document publishers, process servers, etc.). In addition, many businesses that are not otherwise service-oriented in nature may include a consultancy aspect (e.g., a widget manufacturer could well have a consulting arm regarding best practices for widget implementation; software developers often have consultants who customize and implement solutions for specific customers). Clear guidance regarding how to interpret these categories would be extremely welcome to taxpayers.

The Conference Report[12] in several footnotes to the description of the Senate's version of Section 199A suggests that the Senate, at least, viewed Section 448 and the Treasury Regulations thereunder as a good analogue for interpreting these categories. Section 448 addresses the circumstances under which a "qualified personal service corporation" can use the cash method of accounting.[13] The Conference Report notes (in the first sentence of footnote 44) that the list of trades or businesses that are not QTBs is similar to the list of "service" trades or businesses provided in Section 448(d)(2)(a) and Treasury Regulation Section 1.448-1T(e)(4)(i), and notes with specific approval these Treasury Regulations' delineation of (i) services in the field of health being limited to the actual provision of medical services, rather than related services[14] and (ii) services in the field of performing arts being limited to the activities of actual performing artists (and not their managers, agents or broadcasters of their performances).[15] The same Treasury

[12] Conference Report at 216.

[13] For these purposes, a qualified personal service corporation is defined in part as "any corporation…substantially all [95 percent] of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting…" <u>and</u> substantially all (95 percent) of the stock of which is owned by employees (including former employees) who performed the permitted services. Their estates or beneficiaries may be shareholders but only for two-year period.

[14] However, we note that cases and private letter rulings interpreting the scope of the field of health under the Section 448 "function" test, apparently influenced by the broad scope of the term "medical care" under Code Section 213, tend to find that the test is met by the provision of services directly related to patient oriented medical care such as the provision of ultrasound services (*Reza Zia Ahmadi v. Commissioner*, Tax Court Summary Opinion 2017-39 (June 14, 2017)); an emergency ambulance service (PLR 9309004 (November 23, 1992)); physical therapy (PLR 9222004 (January 8, 1992)); and the provision of portable x-rays and EKG's to nursing home patients (FSA 1999-919). This "patient care" distinction seems consistent with the limited guidance in the form of private letter rulings that exists in the context of Section 1202. *See*, *e.g.*, PLR 201436001 (September 5, 2014) (a pharmaceutical company researching, testing, and manufacturing drugs but not providing patient services not disqualified under Section 1202(e)(3)); PLR 201717010 (a laboratory testing patient samples and producing reports for healthcare providers not disqualified under Section 1202(e)(3), discussed in greater detail *infra* at footnote 22). While we acknowledge that private letter rulings cannot be cited as precedent, we include examples from relevant private letter rulings to demonstrate the Service's past views on the interpretation of these analogous provisions.

[15] *See* Conference Report, footnote 45 (at 216) and Treas. Reg. § 1.448-1T(e)(4)(iv). As further color, the Service has held that the services performed by a director of motion pictures are not the performance of

Regulations include a fairly robust definition of what constitutes services as a "consultant" for these purposes, complete with examples.[16]

We recommend these Treasury Regulations under Section 448 as an excellent starting point for defining the specifically listed categories of SSTBs. The rules (sensibly in our view) emphasize the direct provision of services rather than the application of capital or of institutional intellectual property. However, the purposes of and included categories of trades or businesses within the provisions are different, and it is not clear to us that the same policy considerations would apply in all circumstances in making determinations under Section 199A. Therefore, we believe modifications and additions to Section 448 authorities will be necessary. In particular, clear guidance regarding "adjacent" activities to enumerated SSTBs (e.g., process serving, producing and directing content, laboratory testing, billing and collection, etc.) is needed. We recommend that Treasury and the Service clearly address the treatment of these adjacent business types in any guidance.

2. The Reputation and Skill Clause

In addition, taxpayers need guidance regarding the scope of the reputation and skill clause of the SSTB definition.[17] There are many categories of trades or businesses where the reputation and skill of the owner is the critical factor contributing to the success of the business. Indeed, in some sense, all successful businesses rely on the reputation and skill of owners and employees, and determining whether this or some other asset is the business' "principal" asset presents a difficult factual inquiry.[18] On the one hand, the reputation and skill clause could be read very

services in the field of performing arts for the purposes of Section 448. *See* PLR 9416006 (January 4, 1994). With respect to other fields enumerated on the list of Section 448(d)(2)(A), the Service (and a Tax Court decision) has tended to take a narrow view of the services that fall within the enumerated fields of the 'function" test. For example, soil and concrete testing is not encompassed by "engineering" services (*Alron Engineering and Testing Corp. v. Commissioner*, 2000-335 Tax Court Memorandum (November 1, 2000)); appraisal and valuation services are not "consulting" services as no advice or counsel (as required by the applicable regulation) is provided to clients (PLR 200606020 (February 10, 2006)), interior, graphic and lighting design for a building is not included within "architectural" services (PLR 9602013 January 16, 1996)); "claim staking" is not included within "engineering" services (PLR 9232009 (May 5, 1992)); medical billing of insurance claims for doctors and patients is not included within "health" services (PLR 8927006 (March 31, 1989)); the provision of training and educational courses is not included within "consulting" services (PLR 8913012 (December 27,1988)); and a lobbyist's services are not included within "consulting" services (PLR 8902005 (September 29,1988)). On the other hand, under a *Chevron* analysis, a court upheld the inclusion of surveying and mapping as "engineering" services in regulations (despite separate state law classification for licensure purposes) consistent with their inclusion in the legislative history of the provision (*Kraatz Craig Surveying, Inc., v. Commissioner*, 134 T.C. 167 (April 13, 2000)). Similarly, tax preparation and bookkeeping services are included within "accounting" services (*Rainbow Tax Service, Inc., v. Commissioner*, 128 T.C. 42 (March 8, 2007)). If a similar policy should apply in the context of SSTBs, clarification of these sorts of distinctions would be helpful in regulations, rather than leaving taxpayers feeling the need to seek a private letter ruling.

16 *See* Treas. Reg. §1.448-1T(e)(4)(iv).

17 Section 448 does not contain a similar analogue.

18 For instance, a local bakery, while producing a product, might also be viewed as having its principal asset as the reputation or skill of its its owners or employees who make the baked goods. Equally, a restaurant's success may depend on the skill and reputation of its chef and servers, though they also provide a product for

narrowly, in which case it is unclear what businesses, if any, the clause was meant to target, other than enumerated SSTBs. On the other hand, the reputation and skill clause could be read extremely broadly, with potential to subsume the vast majority of businesses that utilize service providers, whether the business is service-oriented or not. If interpreted broadly, the clause could cause businesses to become SSTBs as and if they become more successful (or QTBs as the business becomes more successful yet and less dependent on personal expertise rather than institutional goodwill), meaning that a taxpayer would need to make difficult decisions each year regarding the qualification of the business based on its success.

As further explained below, it is unclear what policy goals Congress was trying to achieve in crafting this particular formulation of SSTB. As such, we are unsure what regulatory approach to suggest to Treasury and the Service. The Conference Report does not provide any illumination as to Congress' intent, and there is no other meaningful legislative history. Therefore, other than broad statements made to the press, there is little information from which taxpayers can divine which businesses were meant to be treated as QTBs, eligible for the Section 199A deduction, and which businesses were meant to be SSTBs. Above all, we recommend that Treasury and the Service do promulgate guidance further interpreting this standard to help to give taxpayers needed certainty. We have outlined a few possible approaches guidance could take (though none of these approaches is a consensus recommendation). If any of the approaches we suggest is a path the Treasury and the Service would like to consider, we are happy to draft an additional report carefully considering that approach.

a. *Reputation and Skill Clause, In General*

A logical place to look for a framework is under existing Section 1202. However, the guidance under this section is limited, and may not inform the language in its Section 199A form. In *John P. Owen v. Commissioner,*[19] the Tax Court examined whether Mr. Owen, whose business was insurance brokerage, was entitled to benefits under Section 1202 with respect to the sale of his interest in a corporation conducting such business. The corporation in *Owen* had extensive training programs and sales structures, but primarily relied on the services of independent contractors (including Mr. Owen) in conducting its business. While the Tax Court acknowledged that the business' success was due to Mr. Owen's efforts, it found that the principal asset of the company in question was the training program and sales structure rather than Mr. Owen's services. While this might be read to suggest that there is a concept of "institutional goodwill" or intellectual property as applied by individual employees that differs from the reputation or skill of employees,

consumption. Other examples (though this list is entirely non-exhaustive) include barbers and beauty salons, sellers of eponymous brands of consumer goods, interior decorators, gardeners and lawn care providers, call centers, staffing agencies, journalists, agents for writers, real estate agents, home builders, personal trainers, hotel managers, plumbers, electricians, auto repair shops, carpenters, tutors, and interpreters.

19 T.C. Memo 2012-21.

query whether this is a useful precedent in the Section 199A context, where the activities of "owners" are also taken into account in determining eligibility.[20]

Separately, the reasoning of the Service in Private Letter Ruling 201436001[21] may provide some additional hints regarding how the Service, at least, historically viewed Section 1202(e)(3), and by analogy, how the Section 199A should be interpreted. In that ruling, the issue was whether a corporation that provided products and services in connection with the pharmaceutical industry was a qualified trade or business under Section 1202(e)(3)(A). The corporation worked with clients to assist in the commercialization of experimental drugs, specifically conducting clinical tests (including related manufacturing and research). In its business it used physical assets (such as manufacturing and clinical facilities) and its intellectual property assets (including its patent portfolio). In relevant part, the Service ultimately found that the business was not disqualified under Section 1202(e)(3), reasoning that a business was disqualified only if it was primarily engaged in performing services for customers. The fact that a business has a service component is not enough; rather the service component must be the primary business of the corporation.[22]

Without citation to any specific authority to support its interpretation, the Service stated the following in the ruling:

> Section 1202(e)(3) excludes various service industries and specified non-service industries from the term 'qualified trade or business'. Thus, a qualified trade or business **cannot be primarily** within service industries, such as restaurants or hotels or the providing of legal or medical services. In addition, section 1202(e)(3) excludes businesses where the **principal asset of the business is the reputation or skill of one or more of its employees**. This works to exclude, for example, consulting firms, law firms and financial asset management firms. **Thus, the thrust of [Section] 1202(e)(3) is that businesses are not qualified trades or businesses if they offer value to customers primarily in the form of services,**

[20] Additionally, this discussion likely constitutes *dicta*, as the conclusion under Section 1202(e)(3)(A) was not dispositive in the ultimate resolution of the case, which turned on the active business requirement of Section 1202(c).

[21] September 5, 2014.

[22] As described above in footnote 14, the ruling also found that the company was not engaged in a "health care" business. The ruling specifically found the following: "Company is not in the business of offering services in the form of individual expertise. Instead, Company's activities involve the deployment of specific manufacturing assets and intellectual property assets to create value for customers. Essentially, Company is a pharmaceutical industry analogue of a parts manufacturer in the automobile industry. Thus, although Company works primarily in the pharmaceutical industry, which is certainly a component of the health industry, Company does not perform services in the health industry within the meaning of [section] 1202(e)(3)…"

> **whether those services are the providing of hotel rooms[23], for example, or in the form of individual expertise (law firm partners).** [emphasis added].

But these authorities do not necessarily add up to an administrable standard of broad application in the Section 199A context. And because of the uncertainty regarding Congress' intention in choosing this particular standard, we are unable to come to a consensus as to a single particular standard to recommend. However, we have the following suggestions for potential approaches:

1. Whatever metric Treasury and the Service adopt in interpreting the reputation and skill clause, there is broad consensus around a recommendation for Treasury and the Service to publish a list of business types that are either clearly QTBs or clearly SSTBs for the purposes of Section 199A (this could be a per se rule or a rebuttable presumption). We suggest that the Principal Business Activity Codes (found, e.g., at the back of instructions for IRS Form 1065 and for IRS Form 1120S) are an excellent starting place and cover a wide range of business types. Using that list, Treasury and the Service could give needed certainty to many taxpayers. This list will necessarily be incomplete, and we therefore believe that it will need to be backstopped by another standard (either one of the standards suggested below or something else).

2. One possible metric for making this determination (and for crafting the backstop) is an activity-based standard as described in the ruling above. Under this standard, businesses providing value to customers in the form of products (including certain kinds of intangible property, e.g., certain software), no matter the reputation and skill of the owners and employees, would qualify for the deduction. This standard would appear effective in that it excludes businesses involving manufacturing, distribution and retail from SSTB status, which seems to be consistent with Congress's intent in crafting Section 199A. This standard, however, appears to capture businesses such as hair care, nail care, tutoring and foreign-language interpreting as SSTBs, and it is unclear whether these businesses were intended to be eligible for the Section 199A deduction. It is also less effective in providing a clear classification of businesses like plumbing, HVAC services, ride sharing services, etc. where there is a strong services component that is more "commoditized."[24] We are unsure which of these business types Congress intended to grant Section 199A deductions for high income taxpayers.

3. We could imagine a balance sheet test that compares the value of assets other than goodwill and workforce in place to the value of such goodwill and workforce in place. This standard

[23] However, note that operating a hotel and restaurant is subject to a specific exclusion under Section 1202(e)(3)(E), so arguably the "reputation and skill" clause alone was not enough to bring these businesses within the scope of businesses excluded from the benefits of Section 1202.

[24] One possible way to distinguish these businesses would be to look to whether the business required state licensure or certification. Because states can widely vary in what they require in terms of such requirements, we do not recommend this approach as a bright-line rule as we do not believe that the federal tax law should treat similarly situated taxpayers differently based on a particular state's decision that for consumer protection purposes or otherwise a particular business type requires a license or certification.

would reach similar businesses as described in the second approach, and leaves the same questions regarding "commoditized" service businesses. However, such a test could easily lead to strange and unintuitive results, and may be difficult to apply in the case of small businesses that do not maintain audited financial statements.[25] It also may not always be possible to untangle such goodwill from a business' other intellectual property (e.g., trademarks). In addition, because valuation (particularly of intangible assets such as goodwill and workforce in place) is relatively subjective, we think that such a standard would both be ripe for abuse, and could potentially set Treasury and the Service up for years of audit litigation. Finally, a standard for "principal" asset (e.g., what percentage of total assets make something the "principal" asset?) would be extremely difficult to implement in practice if appropriate adjustments are to be made, for example, for working capital, passive investments made in connection with the business, and asset balances that may be easily manipulated by taxpayers to achieve a better result under Section 199A.

4. We also have considered whether some other sort of mechanical test could be developed to create a two-way rebuttable presumption regarding the classification of a business as a QTB or an SSTB. For instance, we can imagine a test based on the ratio of (A) the sum of employee wages and payments to independent contractors and/or owners,[26] to (B) gross receipts of the business. We would suggest subtracting payments to "back office" employees and/or independent contractors and/or owners (those who do not routinely interact with customers or provide skills used by those who do interact with customers) from (A). If this ratio is high, there could be a rebuttable presumption that the business' principal asset is providing "skilled" employees and therefore an SSTB. If the ratio is low, then the presumption would be that the business would be a QTB. We have reached no conclusions regarding the correct metrics for this sort of approach. If Treasury and the Service believe that this sort of standard would best express Congressional intent, we can consider it further and submit another report.

5. Finally, we have considered a standard based on whether the trade or business involves the provision of highly skilled services. The primary benefit of this standard is that it harmonizes the meaning of the reputation and skill clause with the list of enumerated SSTBs, each of which involve the provision of services by professionals who either received a substantial amount of training (e.g., health care professionals such as doctors, lawyers and accountants), or who have otherwise achieved a high degree of skill in a given field (e.g., professional athletes or performing artists). The primary drawback of the standard is that it does not offer bright-line results, and as such similarly situated taxpayers may take differing positions in situations as to whether the level of training or development required to perform the service makes the person "highly skilled." While examples may

[25] At least one commentary on Section 199A has suggested that a general concept of "workforce in place" does not exist in the context of at-will employees in a manner that is relevant for purposes of the reputation and skill clause. Martin Sullivan, *Economic Analysis: Do Skills and Reputation Nix the Passthrough Deduction?*, TAX NOTES (Mar. 5, 2018). We disagree with this line of argument, and, whatever the standard under the "reputation and skill" clause is, this likely was not intended.

[26] We recognize that properly accounting for sole proprietorships and partnerships that do not make guaranteed payments in respect of services may be difficult under this standard.

be used to offer guidance in some cases as to the meaning of "highly skilled" in this context, the standard itself could have substantial ambiguity, failing to give taxpayers needed certainty.

These approaches are not exclusive. We could imagine that more than one approach could be applied to help reach the intended result. If it would be helpful, we are happy to draft a more detailed report that further develops the above or considers the best way to implement any approach selected by Treasury and the Service.

b. *Architects and Engineers*

One final ambiguity with respect to the reputation and skill clause is how it applies to architects and engineers. Congress clearly intended to allow at least some architects and engineers to be treated as engaged in QTBs, as it did specifically carve architecture and engineering out of the enumerated categories of SSTBs. However, Congress did not equally carve architects and engineers out of the reputation and skill clause. As currently drafted, the clause can be fairly read to apply to architects and engineers. Under that reading, many (or most) such businesses would likely be treated as SSTBs in practice, whatever standard for applying the reputation and skill clause is chosen. We are not sure whether this is what Congress intended, and the limited legislative history does not further elucidate Congress' intent. Persons engaged in such businesses will need clarity quickly as to their treatment under Section 199A. As a result, we suggest that consideration be given as to what guidance Treasury and the Service can provide to this class of businesses and whether further Congressional action is needed to clarify the effect of the provision.

B. <u>Multiple Trades or Businesses</u>

In addition to questions regarding how individual trades or businesses will be classified for Section 199A purposes, there are difficult questions where a taxpayer is (or purports to be) engaged in multiple trades or businesses, either through a single person or multiple entities. We believe that guidance is most urgently needed to (i) identify and properly classify multiple businesses and (ii) properly allocate expenses and income among activities conducted by a single entity.

1. Multiple Trades or Businesses

The application of the QTB and SSTB rules discussed above is uncertain where a taxpayer is engaged (directly or indirectly) in multiple trades or businesses. For example, Section 199A is silent as to whether (and to what extent) a taxpayer's income with respect to an SSTB might "taint" or otherwise impact a separate qualified business that could otherwise support a deduction under Section 199A, including in cases where SSTB income is earned through the same entity as QBI. These uncertainties compound when a taxpayer owns interests (whether directly or indirectly) in multiple flow-through entities, some of which conduct SSTBs, and some of which conduct QTBs.

As an example, suppose A and B are full-time physicians operating a medical practice through Partnership AB. Partnership AB owns Building X. Half of Building X is utilized by the medical practice of Partnership AB, and half of Building X is rented to an unrelated business. A independently owns Building Y, which A rents to unrelated commercial tenants. Under these facts, how many trades or businesses should A be treated as engaged in for purposes of Section 199A? How should the business activities of Partnership AB be attributed to A? Does the medical practice cause the rental income from Building X to be treated as income from an SSTB? If so, could this result be changed if A and B were to restructure their business to hold building X through a separate entity?

In considering these uncertainties, we have identified a number of existing rules under the Code that could provide a suitable foundation for guidance under Section 199A. Each is explained briefly below:

- Some principles of Sections 446 and/or 469 could be used as a basis for guidance as to the determination of whether multiple trades or business exist.

- In applying Section 199A to flow-through entities, "aggregate" principles should apply to treat the owners of the flow-through entities as engaged in the trades or businesses in which the flow-through entity is engaged.

- As an anti-abuse measure, we recommend consideration of a presumption that two persons are engaged in the same trade or business where (A) such persons are related (e.g., partnerships with substantially the same partners), and (B) one or both persons derives a substantial portion of its gross income from the other.

These recommendations are described in further detail below.

a. *Definition of "Trade or Business"*

Section 199A requires that the taxpayer be engaged in a trade or business (directly or through a flow-through entity). We believe that "trade or business" should be interpreted for purposes of Section 199A in the same manner as under Section 162. We believe that the statute clearly contemplates that a single person may be engaged in multiple trades or businesses, whether or not conducted through separate entities. Section 199A(b) appears to require a taxpayer to separately identify and track its trades or businesses.[27] Section 199A(f)(1)(A)(i) requires Section 199A to be applied at the partner or S corporation shareholder level. Section 199A(f)(1)(A)(ii) requires each partner or shareholder to take into account each qualified item of income, gain, deduction or loss. These two provisions seem to be slightly in tension with each other. In the entity context, we believe that these rules are best read to mean that (i) whether a business is qualified or not is determined at the entity level, but (ii) the separate items attributable to the business are passed through to the owners to determine, for any particular owner, the amount of the deduction available to it. However, we do not believe that a taxpayer should be permitted to achieve different results under Section 199A by splitting a business that might constitute an SSTB into multiple businesses in a manner that does not reflect economic reality, whether through the interposition of entities or otherwise.

In addition, where a taxpayer is clearly engaged in two separately identifiable trades or businesses under the chosen standard, we do not think that the fact of one of those trades or businesses is an SSTB should "taint" another trade or business that is a QTB. However, where the taxpayer's trade or business includes some SSTB elements along with QTB elements that perhaps

[27] Computational issues associated with this separate tracking are discussed *infra* at Section II.C.

do not rise to the level of a separate trade or business under the chosen standard, the essential character of that identified trade or business will have to be determined under the standard chosen as described above in II.A.

i. Section 446 Authorities.

In the first instance, we recommend that rules similar to those under Section 446(d) be adopted to define when a taxpayer may separately identify a trade or business conducted directly by it. This provision permits a taxpayer engaged in more than one business to use different accounting methods for each trade or business. Under Treasury Regulation Section 1.446-1(d), two trades or businesses must be "separate and distinct" for a taxpayer to be eligible to use different methods of accounting for the businesses. As an example, Treasury Regulation Section 1.446-1(d) suggests that a personal service business and a manufacturing business may be "separate and distinct" in certain cases. For these purposes, trades or businesses will not be treated as separate and distinct unless a "complete and separable set of books and records" is maintained for each trade or business.[28]

The rules described in Treasury Regulation Section 1.446-1(d) have been the subject of a number of judicial decisions. In *Peterson Produce Co. v. United States*,[29] for example, the court analyzed whether the sale of feed for livestock and poultry and the raising of broiler chickens constituted two separate and distinct trades or businesses. Pointing to the functional integration and interdependence of the two businesses based on the specific facts of the case, the court held that the two activities failed to meet the "separate and distinct" standard described in Treasury Regulation Section 1.446-1(d). In contrast, *Burgess Poultry Market Inc. v. United States*, in an unpublished opinion,[30] a district court held that the processing and selling of broiler chickens was a "distinct and separate" trade or business from farm-raising baby chicks, in this case because (i) the taxpayer kept separate books and records for each business, (ii) the taxpayer had different employees for each business, (iii) the businesses were geographically separated, and (iv) the divisions transacted on an arm's length basis, and, in fact, the processor had third party sources of chickens which constituted 60% of its supply. Additional case law and IRS authority provide further guidance regarding the "separate and distinct" standard in Treasury Regulation Section 1.446-1(d).[31]

28 We note that Section 446 and the Treasury Regulations promulgated thereunder are designed to achieve a clear reflection of a taxpayer's income from a timing perspective. While we believe that the tools used by Congress, Treasury and the IRS to achieve a clear reflection of income in the Section 446 context can be useful in the Section 199A context as well, we acknowledge that given the distinct policy considerations driving Section 199A and Section 446, not every aspect of the Section 446 authorities will be relevant for purposes of Section 199A.

29 205 F. Supp. 299 (W.D. Ark. 1962).

30 14 A.F.T.R.2d (RIA) 5036 (E.D. Tex. 1964).

31 *See, e.g.*, *W.W. Enters.*, T.C. Memo 1985-313 (making of loans to employees did not constitute a separate and distinct trade or business where loans were to be repaid through bonuses paid to employees from corporation's business); *J.F. Stevenhagen Co.*, T.C. Memo 1975-198 (same); *Bennett Properties Co.*, 45 B.T.A. 696 (1941) ("The operation was unlike its established business and activities, and it had the right to keep its accounts relating to such new operations without regard to the method of keeping its accounts for

The principles of Section 446(d) and Treasury Regulation Section 1.446-1(d) may be helpful to Treasury and the Service in considering guidance under Section 199A with respect to multiple trades or businesses conducted by a single taxpayer. In particular, we believe that the gatekeeping function served by Section 446(d) and Treasury Regulation Section 1.446-1(d) may be recreated in the Section 199A context through guidance that would permit a taxpayer to separate income streams from an activity that arguably constitutes a QTB from another that constitutes an SSTB only where the two businesses are truly distinct from one another.

We note, however, that the rules of Section 446(d) are less helpful with respect to issues posed by tiered and brother-sister flow-through entities. A legal entity that is a separate taxpayer is permitted to select its own method of accounting, which in some cases may incentivize business owners to reorganize or otherwise structure their business affairs to achieve an attractive income tax result. In addition, an approach that is too narrowly focused on entities would not appear to appropriately take into account relatively common structures where activities of a trade or business (such as property ownership, employee services, banking functions, etc.) are isolated in separate entities, some which may have somewhat different ownership (whether for regulatory reasons or otherwise) but all of which are under common control. As further discussed below, we believe that certain existing concepts under Section 469 may be helpful in this regard.

ii. Section 469 Authorities

Section 469[32] restricts taxpayers' ability to deduct certain trade or businesses losses that arise with respect to passive activities. Specifically, where a taxpayer does not "materially participate" in an activity, trade or businesses losses generated by that activity are deemed "passive activity losses." Such passive activity losses are generally available only to offset passive activity income. A taxpayer engaged directly or indirectly in multiple trades or businesses may "materially participate" in certain trades or business for purposes of Section 469, but not in others.

Treasury Regulations issued under Section 469 address questions arising with respect to multiple trades or businesses through a "grouping" approach. Specifically, Treasury Regulation Section 1.469-4 contains a set of rules in which a taxpayer is generally entitled to treat two or more trade or business activities as a single activity if the activities constitute an "appropriate economic unit." The regulations apply a facts and circumstances test for determining whether two activities constitute an "appropriate economic unit," with the greatest weight being given to five factors:

1. Similarities and differences in types of trades or businesses;

2. The extent of common control;

the earlier business."); *Stern*, 14 B.T.A. 838 (1928) (operation of retail stores and coal land sales constitute separate and distinct trades or businesses); Chief Counsel Advice 201430013 (July 25, 2014) (two businesses carrying on different activities in different locations with limited shared employees treated as "separate and distinct" for purposes of Treas. Reg. § 1.446-1(d)).

32 It is perhaps worth noting that the House specifically contemplated using Section 469 principles in its (very different) version of Section 199A. *See* Conference Report at 211.

3. The extent of common ownership;

4. Geographical location; and

5. Interdependencies between or among the activities.

When it comes to flow-through entities, Treasury Regulation Section 1.469-4(a) provides for an "aggregate" approach in which a taxpayer's activities include activities conducted through a partnership or S corporation. In applying the grouping rules to flow-through entities, Treasury Regulation Section 1.469-4(d)(5)(i) contemplates a two-step process in which (i) first, a flow-through entity determines groupings for purposes of Section 469 and (ii) second, each of the owners of the flow-through entity applies the Section 469 grouping rules with respect to his or her allocable share.

First, we suggest that aspects of Section 469's approach to identifying and separating "activities" may prove useful for identifying and separating trades or businesses in the Section 199A context. In particular, the five factors used in Treasury Regulation Section 1.469-4 to determine whether a trade or business constitutes an "appropriate economic unit" may also be helpful in measuring whether a taxpayer's activities should be treated as a single trade or business or as multiple separate and distinct trades or businesses. For example, under this standard, a taxpayer engaged in both (1) the SSTB of offering legal advice in Los Angeles, California and (2) the trade or business of renting commercial real estate to unrelated parties in Kansas City, Missouri may apply these factors and find that the two income streams should be treated as separate trades or businesses. On the other hand, a medical doctor who rents an x-ray machine owned in his individual capacity to his wholly-owned SSTB in which he provides medical care may not be able to treat the two trades or businesses as separate and distinct. The answer would be the same no matter the number and type of flow-through entities interposed between the owner and the activity.

Section 469's approach to identifying and separating activities also provides a sensible answer as to whether an SSTB could somehow "taint" and deny a taxpayer a deduction with respect to otherwise qualified business income. So long as QBI is generated from a separate trade or business, income earned with respect to an SSTB conducted, directly or indirectly, by the taxpayer should not limit eligibility for the Section 199A deduction with respect to the QTB. We believe this is a sound result that is consistent with the policies underlying Section 199A.

Notwithstanding the usefulness of these five factors, we believe that wholesale adoption of Section 469 standards in the Section 199A context may provide an inappropriate windfall in some cases. In particular, because grouping is elective under Section 469, and because multiple groupings may be permitted on the same facts,[33] full adoption of Section 469 standards may prove overly permissive, resulting in taxpayers Congress intended to exclude gaining access to the Section 199A deduction. Accordingly, we recommend Treasury and the Service consider carefully whether and to what extent any sort of elective grouping should be allowed under Section 199A. For administrability purposes, it may be more appropriate to limit regrouping at the taxpayer level to limited related party contexts, and it will be important for the government to have an anti-abuse

[33] *See, e.g.*, Treas. Reg. § 1.469-4(c)(3), Example 1.

backstop to prohibit taxpayers from attempting to artificially separate out QTBs that are integral to SSTBs.

We also believe that Section 469's "aggregate" approach to flow-through entities could provide a helpful basis for measuring whether multiple trades or businesses exist.[34] By treating each partner or S corporation shareholder as engaged in the business activities of the entity, Section 469 significantly limits the ability of taxpayers to affirmatively structure the same trade or business (or the same collection of trades and businesses) in a manner that produces different results. We believe this should be a high priority for Treasury and the Service in crafting guidance under Section 199A, as it does not appear that Congress intended the availability of Section 199A to turn on the form through which a taxpayer owns his or her interest in a trade or business.

Importantly, however, Section 469 does not apply a pure "aggregate" approach when applying its grouping concepts. Instead, Treasury Regulation Section 1.469-4(d)(5)(i) contemplates that a grouping determination should be made at the entity level. We believe a similar requirement in the Section 199A context may be appropriate. By forcing an entity-level determination as to which activities constitute a trade or business, the government ensures some level of consistency among partners or shareholders. Such an approach may yield more accurate tax reporting, as an entity in many cases may have better access to information regarding its trade or business activities as compared to its owners. After making this entity-level determination, each individual taxpayer would be required under similar principles to determine whether income with respect to the trades or businesses conducted by the entity are merely components of another trade or business in which the taxpayer is engaged so that the government is not disadvantaged in more complex cases.

iii. Other Standards for Identifying and Attributing Trades or Businesses

Though Section 446 and Section 469 provide a good existing framework to consider future guidance, there are other places in the Code that attempt to identify trades or businesses. These may provide additional tools for Treasury and the Service to identify when an entity, or group of entities, has properly separated and identified separate businesses, or where, instead, it has non-economically separated the functions of a single integrated business (e.g., an SSTB) to obtain or maximize a Section 199A deduction.

We think it is worth considering an anti-abuse standard that applies relatedness standards (e.g., Section 267(b), Section 707(a), or definitions of "expanded affiliated group" such as are contained in Sections 1471(e)(2) or 7874(c)(1)) to serve as the basis for a presumption regarding the relationship of trades or businesses conducted by two entities. For example, Treasury and the Service might consider a rebuttable presumption for purposes of Section 199A that two partnerships bearing the relationship described in Section 707(b) are engaged in the same trade or business in the event that either partnership derives a substantial amount of revenue from the other.

[34] Section 469's aggregate approach is also consistent with the attribution of businesses from partnerships to non-U.S. persons under Code Section 875(1). Because Section 864(c) principles are used to determine whether a business is a "qualified trade or business", and because application of Section 864(c) necessarily takes Section 875(1) into account, applying this principle has some support in the statutory text.

Applied to the facts of our example above, if Partnership AB were to attempt to separate its real estate assets from its medical practice, a rebuttable presumption that the real estate assets and medical practice are part of a single trade or business would apply.

Certain standards under Section 355 might also be useful. One example is the "secondary business" concept from Treasury Regulation Section 1.355-2(d)(2)(iv)(C), which applies in the context of the "device" requirement of Section 355 and asks if one business' "principal activity is to serve the business of" a distributing or controlled corporation. Such a test could be applied in the Section 199A context to determine whether two sets of activities are truly separate or instead constitute a single trade or business for Section 199A purposes. Alternatively, the Section 355 "expansion" doctrine in the "active trade or business" context may also be considered.[35] Such a test would ask whether under Section 355 standards, two sets of activities would be treated as separate trades or businesses, or whether one would be an "expansion" of the other. However, because these two tests are generally designed in the Section 355 context to address two or more sets of activities that by themselves constitute trades or businesses, we do not recommend that these principles be imported wholesale into the Section 199A context, but instead note these standards may serve as a baseline for Treasury and the Service in crafting regulations.

Once a trade or business has been appropriately identified, we believe that the better answer under the statute is that the items from the business retain their character as relating to QBI through tiers of ownership.[36] However, if Treasury and the Service were to determine that an SSTB at one level of ownership somehow "taints" income from a QTB at another, it should draft clear rules regarding the standards that would apply, because taxpayers would need to be able to take appropriate precautions before investing in any business that may be an SSTB.

b. *Measurement of QBI in a Multiple Business Case*

In a case where a single taxpayer is found to be engaged in multiple trades or businesses, the calculation of QBI for each business is itself potentially uncertain. QBI is defined in Section 199A(c)(1) as a net calculation of "qualified items" with respect to a QTB.[37] "Qualified items," in turn, is defined by reference to Section 864(c). The calculation excludes specified investment items, including capital gains and losses, dividend (or dividend equivalent) income, interest income (other than interest income properly allocable to a trade or business), certain commodities and foreign currency income, income from notional principal contracts, annuity income that is not received in connection with the trade or business and any item of deduction or loss properly allocable to any of the foregoing.[38] Whether an item is attributable to a particular business (whether a QTB, an SSTB, or an excluded investment activity) may be relatively obvious for many items (e.g., if a Section 446 type approach is selected, then items on the separately stated balance

[35] *See* Treas. Reg. §1.355-3(b)(3)(ii).

[36] Section 199A(f)(1); Section 199A(f)(4).

[37] Section 199A(c)(1).

[38] Section 199A(c)(3)(B). We think that this specifically excludes any items exempt from ECI under Section 864(b)(2) that are not already specifically excluded, but this could be clarified.

sheet should generally be allocated to that business). However, allocations for other items (such as overhead, interest on debt borrowed against all of the taxpayer's assets, depreciation on assets used in both businesses) are less obvious. Allocations, for example, could be in proportion to the gross income of the businesses, the relative fair market value of the businesses, or a tracing approach, all of which have benefits and potential detriments. Given the cross reference to Section 864(c) in Section 199A(c)(3)'s definition of "qualified items," Treasury Regulations issued under Section 861 (which provides rules for the calculation of U.S.-source income) seem to be a logical place to look for a regulatory framework.[39]

In the partnership context, a further question arises regarding the treatment of guaranteed payments in respect of capital where a single partnership is engaged in multiple businesses. Section 199A appears to treat guaranteed payments in respect of capital as QBI eligible for the deduction.[40] So, for instance, assume Partnership X, which is engaged in a single QTB, has two equal partners, A and B. Assume that A is entitled to a guaranteed payment in respect of capital of $800. Before taking into account the guaranteed payment, Partnership X has net income of $600 (so an overall net loss of $200). It appears in this example that A would have QBI of $700 (and be allocated 50% of any W-2 wages and unadjusted basis in assets). If X had two businesses, there would be a further question as to how the $800 guaranteed payment should be allocated as between those businesses. We believe the same principles for allocating expenses among businesses as described above should govern the allocation of the deduction for the guaranteed payment.[41]

C. Calculations with Respect to Multiple Businesses

As mentioned above, Section 199A clearly contemplates that a taxpayer may be engaged in multiple QTBs (directly, or indirectly through a partnership or S corporation). However, Section 199A does not contain clear guidance regarding whether and to what extent income from multiple QTBs should be aggregated and netted for purposes of the deduction.

1. Background

Section 199A clearly provides that loss from a particular QTB offsets income with respect to that same QTB. This rule is contained in the definition of "Qualified Business Income" itself -

39 We note that such an approach was used under regulations issued pursuant to old Section 199. *See* Treas. Reg. § 1.199-4(d) (describing the "Section 861 method"). We further note that any such approach would need to be harmonized with the "identification" approach (discussed above) that is selected for measuring the number of trades or businesses in which a taxpayer is engaged.

40 This follows from the statute's reference to Section 864(c) as the standard. Guaranteed payments for services are specifically excluded from the definition of QBI under Section 199A(c)(4).

41 We also note that Treasury and the Service could consider applying concepts similar to those found in Treas. Reg. § 1.469-7, which provides special rules for determining the extent to which self-charged interest (including guaranteed payments for the use of capital) is subject to the Section 469 passive loss limitation rules.

described as the "***net amount*** of qualified items of income, gain, deduction and loss with respect to any qualified trade or business of the taxpayer [emphasis added]."[42]

A much more complex and uncertain mechanism addresses the netting of income and losses from different QTBs. Section 199A appears to envision a four-step process:

- **Step #1:** As noted above, Section 199A(c)(1) begins by measuring the net QBI with respect to each of the taxpayer's QTBs. Section 199A(c)(2) provides that if the net QBI with respect to all trades or businesses of the taxpayer is less than zero, such amount shall be treated as a loss from a QTB in the succeeding taxable year.

- **Step #2:** After measuring net QBI, Section 199A(b)(2) measures the tentative "deductible amount"[43] with respect to each QTB, calculated as the lesser of (A) 20% of the taxpayer's QBI with respect to such trade or business or (B) the greater of (i) 50% of the W-2 wages with respect to such trade or business or (ii) the sum or 25% of the trade or business's W-2 wages and 2.5% of the unadjusted basis in qualified property.[44]

- **Step #3**: Following calculation of the tentative deductible amount with respect to each QTB, Section 199A(b)(1) calculates the Combined QBI amount, which is the sum of (A) each QTB's tentative deductible amount, and (B) 20% of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year.

- **Step #4**: Section 199A(a) grants a deduction to the taxpayer that is generally based on this Combined QBI amount, subject to a number of limitations and additions discussed above in Part I.

As we discuss below, the details of these mechanics are ambiguous and incomplete, requiring technical guidance. In particular, we note the following ambiguities needing urgent guidance.

- First, it appears that net losses from an unprofitable QTB are intended to reduce net income from profitable QTBs on a year by year basis, with any overall net loss from all QTBs carried forward to subsequent years.[45] However, this conclusion is not free from doubt in light of ambiguities in the statutory language.

[42] Section 199A(c)(1).

[43] Though this term is used in the statute, the actual deduction is subject to the limitations described in Part I.

[44] Section 199A(b)(2). Note that the discussions in this Section generally assumes that the taxpayer's income exceeds the applicable threshold amount defined in Section 199A(e)(2).

[45] We use the terms "profitable" and "unprofitable" throughout this Section. Unless otherwise indicated, "profitable" is meant to refer to a QTB in which gross items of income and gain exceed gross items of loss and deduction. "Unprofitable" in turn is meant to refer to a QTB in which gross items of loss and deduction exceed gross items of income and gain.

- Second, assuming that some form of netting applies between net income from profitable QTBs and net loss from unprofitable QTBs, when does this netting occur in the process described above (which generally depends on whether the "deductible amount" calculated under Section 199A(b)(2) can be negative for purposes of applying Section 199A(b)(1))?

- Third, does the same rule or another rule apply with respect to loss carryforwards described in Section 199A(c)(2)?

- We believe that the loss use and carryforward rules described in Section 199A(c)(2) are intended to apply solely for purposes of calculating the amount of the deduction under Section 199A, and that Section 199A(c)(2) and the "net QBI" rule should not be read to actually change the application and limit the use of tax losses for general U.S. federal income tax purposes.

Each of these ambiguities is discussed in turn below.

a. *Current Year Netting Under Section 199A*

The statute itself is unclear whether net losses from an unprofitable QTB are intended to reduce net income from profitable QTBs on a year by year basis. There is support for both a "netting" and a "no netting" approach in the statute and legislative history, although we believe on balance a "netting" approach best reflects the drafters' intent with respect to Section 199A.

The ambiguity arises because Section 199A(c)(2) mandates carryforward of net losses "with respect to qualified ***trades or businesses*** of the taxpayer" [emphasis added], suggesting that all QTBs are aggregated for purposes of measuring the loss carryforward.[46] However, the statutory mechanics for measuring the Section 199A deduction with respect to profitable QTBs seem to contemplate a business-by-business calculation, without any explicit reference to netting. Read literally, the statute arguably measures net losses from QTBs on an aggregate basis taking into account net income and loss from all QTBs, while net income from QTBs is arguably measured on a business-by-business basis.

Such a literal reading would lead to inconsistent and counterintuitive results that we do not believe Congress intended. Particularly helpful in shedding light on this apparent inconsistency in the statute is the Conference Report discussion of netting, which includes an example clarifying the application of Section 199A where a taxpayer has an overall net loss across multiple QTBs.[47] In the example, a taxpayer has QBI of $20,000 from QTB A and a $50,000 loss from QTB B in Year 1. The example concludes that the taxpayer is not permitted a deduction under Section 199A for Year 1 and has a loss carryforward of $30,000 into Year 2.[48] This example strongly suggests

[46] Section 199A(c)(2). This is in contrast to Section 199A(b), which appears to operate on a business by business basis.

[47] Conference Report at 29.

[48] *Id*. ("For example, Taxpayer has qualified business income of $20,000 from qualified business A and a qualified business loss of $50,000 from qualified business B in Year 1. Taxpayer is not permitted a deduction for Year 1 and has a carryover qualified business loss of $30,000 to Year 2. In Year 2, Taxpayer has qualified

that Congress intended net income from profitable QTBs to be offset by net loss from unprofitable QTBs in measuring whether a taxpayer is entitled to a deduction under Section 199A in a given tax year.

The example does not deal with a scenario where the taxpayer has net income across its QTBs. Assume in the example above, the loss from QTB B was only $5,000. In that case, there would be no loss carryforward. Under a netting approach, the taxpayer's deduction for Year 1 would take into account the loss from QTB B. However, if a "no netting" approach is adopted, the taxpayer would get a deduction based on $20,000 of QBI, with no carryforward of the loss to reduce future deductions. This seems plainly incorrect.

We accordingly recommend that Treasury and the IRS confirm in guidance that in applying Section 199A(b), a taxpayer's net income from one QBI is offset by the taxpayer's net loss from another QBI on a year by year basis.

b. *How Netting Rules Interact with Limitations on Section 199A Deduction*

i. <u>Netting In General</u>

If the Treasury and the IRS accept netting of income from profitable QTBs against losses from unprofitable QTBs, the next question to be answered is when and how precisely that netting takes place under the statute.

**Example 1.** A taxpayer has three QTBs: one (QTB X) that pays $500,000 of W-2 wages, and two (QTB Y and QTB Z) that pay no W-2 wages.[49] If the taxpayer has $1 million of income each from QTB X and QTB Y, and $600,000 of losses from QTB Z, how should netting be applied? Should the $600,000 of losses reduce the potential Section 199A deduction by $120,000 (i.e., 20% of $600,000), or should the $600,000 be spread pro rata among each of QTB X and QTB Y, such that the potential Section 199A deduction is reduced by $60,000 (i.e., 20% of one-half of $600,000).

There are two potential approaches to addressing this uncertainty in our view.[50] We believe that these approaches can apply equally with respect to net losses from an unprofitable QTB in a

business income of $20,000 from qualified business A and qualified business income of $50,000 from qualified business B. To determine the deduction for Year 2, Taxpayer reduces the 23 percent deductible amount determined for the qualified business income of $70,000 from qualified businesses A and B by 23 percent of the $30,000 carryover qualified business loss."). The example in the Conference Report was technically given in the context of explaining the Senate proposal, which is why the example refers to a 23% deduction rather than a 20% deduction. However, no material changes were made to the statutory text of Section 199A(c)(2) between the Senate proposal and the final bill, and so we believe the example to be informative in understanding Section 199A(c)(2) as finally enacted.

49 For simplicity, these examples ignore the alternative calculation under Section 199A(b)(2)(B)(ii).

50 A "tracing" approach is also theoretically possible, particularly with respect to loss carryforwards. However, we do not believe that a tracing approach does the best job of implementing the statutory language (e.g., Section 199A(c)(2) implies the exact opposite of tracing). A tracing approach would give rise to needless complexity, and there would be questions regarding the fate of any traced losses when a taxpayer exits a particular business.

current year and with respect to net loss carryforwards from prior years described in Section 199A(c)(2).

ii. Pre-Limitation Netting

The first approach to netting we call "Pre-Limitation Netting." Under this approach, netting of gains from profitable QTBs against losses from unprofitable QTBs is taken into account before any limitations on the Section 199A deduction based on W-2 wages or unadjusted basis in qualified property. Thus, the netting is effectively done when calculating QBI for each QTB in Section 199A(b)(2)(A).

The benefits of Pre-Limitation Netting are twofold. First, Pre-Limitation Netting is more consistent with the approach taken to calculating net losses for the purposes of the carryforward under Section 199A(c)(2). That is, under Section 199A(c)(2) it is clear that the amount of an overall loss for purposes of the carryforward rules is measured by solely looking to qualified items of income, gain, loss or deduction and without regard to W-2 wages or unadjusted basis in qualified property. Pre-Limitation Netting thus offers some amount of symmetry when the situation is reversed and net income from profitable QTBs exceeds net losses from unprofitable QTBs.

Second, Pre-Limitation Netting arguably offers fairer results to taxpayers. As discussed in greater detail below, the alternative to Pre-Limitation Netting effectively results in net losses from an unprofitable QTB being used to reduce first the net income from profitable QTBs that have paid W-2 wages or have made capital expenditures with respect to qualified property. Pre-Limitation Netting, however applies without regard to limitations based on W-2 wages or basis in qualified property. Additionally, Pre-Limitation Netting may deliver fairer results across tax years if a taxpayer's income from each QTB is constant, but W-2 wages and unadjusted basis in qualified property fluctuate. This is because Pre-Limitation Netting applies consistently across all QTBs based on net income, rather than effectively allocating losses disproportionately to QTBs that are paying more W-2 wages or investing in more qualified property.[51]

The primary weakness of Pre-Limitation Netting is that Section 199A(b)(2)(A) by its terms does not offer any guiding principle as to how net loss from unprofitable QTBs should be spread across the taxpayer's profitable QTBs. While we believe a pragmatic and reasonable approach would be to allocate net loss from unprofitable QTBs against the taxpayer's profitable QTBs proportionally based on the net income of each profitable QTB, other allocation methods may be considered by the Treasury or the IRS.[52]

As an illustrative example, if Pre-Limitation Netting were applied to Example 1 above, the taxpayer would use his or her $600,000 of net loss from unprofitable QTB Z to reduce equally the $1 million of net income from profitable QTB X and the $1 million of net income from profitable QTB Y. Thus, each of QTB X and QTB Y would be treated as having $700,000 of net income for

[51] We think that there is some evidence that Congress intended these provisions to encourage job/wage creation and capital investment. If that is true, then it seems inconsistent to apply the netting rules in a manner that disproportionately negatively effects such businesses.

[52] For instance, there may be concerns that taxpayers would time income or losses in different QTBs to maximize the deduction in particular years.

purposes of applying Section 199A(b)(2)(A), and taxpayer would be entitled to a deduction under Section 199A of $140,000 (i.e., $700,000 x 20%).

iii. Post-Limitation Netting

The alternative to Pre-Limitation Netting is an approach in which net losses from unprofitable QTBs are taken into account only after the Section 199A limitations based on W-2 wages and unadjusted basis in qualified property are applied ("Post-Limitation Netting"). Post-Limitation Netting would be achieved by applying the statutory calculation of Section 199A(b)(2) to each trade or business of the taxpayer and then netting the results.

As discussed above, the statutory formula under Section 199A(b)(2) requires a calculation of the lesser of:

(A) 20% of the taxpayer's QBI with respect to such QTB or

(B) the greater of (i) 50% of the W-2 wages with respect to such trade or business or (ii) the sum or 25% of the trade or business's W-2 wages and 2.5% of the unadjusted basis of qualified property.

For profitable QTBs, this formula may result in the Section 199A deduction being capped due to insufficient W-2 wages and/or unadjusted basis in qualified property. However, for unprofitable QTBs, the taxpayer would always simply multiply his or her net loss with respect to the QTB by 20%, because while QBI can apparently be less than zero, W-2 wages and unadjusted basis in qualified property can never be less than zero.

The primary benefit of this approach is that it arguably is more consistent with the plain language of Section 199A(b)(2), which suggests that the limitations based on W-2 wages and unadjusted basis in qualified property should be applied on a business-by-business basis. Indeed, it is very clear that if all of a taxpayer's QTBs generate net income in a given taxable year that the limitations should not be aggregated or otherwise split between QTBs. Post-Limitation Netting is fundamentally just an extension of this concept that takes into account net losses from unprofitable QTBs and does not require Treasury or the Service to impute allocation principles into the statute to measure how losses from an unprofitable QTB should otherwise be taken into account.[53]

The drawbacks of Post-Limitation Netting are the inverse of the benefits to Pre-Limitation Netting described above. Thus, one potential drawback of Post-Limitation Netting is that it results in somewhat inconsistent netting concepts within Section 199A. That is, netting for purposes of measuring an overall loss from QTBs under Section 199A(c)(2) across all trades or businesses clearly does not take into account W-2 wages or unadjusted basis in qualified property, but netting for purposes of measuring overall income from QTBs under the Post-Limitation Netting approach

[53] We note, however, that the concept of netting income from profitable QTBs against losses from unprofitable QTBs requires at least some level of deviation from the plain statutory text of Section 199A. Accordingly, once netting is accepted as a concept, the benefit of adhering tightly to the plain language of the remainder of the statute may be diminished.

would effectively take these limitations into account. It is not clear why such an inconsistency is justifiable as a policy matter, and so it is unclear whether Congress intended such an inconsistency.

The second drawback of Post-Limitation Netting is that it has the effect of allocating net loss from unprofitable QTBs disproportionately to profitable QTBs that have paid W-2 wages or invested in qualified property. This effective allocation to QTBs paying W-2 wages or investing in qualified property occurs because Section 199A(b)(2) by its terms would eliminate some or all of the potential net income from profitable QBIs that did not pay W-2 wages or invest in qualified property. After these limitations have been imposed on profitable QTBs, all that is left to be reduced are the profitable QTBs in which the taxpayer has in fact paid W-2 wages or invested in qualified property.

Returning to our illustrative example, if Post-Limitation Netting were applied to Example 1 above, the taxpayer would apply Section 199A(b)(2) separately with respect to each QTB. Thus, the statutory formula when applied to QTB X would yield \$200,000 (because 20% of \$1 million is less than 50% of the W-2 wages paid in QTB X), when applied to QTB Y would yield \$0 (because no wages were paid and no investments in qualified property were made in QTB Y), and when applied to QTB Z would yield (\$120,000). When these three figures are added together, the result is a Section 199A deduction of \$80,000 (i.e., \$200,000 – \$120,000). This is the same result that would be achieved by reducing the \$1 million income from QTB X by the full \$600,000 of loss from QTB Z (i.e., \$400,000 x 20% = \$80,000).

iv. <u>Netting With Respect to PTPI</u>

A variation on the issues described above applies with respect with respect to qualified publicly traded partnership income ("***PTPI***"). We note two specific uncertainties in the PTPI context when it comes to netting.

First, it is uncertain whether and to what extent PTPI should be netted against other qualified items generated by a taxpayer's other QTBs. Whereas it appears relatively clear that some form of netting is required as between QTBs that do not generate qualified publicly traded partnership income, it is less clear whether (a) PTPI should be segregated and treated as a distinct class of qualified items, with tracing rules that result in a separate loss carryforward under Section 199A(c)(2) for PTPI,[54] or (b) PTPI should be aggregated with all other qualified items generated by QTBs, subject to the same rules described in Section II.C.1.b.ii, above.

Second, assuming PTPI loss is netted with qualified items generated by other QTBs rather than being segregated, it is not entirely clear whether PTPI should be subject to the same Pre-Limitation Netting or Post-Limitation Netting rule that applies with respect to QTBs that do not generate PTPI. This uncertainty is due large in part to the fact that the limitations based on W-2 wages or unadjusted basis for most QTBs do not apply in the PTPI context. However, because we believe that the benefits and drawbacks described above in weighing Pre-Limitation Netting and Post-Limitation Netting apply with equal force in the context of PTPI, our view is that the more sensible and more administrable approach would be to apply Pre-Limitation Netting or Post-

[54] In such a case, it would appear that negative PTPI could still reduce eligibility for the Section 199A deduction with respect to REIT dividends described in Section 199A(b)(1)(B), if PTPI can be negative.

Limitation Netting (whichever is chosen) consistently with respect to both QTBs that generate PTPI and QTBs that do not generate PTPI.

v. Recommendation

We believe that either of the two approaches described above is worthy of consideration by Treasury and the IRS. While we do not express a view as to which of the two approaches is the most appropriate way to reconcile the Section 199A statutory language with the drafters' intent, we believe that adoption of a consistent approach one way or another is critical for taxpayers. To further ensure consistency, we believe that any approach chosen should apply in the same manner for current year losses from an unprofitable QTB as it would for any carryforward of losses from a prior-year pursuant to Section 199A(c)(2).

c. *Confirmation that Loss Carryforwards Described in Section 199A(c)(2) Are Taken into Account Solely for Section 199A Purposes*

While there is no provision explicitly indicating that QBI losses reduce overall taxable income, the lack of any explicit override to generally applicable rules for calculating taxable income strongly suggests that such losses do reduce taxable income for purposes of applying the Section 199A(a)(1)(B) cap to the extent that any such items are deductible under other sections of the Code. That is, we believe that the various loss and loss carryforward provisions of Section 199A are merely for the purposes of calculating the deductible amount under Section 199A and do not otherwise change the taxpayer's calculation of its overall taxable income for any particular year.

For example, assume that a taxpayer has a net loss from QTB A of $1 million, net income from QTB B of $1.5 million (the deduction for which will not be limited under Section 199A(b)(2)), and $2 million of income from SSTB C. Subject to any other loss limitation rules, the taxpayer has $2.5 million of net income. We do not believe that Section 199A should affect this result. We believe, however, that in calculating its taxable income, the taxpayer's deduction under Section 199A should be reduced because of the loss with respect to QTB A.

There is some tension between this reading and the actual words of Section 199A(c)(2), which provides that net QBI losses "shall be treated as a loss from a qualified trade or business in the succeeding taxable year." This could be read to imply that instead, net QBI loss cannot be applied to reduce current year taxable income and must be carried forward until the taxpayer has net positive QBI in a future year. This would create an analogue to the passive loss rules under Section 469. In this case "active" losses from a QTB would be suspended until there was additional "active income" from the same or a similar QTB.[55]

We believe that this is an incorrect reading. In addition, creating a new suspended loss rule for losses with respect to QTBs is both not required by the statute and will lead to needless

[55] Calculated by allocating a proportionate amount of loss to each QTB.

complexity, particularly given the limited duration of Section 199A.[56] Instead we recommend that Treasury and the Service clarify, that any Section 199A(c)(2) is carried forward for the sole purpose of limiting the Section 199A deduction in a future year.

D. <u>Calculation of W-2 Wages and Limitations on QBI Based on Compensatory Payments</u>

The calculation of W-2 wages and the treatment of compensatory payments are the subject of significant uncertainty under Section 199A. We believe that the two issues requiring immediate guidance are (1) the treatment of professional employee organizations ("PEOs") and similar arrangements and (2) the meaning of "reasonable compensation" under Section 199A(c)(4). We discuss each of these points and make recommendations below.

In addition to the issues discussed below, we note that if an analogue to the Section 469 "aggregate" approach described above is not implemented, additional guidance will be required in many cases to help taxpayers determine whether and to what extent W-2 wages paid by a related person should be taken into account for purposes of Section 199A. Additional guidance may also be considered where employees of a related C corporation provide services to a partnership, S corporation, or individual to which such C corporation is related.[57]

1. Professional Employment Organization and Similar Arrangements Where Common Law Employer Is Not Payor of Wages

As drafted, Section 199A does not include clear principles under which a taxpayer can determine whether W-2 wages are properly allocable to a specific QTB. This is particularly troublesome for taxpayers who make use of PEOs or similar arrangements in which the taxpayer is the common law employer of a person but wages are reported by another taxpayer. PEOs and similar arrangements are commonly used by smaller businesses to outsource employee management tasks, including management of payroll tax withholding and reporting.

[56] Consider for example, the fate of such carryforwards when (and if) Section 199A expires in accordance with its terms.

[57] In addition to the uncertainties described herein, we note that Section 199A by its terms creates an incentive for service providers to seek treatment as an independent contractor rather than as an employee. This incentive exists because independent contractors appear generally to be eligible for the Section 199A deduction, whereas employees are clearly excluded under Section 199A(c)(4)(A). At the same time, a flow-through person paying a service provider may prefer employee classification to increase that person's W-2 wage base for purposes of the Section 199A deduction. We note that this tension is not specific to Section 199A (there are many other instances in the Code and Regulations in which the distinction between employee and independent contractor are relevant). However, we believe that Section 199A increases the likelihood that taxpayers will attempt to affirmatively (and artificially) plan into one status or the other. We believe this is the case particularly in fields like truck driving, hair styling, and nursing, where historically the line between independent contractor and employee has not been readily apparent. Whether an individual decides to press for employee status (where a greater degree of benefits may be available) or independent contractor status (where a Section 199A deduction may be available) will presumably depend on the individual's preferences and circumstances.

Treasury Regulations issued under old Section 199 for purposes of the domestic production activity deduction specifically provided rules under which W-2 wages paid and reported by a person who was not the common law employer of an employee could be attributed to the common law employer.[58] We recommend that these rules be applied for purposes of Section 199A as well.

2. Meaning of "Reasonable Compensation"

Section 199A(c)(4)(A) provides that QBI does not include "reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business." Accordingly, any income of the taxpayer that is treated as "reasonable compensation" will not be eligible for the Section 199A deduction.

Outside of the subchapter C context, "reasonable compensation" is a term generally used to refer to the required payment of a salary to the owner (or owners) of an S corporation who provide services to the S corporation. Because under long-standing U.S. federal income tax principles a partner cannot be treated as an employee of a partnership,[59] the "reasonable compensation" rules have not been applied in the partnership context.[60] However, the statutory language of Section 199A is not explicitly limited to taxpayers who own interests in a QTB through an S corporation, and certain public statements by Treasury officials have suggested that Treasury and the Service may consider regulations under which the income of a partner or a sole proprietor may be treated as "reasonable compensation" for purposes of Section 199A.[61]

We believe that use of the term "reasonable compensation" in Section 199A(c)(4) was clearly intended as a means of incorporating the long-standing statutory and regulatory authorities that have for many decades applied solely in the corporate context. We believe that if Congress intended that Treasury and the IRS revisit such a fundamental principle of tax law, this would have been made clear in the statutory text and legislative history. The absence of any explicit suggestion strongly implies that Congress intended no such deviation, and accordingly we believe that if any portion of a partner's distributive share or a sole proprietor's items of income were intended to be treated as "reasonable compensation," a legislative amendment may be required.[62]

58 Treas. Reg. § 1.199-2(a)(2).

59 Rev. Rul. 69-184, 1969-1 C.B. 256. The continuing validity of the holding in Rev. Rul. 69-184 was reinforced through the recent promulgation of Treasury Regulations under Section 7701 of the Code. *See* Treasury Decision 9726, 81 Fed. Reg. 26693 (2016) ("[T]he Treasury Department and the IRS do not believe that the regulations alter the holding of Rev. Rul. 69–184, 1969–1 CB 256").

60 *See, e.g.*, Chief Counsel Advice 201640014 (Sept. 30, 2016) ("Partnership is not a corporation and the 'wage' and 'reasonable compensation' rules which are applicable to corporations and were at issue in the *Brinks* case do not apply.")

61 *See, e.g.*, *No Plans to Apply Reasonable Compensation Beyond S Corps*, TAX NOTES (Feb. 26, 2018) (reporting then-Treasury Deputy Assistant Secretary for Tax Policy Dana Trier taking the position that "Treasury has the power to issue guidance expanding reasonable compensation beyond subchapter S corporations.")

62 If, notwithstanding our recommendation, Treasury and Service were to take the view that regulations altering the meaning of "reasonable compensation" were appropriate in order to achieve parity between S corporations on the one hand, and partnerships and sole proprietorships on the other hand, we believe that it

Notwithstanding our view that Congress did not intend to redefine "reasonable compensation" to include a partner's distributive share for purposes of Section 199A, we believe Treasury and the Service do have authority under Section 707 to treat certain economic entitlements of partners as "guaranteed payments" that, pursuant to Section 199A(c)(4)(B) and Section 199A(c)(4)(C), would be excluded from QBI. We note that Treasury and the Service have recently issued proposed regulations regarding disguised payments for services, including the treatment of minimum amounts guaranteed to be received by a partner without regard to the income of the partnership.[63]

E. Guidance Regarding Other Issues and Ambiguities

1. Qualified Property

Section 199A(b)(6) defines "qualified property" as tangible depreciable property held by, and available for use in the qualified trade or business at the close of the taxable year, that was used by such business in the production of QBI, and the "depreciable period" for which has not ended before the end of the taxable year. The "depreciable period" is further defined as ending either 10 years after the property was first placed in service by the taxpayer, or the last day of the last full year that the applicable recovery period applies to such property under Section 168, whichever is later.

There are several ambiguities with this rule with respect to which we recommend clarification:

- How are improvements to tangible property treated? Do they get a new depreciable period?

- How do qualified property rules operate in the case of Section 1031 exchanges? Does unadjusted basis carry over to replacement property? Does an exchange alter the depreciable period?

- Section 199A(f)(1)(A)(iii) (including flush language) suggests that members' shares of unadjusted basis in property held by a pass-through entity is determined immediately after acquisition of the property. Do those percentages change if the members' interests in the entity change or a new member joins the pass-through entity?

would also be appropriate to treat any such "reasonable compensation" as W-2 wages for purposes of calculating a taxpayer's Section 199A deduction. Such an approach would ensure that in attempting to create parity between S corporations, partnerships, and sole proprietorships, Treasury and the Service would not inadvertently handicap partnerships and sole proprietorships by limiting the extent to which their "reasonable compensation" paid in a taxable year can support a Section 199A deduction.

63 *See* Disguised Payments for Services, 80 Fed. Reg. 43652 (July 23, 2015); Prop. Reg. § 1.707-1(c), Example 2 (full amount guaranteed to partner without regard to partnership income treated as guaranteed payment, even if partnership has items of income equal to or exceeding partner's entitlement). We believe that these regulations, if finalized, would represent a more appropriate avenue for administrative guidance. *See also*, New York State Bar Association Tax Section, Report on the Proposed Regulations on Disguised Payments for Services (Nov. 13, 2015).

2. Partnership issues

The statute contains specific provisions outlining treatments of pass-through entities.[64] There are still some ambiguities regarding how specific partnership provisions of the Code would apply in the context of Section 199A, which we have identified below.

a. *Section 702 Separately Stated Items*

It appears that there is an intention that the allocation of wage expense and depreciation must be separately reported items, at least where the partnership has non-corporate partners. Confirmation of this result would be helpful. In addition, it is possible that partnerships now should be reporting income, unadjusted basis and W-2 wages on a business-by-business basis, together with a determination of SSTB or QTB status so that partners can accurately prepare their tax returns. The Service should consider amendments to Schedule K-1 and IRS Form 1065 to achieve this result.

b. *Special Allocations under Section 704*

Special allocations that otherwise have substantial economic effect under the Section 704 rules appear to be taken into account in measuring W-2 wages and unadjusted basis in qualified property under Section 199A(f)(1), but confirmation would be helpful.[65] That is, the statute clearly contemplates that such amounts be allocated in the same manner as the allocation of the underlying wage expense and depreciation.[66] In addition, to the extent that a partnership is engaged in multiple trades or businesses, and items with respect to the trades or businesses are allocated differently, we believe that the allocation of W-2 wages and the unadjusted basis of assets should also be allocated on a business-by-business basis in accordance with the sharing percentages for each particular business.

We have considered whether to recommend that Treasury and the Service consider additional anti-abuse rules beyond mere compliance with the substantial economic effect standard for such allocations. For instance, a partnership could issue a preferred equity instrument to a corporate taxpayer not eligible for the Section 199A deduction, with the common equity held by an individual in a manner that has the effect of allocating a disproportionate amount of the W-2 wage expense to the individual rather than the corporation. Congress has clearly authorized Treasury and the Service to promulgate such rules if they believe it is necessary pursuant to the regulatory authorization in Section 199A(f)(4). At this time, we do not believe that additional restrictions on partnership allocations beyond the substantial economic effect standard of Section 704(b) are necessary. However, if Treasury and the IRS were to find situations where the substantial economic effect standard was insufficient to prevent abuse, we recommend that these regulations be narrowly targeted to disregard, solely for purposes of Section 199A special allocations, a principal purpose of which is to increase the Section 199A deduction available to

64 Section 199A(f)(1).

65 We note that such an approach was taken in Treas. Reg. § 1.199-5 (issued under old Section 199).

66 Section 199A(f)(1).

one or more partners.[67] If Treasury or the Service would like us to consider any particular anti-abuse rules, we would be pleased to submit an additional report.

c. *Treatment of Section 751 Inclusions*

It is unclear whether income treated as ordinary income under Section 751 should be "qualified business income." Section 199A(c)(3) defines "qualified items of income, gain, deduction, and loss" by reference to Section 864(c).

The *Grecian Magnesite* case[68] and Section 864(c)(8) read in tandem strongly suggest that all income from the sale of a partnership interest is described in Section 864(c) to the extent the property of the partnership is used in a U.S. trade or business.

However, Section 199A(e)(5) lists out (i) the taxpayer's allocable share of the QBI from a publicly traded partnership and (ii) income described in Section 751 as separate categories of "qualified publicly traded partnership income," which could be read to imply that income described in Section 751 is not "qualified business income." Alternatively, the language in Section 199A(e)(5) may be intended to clarify that income described in Section 751 does not otherwise need to meet the standards for "qualified business income" to qualify as "qualified publicly traded partnership income."[69]

d. *Purchases and Sales of Partnerships Interests*

It appears that Section 706 principles should be taken into account in measuring QBI in the context of a transfer of a partnership interest, but we believe confirmation would be helpful. It is less clear how Section 704(c) and Section 734 or Section 743 principles should be taken into account in calculating QBI, if at all. In particular, Section 199A(f)(1) provides that a partner's allocable share of the unadjusted basis of property is determined "in the same manner as the partner's. . . allocable share of depreciation." The provision does not specify whether this is a Section 704(b) "book" concept (which would lead to one result) or a "tax" concept that takes into account Section 704(c) (which could lead to another result). In addition, regulations under Section 743 and Section 734 could lead to different conclusions in many cases when measuring a taxpayer's share of the unadjusted basis of tangible assets. Treasury Regulation Section 1.743-1(j)(1) provides that the Section 743 adjustment does not affect the partner's capital account or change how the partnership calculates income under Section 703. On the other hand, for purposes of calculating a depreciation deduction allocable to the partner, Treasury Regulation Section

[67] In making this recommendation, we are mindful of the complexity of other regimes in Subchapter K that police special allocations, such as the "fractions rule," and would recommend that considerable thought be given to crafting any such standard, particularly if it applies to provisions other than Section 199A, given the potential effects on other provisions of the Code.

[68] *Grecian Magnesite Mining, Industrial & Shipping Co.*, 149 T.C. No. 3 (2017).

[69] That is, Section 751(a) gain is not included in the allocable share of income from a qualified publicly traded partnership since it is not a share of income from the partnership itself. Therefore, a special rule may have been needed. Note that regulations under old Section 199 specifically counted Section 751 gains as "domestic production gross receipts. *See* Treas. Reg. §1.199-5(f).

1.743-1(j)(2) then adjusts the purchasing partner's distributive share of income to take into account additional depreciation as a result of the adjustment. Therefore guidance will be needed regarding how these items could shift allocations of unadjusted basis in property for purposes of Section 199A. In addition, guidance is also needed as to how allocations of unadjusted basis in qualified property may be calculated once the adjusted basis of property is actually depreciated to zero (either because the useful life is less than 10 years or as a result of bonus depreciation).[70]

3. Additional Issues

a. *Application to Nonresident Aliens*

We recommend confirming that a foreign individual with effectively connected income is entitled to benefit from the Section 199A deduction.

b. *Application of Section 1231*

It is not entirely clear whether income treated as capital gain pursuant to Section 1231 is excluded from QBI under Section 199A(c)(3)(B). Nor is it entirely clear that losses treated as ordinary pursuant to Section 1231 are taken into account in measuring QBI. We believe, however, that the better reading of Section 199A is that gain or loss treated as long-term capital gain pursuant to Section 1231(a)(1) should not be treated as QBI, whereas qualified items of gain or loss treated as ordinary pursuant to Section 1231(a)(2) should be taken into account in measuring the Section 199A deduction.[71]

c. *Electing Small Business Trusts*

Treasury Regulation Section 1.641(c)-1(d)(2)(i) provides that the "S portion" of an electing small business trust "takes into account the items of income, loss, deduction, or credit that are taken into account by an S corporation shareholder pursuant to Section 1366 and the regulations thereunder." Clarification should be provided that (1) the deduction described in Section 199A is permitted in calculating the trust's taxable income pursuant to Section 641,[72] and (2) the S portion's share of W-2 wages and unadjusted basis in qualified property are taken into account for

[70] We note that Treas. Reg. § 1.199-5 (issued under old Section 199) grappled with some analogous issues in the context of the domestic production activities deduction, and accordingly may serve as a helpful base for guidance.

[71] In addition, we believe it is instructive that for purposes of measuring a taxpayer's limitation on the Section 199A deduction under Section 199A(a)(1)(B)(ii), Congress specifically referred to Section 1(h) in defining "net capital gain." Importantly, it is clear under Section 1(h), such "net capital gain" would generally take into account amounts treated under Section 1231 as long-term capital gain, subject to certain exceptions under Section 1(h)(6)(B) and Section 1(h)(8).

[72] We note that the statutory language under Section 641(c) limits deductions allowed to electing small business trusts to items specified in Section 641(c)(2)(C). However, Congress failed to specifically amend Section 641(c)(2)(C) to take into account the deduction described in Section 199A. We believe that this was a drafting oversight. If Treasury does not believe regulations can be issued, we suggest it be addressed through a technical correction.

purposes of Section 199A notwithstanding that W-2 wages and unadjusted basis in qualified property are technically not described in Section 1366.

d. *Application of the Rules to Cooperative Dividends*

It appears that there was a potentially unintended benefit conferred on cooperatives with respect to qualified cooperative dividends in that qualified cooperative dividends are effectively calculated on gross proceeds of sales to cooperatives rather than net proceeds. In light of this benefit (and because the SSTB restrictions do not apply to qualified cooperative dividends), we understand that many taxpayers who have not traditionally operated in cooperative form may be considering utilizing a cooperative both within and without the agricultural context to achieve a superior result under Section 199A.[73] While it is our understanding that legislative amendments to Section 199A to address these issues are currently being contemplated,[74] we recommend that Treasury and the Service nonetheless consider the application of Section 199A to cooperatives in drafting regulations.

## III. Conclusion

The issues addressed above are only a subset of the significant issues raised by Section 199A. The Tax Section would be happy to issue a more detailed report addressing some or all of the issues listed above. We note that certain of these issues (such as the treatment of a partner's distributive share as "reasonable compensation" pursuant to Section 199A(c)(4)(C) or the application of Section 199A(g)) may be more properly addressed through Congressional amendment to Section 199A.

* * *

73 We note that an amendment of some aspect of these rules appears to have been agreed by lawmakers. *See* Joshua Rosenberg, *Omnibus Spending Bill Would Fix Tax Law's 'Grain Glitch'*, Law 360 (Mar. 21, 2018).

74 *See* Lynnley Browning, *Rich Americans Have Found Yet Another Tax Loophole*, Bloomberg Politics (Mar. 6, 2018).

Report No. 1393
March 28, 2018

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
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The Honorable David J. Kautter
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The Honorable William M. Paul
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Re: *Report No. 1393 on Section 163(j)*

Dear Messrs. Kautter and Paul:

I am pleased to submit Report No. 1393 adressing Section 163(j) of the Internal Revenue Code of 1986, as amended (the "**Code**"), which was amended by P.L. 115-97 (the "**Act**"), enacted on December 22, 2017. Under Section 163(j), a taxpayer's annual deduction for business interest expense is generally limited to the sum, for the relevant taxable year, of (A) the taxpayer's business interest income, (B) 30% of the taxpayer's adjusted taxable income, and (C) any floor plan financing interest of the taxpayer.

As discussed in the Report, we recommend that guidance be issued under Section 163(j) addressing several technical and interpretive questions, including: (1) the definitions of "interest," "business interest expense," "business interest income," and "adjusted taxable income" as used in the provision; (2) in the case of a taxpayer that conducts both one or more trades or businesses subject to Section 163(j) and one or more trades or businesses excluded from the scope of the provision pursuant to Section 163(j)(7), rules for allocating interest expense among those trades or businesses; (3) guidance concerning the application of Section 163(j) to consolidated groups, including where a member enters or leaves a group; (4) clarification of the rules in Section 163(j)(4) regarding the application of the statute to partners and partnerships; and (5) guidance as to the interaction of Section 163(j) with international tax rules in the Code, including the rules concerning controlled foreign corporations and U.S. shareholders and the rules concerning effectively connected income of a foreign corporation. In addition to providing specific recommendations in the Report concerning these and other issues, we also set forth in the concluding section of the Report a list of additional questions as to which it may be appropriate to issue guidance.

We appreciate your consideration of our recommendations. If you have any questions or comments regarding this Report, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Karen G. Sowell

Karen G. Sowell
Chair

Enclosure

Cc:

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**NEW YORK STATE BAR ASSOCIATION TAX SECTION**

**REPORT ON SECTION 163(j)**

**March 28, 2018**

PLEASE SEE PANEL ONE MATERIALS
OR ACCESS REPORT 1393 ONLINE AT:

http://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Section_Reports_2018/1393_Report.html

# BIOGRAPHIES

# WILLIAM D. ALEXANDER, ESQ.
## BIOGRAPHY

William D. Alexander, is of counsel to Skadden, Arps, Slate, Meagher & Flom LLP, where he focuses on the tax aspects of corporate transactions, including U.S. and cross-border mergers and acquisitions, spin-offs, corporate restructurings and other business transactions. Before joining Skadden in 2015, Mr. Alexander served as Associate Chief Counsel (Corporate) of the Internal Revenue Service's Office of Chief Counsel. He had been with the Office of Chief Counsel since 1990, serving as Associate Chief Counsel (Corporate) since November 2001. In this role, he was the chief adviser to the IRS on interpretations of the corporate tax laws, such as provisions dealing with corporate mergers and acquisitions, spin-offs, corporate-shareholder relationships, the use of corporate losses and consolidated returns of corporate groups. Mr. Alexander played a major role in the government's development of published and private guidance, and in developing and implementing the IRS' enforcement positions in these areas. Mr. Alexander is a frequent speaker on corporate tax issues at bar association programs and other tax conferences.

# KIMBERLY S. BLANCHARD, ESQ.
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**Kim Blanchard** is a partner in Weil's Tax group whose practice encompasses a variety of largely international transactions involving corporate M&A, internal restructurings, business formations and joint ventures. Kim is the immediate past President of the International Tax Institute and a former Chair of the New York State Bar Association Tax Section. She is a "Leading Practitioner Contributor" to the *Tax Management International Journal* and a member of Practical Law Company's U.S. advisory board. In addition, Kim is a member of the Board of Trustees of the American Indian College Fund and of the Board of Directors of the Girl Scouts of Greater New York.

She has consistently been recognized as a leading Tax lawyer by ***Chambers USA*****,** ***Chambers Global*****,** ***Legal 500 US*****,** ***Best Lawyers in America*** and ***The Best of the Best US.***

# MEGAN L. BRACKNEY, ESQ.
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**Megan L. Brackney** concentrates her practice in the areas of civil and criminal tax controversies.  Ms. Brackney received her J.D. from the University of Kansas School of Law and her LL.M. in Taxation from New York University.  Prior to joining Kostelanetz & Fink, LLP, Ms. Brackney was an Assistant United States Attorney for the Southern District of New York.  Ms. Brackney is a member of the New York State Bar Association Tax Section's Executive Committee, a Fellow of the American College of Tax Counsel, and the incoming Vice Chair of Committee Operations for the American Bar Association Section of Taxation.  Ms. Brackney annually contributes to the two-volume ABA publication, *Effectively Representing Your Client Before the IRS* and is a regular columnist for the "Tax Controversy Corner" of *The Journal of Passthrough Entities*, and serves on the editorial board of the *Journal of Taxation* and *The Tax Lawyer.*  Ms. Brackney has been recognized by New York Super Lawyers' since 2012.

# PAUL R. COMEAU, ESQ.
## BIOGRAPHY

PAUL R. COMEAU, Chairman Emeritus and current Senior Partner at Hodgson Russ LLP, has been with the 200-year-old law firm since 1973. He has practiced New York law since 1974 and Florida law since 1975. Early in his career, he gained valuable experience in federal and international taxation, as well as merger and acquisition projects for private and publicly traded companies. He focuses on high- net-worth clients, tax planning for individuals and businesses, and multistate tax issues.

Paul began working on state and local tax matters in the 1970s and founded the Hodgson Russ State & Local Tax Practice at that time. His client projects helped to shape the laws and interpretations in New York and impacted such industries as computer software, direct mailing, transportation, fuel, publishing, catering, nonprofits, emerging technologies, tax incentives, credits, marketing, temporary help, real estate, manufacturing, information services and numerous others through group lobbying efforts, legislation, litigation and contributions toward the publication of regulations and other guidance.

When New York State began conducting residency audits in the late 1980s, Paul handled some of the first cases and authored Bar Association reports and articles that were subsequently reflected in detailed audit guidelines which continue to serve as a model for other states.

Paul's speeches on residency, as well as his reports, were instrumental to the historic 1996 North Eastern State Tax Official Association (NESTOA) agreement, which called for greater uniformity in residence audits in the Northeastern States.

In recent years, Paul has split his time between his tax practice and high-end estate planning, working with sophisticated clients and their advisors on cutting-edge solutions, often with state, federal or international tax benefits.

In 1996, Paul founded and chaired the New York State Bar Association's annual New York State and City Tax Institute.

Paul is Editor of CCH's New York Tax Analysis, and a co-author of the New York Residency and Allocation Audit Handbook (2016) published by CCH. It was first published in the 1990s. He also co-authored Contesting New York State Tax Assessments and the New York chapter of the Sales and Use Tax Handbook published each year by the American Bar Association.

Paul is a Board Member and Tax Committee Co-Chair of the New York State Business Council; Co-Chair of the New York Tax Committee of the New York State Bar Association Tax Section; and has served on numerous college, community and other boards.

# TIJANA J. DVORNIC, ESQ.
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Tijana J. Dvornic is a Partner in Wachtell, Lipton, Rosen & Katz's Tax Department.

Ms. Dvornic focuses on tax aspects of U.S. and cross-border mergers and acquisitions, reorganizations, carve-outs, spin-offs and other dispositions, leveraged buy-outs, joint ventures, equity investments and other financing transactions.

Ms. Dvornic received a B.B.A. with highest distinction from the University of Michigan. Ms. Dvornic completed a J.D. *magna cum laude* from Harvard Law School, where she was the articles editor for the *Harvard Civil Rights-Civil Liberties Law Review*. Following law school, she was a law clerk to the Honorable Judge Priscilla R. Owen in the United States Court of Appeals for the Fifth Circuit. Ms. Dvornic received an LL.M. in taxation from New York University School of Law in 2016 and was awarded the David H. Moses Memorial Prize.

Ms. Dvornic is a member of the Tax Sections of the New York State Bar Association and the American Bar Association.

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Ms. Ferrell is a partner in Davis Polk's Tax Department. She frequently advises corporate and private equity fund clients on federal income tax matters, including mergers, acquisitions, spinoffs and other major U.S. domestic and cross-border corporate transactions. She also advises domestic and international clients on capital markets transactions, joint ventures, bankruptcy and workouts, and tax legislative and administrative matters.

She served in the Treasury Department's Office of Tax Policy from 1987 to 1990, as an Attorney-Adviser in the Office of Tax Legislative Counsel and as the Special Assistant to the Assistant Secretary of Tax Policy.

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### RECOGNITION

Ms. Ferrell is recognized as a leading tax lawyer in various industry publications:

- *Chambers USA*
- *PLC Cross-border Tax on Corporate Transactions Handbook*
- *Who's Who Legal – International Who's Who of Business Lawyers* and *Who's Who Legal – International Who's Who of Corporate Tax Lawyers*
- *Corporate Counsel: Best Lawyers Annual Guide to Tax Law*
- *Tax Directors Handbook*

She is recognized as a leader in the legal industry:

- *International Tax Review* – "Women in Tax Leaders": United States
- Elected as a Fellow of the American College of Tax Counsel

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### OF NOTE

- Frequent speaker on M&A tax topics
- Member, Executive Committee, Taxation Section, New York State Bar Association
- Member, International Fiscal Association USA Branch

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### PROFESSIONAL HISTORY

- Partner, 1997-present
- Associate, Davis Polk, 1990-1997
- Attorney-Adviser, Office of Tax Legislative Counsel; Special Assistant to the Assistant Secretary of Tax Policy, Treasury Department's Office of Tax Policy, 1987- 1990
- Law Clerk, Hon. Andrew A. Caffrey, U.S. District Court, Massachusetts, 1981- 1982

# EDWARD E. GONZALEZ, ESQ.
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Edward Gonzalez handles the tax aspects of a variety of transactions, including mergers and acquisitions, U.S. and non-U.S. financial instruments, leveraged buyouts, private equity investments, cross-border financial transactions, debt restructurings, asset-based financings, derivatives and tax controversies at Skadden Arps.

Mr. Gonzalez has advised investment banks, corporations and investment partnerships in the structuring of various acquisitions, financings and refinancings. He also has represented Australian, Japanese, Latin American and European corporations in structuring their investments in the United States, and non-U.S. issuers in raising capital in the United States.

Mr. Gonzalez has worked in the development of innovative financial products such as “tracking stock” (General Motors Class E Stock), 100-year debt, trust preferred securities, financial institution regulatory capital products for both U.S. and non-U.S. financial institutions, and “basket D” securities. He has worked on issues raised by offshore funds investing in the United States, and he has worked extensively with real estate investment trusts (REITs) including the development of the first timber REIT.

Mr. Gonzalez repeatedly has been selected for inclusion in *Chambers Global: The World’s Leading Lawyers for Business*, *Chambers USA: America’s Leading Lawyers for Business* and *The Best Lawyers in America*. He was named a "BTI Client Service All-Star 2014" by The BTI Consulting Group.

Transactions include representing:

- Bank of America Merrill Lynch (as part of a consortium which also includes Prologis, Inc. and NRG Energy, Inc.) in securing a conditional $1.4 billion commitment from the U.S. Department of Energy’s Loan Programs Office to help finance the largest distributed rooftop solar generation project in the world;
- Cementos Argos S.A. (Colombia) and its subsidiary, Argos USA Corp., in the $760 million acquisition of the southeastern U.S. cement and ready-mix businesses of Lafarge S.A. (France);
- Endurance Specialty Holdings Ltd. (Bermuda), a provider of property and casualty insurance and reinsurance, in its $230 million offering of 7.5% non-cumulative preferred shares, Series B;
- National Australia Bank Limited in its acquisition of a 35 percent stake in AREA Property Partners, a real estate fund manager and affiliate of Apollo Management, L.P.;

# JOHN T. LUTZ, ESQ.
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John T. Lutz advises clients on federal and state taxation, particularly the taxation of structured finance, derivative, structured products and hedge funds. He also counsels clients on matters related to tax examinations and controversies, insurance products, investment tax credits, conventional US and cross-border securities offerings, and corporate mergers and acquisitions. John is partner-in-charge of the New York office of McDermott Will & Emery LLP.

John handles all aspects of developing derivatives products and new structures for financings and other capital market transactions, including the structuring of cross-border tax-advantaged financings and asset-backed securities. He represents banks and investment managers in connection with collateralized loan obligations, structured notes and repackagings.

John is a recognized leader in the tax aspects of municipal derivatives and tax-exempt bond securitizations. He provides tax advice to derivative products dealers in the domestic and cross-border contexts, advising on US and international tax issues related to equity swaps, repurchase agreements, structured notes and offshore structured finance vehicles.

Internationally, John provides advice to banks, insurance companies, hedge funds, investment managers, sponsors and other market participants in a wide variety of investment transactions.

Previously, John served as chief counsel to US Senator Jeff Chiesa.

# WILLIAM L. McRAE, ESQ.
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William McRae's practice focuses on U.S. federal income tax matters, including the taxation of financial products, corporate transactions, and international mergers and acquisitions. He regularly speaks on tax matters at conferences.

William joined Cleary Gottlieb in 1996 and became a partner in 2005.

### Practice Areas

U.S. federal income tax matters, including the taxation of: corporate transactions, bankruptcies and debt restructurings, international and domestic mergers and acquisitions, international tax planning for corporate groups, and financial products. Recent clients include Citigroup, Goldman Sachs, iCapital, INSW, J.P. Morgan, McDonald's, Synchrony Financial, TPG, Verizon, Warburg Pincus and various sovereign wealth funds.

### Professional Memberships

New York Bar; New York State Bar Association, where he serves on the Tax Section Executive Committee.

### Education

LLM in taxation, New York University; JD, cum laude, Harvard Law School (1996); BA, magna cum laude, Williams College (1991).

# JOHN J. MERRICK, ESQ.
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John Merrick is a Senior Level Counsel to the Associate Chief Counsel (International) in the Office of Chief Counsel. Prior to joining Chief Counsel, Mr. Merrick practiced international tax in the national offices of two accounting firms in Washington. He also practiced international and corporate tax in Chicago with an accounting firm and a law firm. Mr. Merrick holds a Bachelors in Business Administration in accounting from Loyola University Chicago, *summa cum laude*, where he also earned his J.D., *cum laude*, and was a member of the Loyola Law Journal. He obtained an LL.M. in Taxation from the De Paul College of Law. He also passed the Certified Public Accountant exam.

# JOSE E. MURILLO, ESQ.
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- José is the leader of the International Tax Services (ITS) practice, Washington, DC at Ernst & Young LLP, the US EY member firm. He also serves as the National Director of Technical Services for ITS. José practices primarily in the area of cross-border acquisitions, dispositions and restructurings.
- Prior to his current role, José was a member of the Treasury Department's Office of Tax Policy, where he assisted in the development of international tax policy, Treasury regulations and other guidance and in negotiating income tax treaties.
- Before serving with the Treasury Department, he was a member of Ernst & Young LLP's International Tax Services practices in Houston and Washington, DC.
-

José is a frequent contributor to tax publications and a presenter at internal and external international tax seminars and conferences.

# ANDREW W. NEEDHAM, ESQ.
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Andy Needham is a partner in Cravath's Tax Department. His practice concentrates on tax advisory work in mergers and acquisitions, spin-offs, partnership taxation and general tax planning for the preservation of net operating losses and other tax attributes.

Andy has been recognized as a leading tax practitioner by *Chambers USA: America's Leading Lawyers for Business* from 2008 through 2017; *Chambers Global: The World's Leading Lawyers for Business* from 2014 through 2017; *The Legal 500* from 2007 through 2017; *The Best Lawyers in America* from 2011 through 2018; and *Who's Who Legal: Corporate Tax* from 2011 through 2016. In 2017, he was named to *The Legal 500* Hall of Fame in the International Tax category.

In 2012, Mr. Needham served as Chair of the New York State Bar Association Tax Section and is currently a member of its Executive Committee. He is a frequent speaker at various tax conferences and the author of many published articles.

Mr. Needham received a B.A. from the University of Arizona in 1982, a J.D. and an LL.M. from Georgetown University Law Center, in 1986 and 1990, respectively, and an M.B.A. from the University of Pennsylvania's Wharton School in 1992.

# AMANDA H. NUSSBAUM, ESQ.
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Amanda H. Nussbaum is a partner in Proskauer's Tax Department and a member of the Private Investment Funds Group. Her practice concentrates on planning for and the structuring of domestic and international private investment funds, including venture capital, buyout, real estate and hedge funds, as well as advising those funds on investment activities and operational issues. She also represents many types of investors, including tax-exempt and non-U.S. investors, with their investments in private investment funds.

Amanda has significant experience structuring taxable and tax-free mergers and acquisitions, real estate transactions and stock and debt offerings. She also counsels both sports teams and sports leagues with a broad range of tax issues.

In addition, Amanda advises not-for-profit clients on matters such as applying for and maintaining exemption from federal income tax, minimizing unrelated business taxable income, structuring joint ventures and partnerships with taxable entities and using exempt and for-profit subsidiaries.

Amanda has been recognized as a leading tax practitioner by *Chambers USA* 2014-2018; *The Legal 500* for Tax 2013-2018, Investment Fund Formation & Management: Alternative/Hedge Funds 2011-2018 and Non Profit and Tax Exempt Organizations 2016-2018; *The Best Lawyers in America* 2013-2018; and *New York Super Lawyers* 2010-2017. In 2018, she was named by *Crain's New York Business* to the list of Leading Women Lawyers; she was named "Best in Tax" at Euromoney's 2017 Women in Business Law Awards. Amanda is a fellow of the American College of Tax Counsel and The American Bar Foundation.

# LEAH S. ROBINSON, ESQ.
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Leah Samit Robinson leads Mayer Brown's State & Local Tax group and is a member of the Tax Transactions & Consulting practice. A partner in the firm's New York office, she advises public and private business entities on state and local tax planning, controversy and litigation.

She provides national and state tax strategy and audit assistance for clients on a full range of tax matters, including nexus, combination and apportionment, and net operating loss issues. She is the co-author of the chapter on "Appeals" in *State Business Taxes* (Law Journal Press 2009).

Leah regularly advises on the sales tax characterization of goods and services, with a particular focus on digital services and software as a service issues. Leah has litigated a number of sales tax cases but is sensitive to most companies' preference to resolve matters without litigation.

She is particularly well-known for her advocacy in New York City and New York State, as well as for advising on the impact of the massive New York tax reform undertaken in 2014 and 2015. She was appointed to the New York City Department of Finance Commissioner's Advisory Board (2014–present) as well as to the city's Pass-Through Taxation Working Group (2014–present), a think tank formed by the Department of Finance to assist with bringing reform to the city's Unincorporated Business Tax. Leah has been a principal drafter of six reports issued by the New York State Bar Association Tax Section commenting on tax reform legislation and proposed draft regulations and one report issued by the New York City Bar Tax Section. She is the author of the "In a New York Minute" column published by *State Tax Notes*.

Leah is also well known for her advocacy in New Jersey tax disputes, covering income tax and sales tax matters. Leah was counsel or co-counsel in disputes related to New Jersey's now-defunct throwout rule (*Pfizer*), taxation of extraterritorial income (*IBM*), treatment of limited partners (*Preserve II*), taxation of partnerships (*Pulte Homes*), apportionment of income from securitized loan portfolios (*Capital One*), and sales taxation of temporary help services (*Labor Ready*) and electricity distribution charges (*Atlantic City Showboat*). She has been appointed to the New Jersey Supreme Court Committee on the Tax Court (2017–2018 term) and authors the *State Tax Notes* column, "The Jersey Short—Everything You Need to Know about New Jersey Tax." She is an editor of BNA's *Corporate Income Tax Navigator (New Jersey)*.

Previously, as a tax lawyer with the IRS Office of Chief Counsel in New York City, she was part of the strategic trial team handling the largest section 482 transfer pricing controversy in history.

# MARJORIE A. ROLLINSON, ESQ.
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Marjorie Rollinson was selected as the Associate Chief Counsel (International) at the Internal Revenue Service in the spring of 2016. She heads the office within counsel of 75 attorneys and other professional responsible for legal advice, guidance, and support to the IRS, Treasury and the public on international tax issues in all procedural postures. Before becoming the Associate, Ms. Rollinson served as the Deputy Associate Chief Counsel (International - Technical) from October, 2013 – March 31, 2016.

Prior to joining the IRS, Ms. Rollinson was a principal in EY's National Tax Department where she was also the National Director of International Tax Services – Technical and co-chaired the firm's International Tax Technical Committee.

Ms. Rollinson received her law degree from the University of Maryland in 1987. She received her undergraduate degree from Wellesley College in 1984.

Ms. Rollinson is a member in good standing of the Maryland Bar.

# STEPHEN E. SHAY, ESQ.
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Stephen E. Shay is a Senior Lecturer at Harvard Law School.

Before joining the Harvard Law School faculty as a Professor of Practice in 2011, Mr. Shay was Deputy Assistant Secretary for International Tax Affairs in the United States Department of the Treasury. Prior to re-joining the Treasury Department in 2009, Mr. Shay was a tax partner for 22 years with Ropes & Gray, LLP. Mr. Shay served in the Office of International Tax Counsel at the Department of the Treasury, including as International Tax Counsel, from 1982 to 1987, during which Mr. Shay actively participated in the development and enactment of international provisions in the Tax Reform Act of 1986.

Mr. Shay has published scholarly and practice articles relating to international taxation, and testified for law reform before Congressional tax-writing committees. He has had extensive practice experience in the international tax area and while in active practice was recognized as a leading practitioner in *Chambers Global: The World's Leading Lawyers*, *Chambers USA: America's Leading Lawyers*, *The Best Lawyers in America*, *Euromoney's Guide to The World's Leading Tax Advisers* and *Euromoney's, Guide to The Best of the Best*. Mr. Shay discloses certain related interests and activities not connected with his position at Harvard Law School on the Harvard Law School website.

Mr. Shay is President of the American Tax Policy Institute Board of Trustees and is the IBFD Professor in Residence for 2015. Mr. Shay serves on the Executive Committee of the New York State Bar Association Tax Section and has been active in the American Bar Association Tax Section as a Council Director and Chair of the Committee on Foreign Activities of U.S. Taxpayers, in the American Law Institute as an Associate Reporter and in the Taxes Committee of the International Bar Association. Mr. Shay is a 1972 graduate of Wesleyan University, and he earned his J.D. and his M.B.A. from Columbia University in 1976.

# MICHAEL B. SHULMAN, ESQ.
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Mr. Shulman is Head of the Tax Group at Shearman & Sterling. Mr. Shulman represents and advises clients on the tax aspects of a wide variety of business and financial transactions. Mr. Shulman works extensively in the areas of corporate acquisitions, dispositions and restructurings. He also represents regulated investment companies and onshore and offshore investment funds on a broad range of organizational and transactional matters.

Mr. Shulman is the former Chair of the Financial Transactions Committee of the American Bar Association Tax Section and is member of the Executive Committee of the New York State Bar Association Tax Section. Mr. Shulman joined the firm in 1996 and became a partner in 2001.

**Education**

New York University School of Law, LL.M., 1997

Vanderbilt University School of Law, J.D., 1993

University of Chicago, B.A., 1990

# JACK TRACHTENBERG, ESQ.
## BIOGRAPHY

Jack Trachtenberg is a Principal in Deloitte's Multistate Tax Controversy Services team in New York and a liaison to the Washington National Tax-Multistate practice as a New York controversy and technical lead. Jack focuses on all aspects of state and local tax controversy matters for corporations and pass-throughs, including income/franchise and sales and use tax, and has deep experience serving high-net-worth individuals in personal income tax matters, including residency.

Jack has extensive experience advising clients on New York State and New York City tax matters, having successfully litigated cases before the New York State Division of Tax Appeals, the New York State Tax Appeals Tribunal and the New York State Supreme Courts. Before joining Deloitte, Jack was a partner in the state tax practice at Reed Smith LLP. In 2009, the Governor of New York appointed Jack to serve as the first Deputy Commissioner and Taxpayer Rights Advocate at the New York State Department of Taxation and Finance. In this role, Jack created and implemented the state's Office of the Taxpayer Rights Advocate, which intervenes on behalf of taxpayers facing intractable tax disputes.

Jack is a frequent speaker on state tax issues. Jack is also an author, editor, co-author or publisher of many publications, including the "Multistate Corporate Tax Guide," the "Multistate Guide to Sales and Use Tax," the "New York State Sales and Use Tax Answer Book," and the LexisNexis "Tax Practice Insights: New York." He is also a frequent contributor to tax and accounting publications, such as State Tax Notes and The CPA Journal, and has taught State and Local Tax courses at Albany Law School.

Jack holds a master's and bachelor's degree in political science from Case Western Reserve University and a Juris Doctor from the University at Buffalo School of Law.

# KRISHNA P. VALLABHANENI, ESQ.
## BIOGRAPHY

Krishna P. Vallabhaneni serves as Deputy Tax Legislative Counsel in the U.S. Department of the Treasury's Office of Tax Policy. In that capacity he leads the Office of Tax Legislative Counsel staff in developing published guidance, proposed legislation, and tax regulations concerning corporations, passthrough entities, and financial institutions and products. Prior to November 2015, he served as the principal corporate tax advisor to the Assistant Secretary for Tax Policy.

Mr. Vallabhaneni was previously a senior manager in the Subchapter C group of Deloitte Tax LLP's Washington National Tax Office, where he advised corporate clients and their shareholders regarding the federal income tax consequences of a wide array of transactions, including taxable and tax-free mergers and acquisitions, reorganizations, and spin-offs.

Between 2001 and 2005, Mr. Vallabhaneni served as an attorney with the Internal Revenue Service's Office of Associate Chief Counsel (Corporate). He earned an LL.M. in Taxation from New York University School of Law, his J.D. from the George Washington University Law School, and a B.A. in Biology from Johns Hopkins University.

# KARL T. WALLI, ESQ.
## BIOGRAPHY

Karl Walli worked at the IRS from 1986 to 1996. An original member of the Financial Institutions & Products division of Chief Counsel, he specialized in the taxation of derivatives and was one of the principal authors of the notional principal contract regulations. After transferring to the International Division in 1991, Karl worked on a variety of banking and financial product issues, including foreign currency, subpart F, and interest expense allocation. He joined the Washington, D.C. office of Weil Gotshal & Manges in 1996 and became a partner in the tax department in 2000. His work at Weil included advising clients on inbound and outbound issues concerning the application of U.S. tax rules to derivative financial instruments, capital market transactions, private equity transactions, and effectively connected income. He returned to the government in 2009, joining the Treasury Department as Senior Counsel (Financial Products) and now serves as Senior Counsel in the Office of Tax Policy.

# LISA ZARLENGA, ESQ.
## BIOGRAPHY

Lisa Zarlenga represents public and private companies on federal income taxation issues, with a focus on tax policy issues with respect to tax legislation and Treasury guidance as well as on corporate transactional and planning matters. Lisa serves as co-chair of Steptoe's Tax Group and leads the firm's tax policy practice. Drawing on her experience as Tax Legislative Counsel at the US Treasury Department's Office of Tax Policy, Lisa marries substantive tax knowledge with strong relationships at Treasury and first-hand insights on the guidance and other processes at Treasury. She helps clients advocate for and resolve tax policy issues before the Treasury Department and IRS involving proposed and pending regulations and other administrative guidance, and before Congress involving legislation.

Lisa also advises clients on structuring tax-free and taxable acquisitions and dispositions, tax-free spin-offs, and internal restructurings, including providing opinion letters and seeking advance rulings from the IRS. She also assists clients in restructuring financially troubled businesses and advises on the special rules governing consolidated groups.

Lisa has combined her policy and transactional backgrounds to advise clients on tax issues relating to blockchain and digital currency. She advises clients on conducting digital currency transactions and conversions, token offerings, and different investment and entity structures. Her experience includes advising a coalition of the leading companies in the blockchain space that was engaging directly with the IRS and policymakers to develop workable policies at an industry-wide level.

As Tax Legislative Counsel at the Treasury Department, Lisa advised Treasury's Assistant Secretary for Tax Policy on a broad range of domestic tax policy issues, including corporate, partnership, healthcare, tax-exempt organizations, energy, income tax accounting, estate and gift, and procedure and administration. She oversaw preparation of regulations and other administrative guidance implementing the Internal Revenue Code and the president's annual revenue proposals in these areas.

**Bar & Court Admissions**

- District of Columbia
- Ohio
- Supreme Court of the United States
- US Tax Court
- US Court of Federal Claims

**Clerkship**

- Hon. Robert P. Ruwe, US Tax Court, 1994-1996

**Education**

- LL.M., Georgetown University Law Center, 1997, with honors, Taxation
- J.D., Ohio State University Moritz College of Law, 1994, Order of the Coif; Associate Editor, *Ohio State Law Journal*
- B.S., Ohio State University, 1991, *summa cum laude*, Beta Gamma Sigma, Accounting

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