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Practical advice on current issues.

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Employee Benefits & Pensions

Social Security concerns for remote workers and international assignees

Many Americans have little sense of how their Social Security retirement benefits are calculated. At the end of a long career, they apply for their pension and accept what is paid. Likewise, when it comes to tax planning, U.S. Federal Insurance Contributions Act, or FICA, tax, which includes Social Security tax, does not get much attention. A flat tax with no deductions, imposed on higher levels of earnings at a relatively low rate, FICA is generally an afterthought when tax planning is concerned.

However, when a worker moves across international borders, the cost can be significant, and there could be a substantial impact on the worker's future retirement benefits. For these reasons, it is important to understand the basics of U.S. Social Security coverage and benefits.

The Social Security component of FICA, formally known as Old-Age, Survivors, and Disability Insurance (OASDI), is withheld at the rate of 6.2% of wages with respect to employment and ceases to apply when taxable wages reach an annual limit of $147,000 (the inflation-adjusted 2022 amount). The employer pays the same amount as a payroll tax. The other component is Medicare tax, which has no upper limit. The withholding rate of 1.45% increases to 2.35% when wages exceed $200,000. (The increased withholding rate threshold of $200,000 applies to all employees, but a married couple filing jointly could be over- or underwithheld because their combined compensation over $250,000 is subject to the 2.35% rate. The difference is reconciled on their tax return.) The employer pays a corresponding payroll tax of 1.45% on all compensation paid to the employee.

FICA tax for international workers

In general, all compensation earned for employee services provided in the United States is subject to FICA. (A few statutory exceptions are not covered here.) In addition, compensation for services provided to a U.S. employer by an employee who is a U.S. citizen or resident is subject to FICA no matter where the services are provided. This simple rule, found in Sec. 3121(b), may have a major impact on mobility cost.

Example 1: *L*, a U.S. citizen who is employed by a U.S. employer, requests a remote-work arrangement for a year to care for her ailing parents in a foreign country. While living abroad, she will continue to be subject to FICA but may also be subject to the host country's social security tax. Many foreign countries' social security tax rates are much higher than those of the United States, so being subject to double social security tax may be a huge incremental cost. Even if *L* is held responsible for the employee-level foreign social security tax, the additional employer-level tax would also significantly increase the cost to her employer of her work abroad.

A similar problem can be imagined in the reverse scenario, when a foreign worker might find herself subject to FICA while temporarily working in the United States, while still subject to her home country's social security tax because that is her permanent base.

Social security 'totalization' agreements

The United States shares special social security agreements (often referred to as "totalization agreements") with 30 countries, which are intended to prevent the payment of double social security tax. However, issues can still arise. Most agreements the United States has entered into set forth a general rule that a worker should pay only the social security tax of the country where service is being provided. They also include a special "detached worker" rule: If a worker is sent by his or her current employer on an assignment of no more than five years, he or she can remain covered by his or her home country's social security system and avoid paying host country tax. (The agreement with Italy is the exception; in that agreement the determination of which country can impose its social security

tax is generally based on the employee's country of citizenship.)

Example 2: *R* is a U.S. citizen with a U.S. employer. If *R*'s employer sends him to Germany to work for a period of no more than five years, under the United States–Germany totalization agreement, he can continue his FICA coverage and will be exempt from German social security tax. It is a different story, however, if *R* initiated a remote-worker arrangement for his own purposes that his employer was simply accommodating. In that case, because he was not sent to Germany by his employer, the employment would be subject to the general rule of the U.S.–Germany totalization agreement, exempt from FICA but subject to German social security tax at a rate of 20.23% for the employee and 19.98% for the employer.

Even if *R* bears the incremental cost of the employee tax, his cost of employment has increased by more than 12 percentage points to his employer over the 7.65% U.S. FICA rate. In the current environment, then, with "work from anywhere" arrangements proliferating, U.S. employers may need to consider whether "anywhere" should be limited to "anywhere in the United States."

Compensation for services provided to a US employer by an employee who is a US citizen or resident is subject to FICA no matter where the services are provided.

Social Security retirement benefits for mobile workers

Less often considered than the rate of home/host country social security tax is the impact of mobility on a worker's social security benefits. To address that consideration, it is important to have a basic understanding of how U.S. Social Security retirement benefits are calculated. In general, to qualify for U.S. retirement benefits, a person needs at least 40 "quarters" of coverage by FICA. These credits do not correspond to calendar quarters but rather to the amount earned: a person earns one credit for each $1,510 earned (2022 amount), up to a maximum of four credits per year. Thus, most workers will earn their 40 credits by working during 10 calendar years.

But the benefit calculation is more complicated, taking into account an average of the worker's top 35 years of inflation-adjusted earnings. (Any year that a worker is over the Social Security wage maximum is essentially equivalent for purposes of the calculation.) So, in the example above, if *R* works for a foreign employer abroad for a year or two and does not pay FICA, over the course of his career he will still likely have 40 or more years of earnings in the United States. Once a person exceeds 35 years, additional years may just replace earlier, lower-earning years in the calculation, which may not have a large impact on the amount of the benefit.

Example 3: *B* was born in 1965 and earned 10% of the Social Security wage maximum at age 22, 20% at age 23, and so forth. If he also earns more than the wage maximum in every year from ages 31 through 65, he will have 44 years of earnings in his U.S. Social Security record. None of those early, lower-income years will be included in his 35-year average, and his monthly benefit on reaching age 67 in 2032 should be $3,392 (in current dollars). (All retirement benefit projections in this article were performed using the U.S. Social Security Administration ANYPIA software, version 2022.1.)

If *B* took a position outside the United States with a foreign employer and did not pay FICA in 2022 or 2023, but the facts were otherwise the same, his benefit would be $3,372 — the loss of two high-income years from the 35-year average having a negligible impact on the amount of the benefit.

As noted above, the United States has entered into bilateral social security totalization agreements with 30 countries. In many cases, these agreements allow workers whose employer sends them to work abroad for no longer than five years to avoid the foreign tax and continue home country coverage. Thus, if, in this example, it had been *B*'s U.S. employer that sent him to work in a totalization country for two years, there would have been no break in FICA coverage and no impact at all on his eventual retirement benefit.

Example 4: Now assume that *B* left the United States permanently after 2021 and did not contribute to FICA for the remainder of his career. His 35-year average would include nine lower-earning years, not just two, but his monthly retirement benefit upon reaching age 67 would be $3,140 — not as drastic a reduction as many workers might fear.

However, if *B* worked abroad without paying FICA for so many years that he had fewer than 35 years in his lifetime U.S. Social Security average, this could have a more significant impact on his retirement benefit. If he left the United States permanently after 2011, having only 25 years in his earnings record, his monthly benefit upon reaching age 67 would be $2,645. Clearly, when discussing work abroad with an employee who has concerns about the long-range

consequences of not paying FICA, it may be worthwhile to quantify the potential impact.

Benefits for temporary US residents

A common concern of workers temporarily present in the United States is that the FICA tax they pay will result in no future benefit to them. For many workers, this is valid, given the 40-credit/10-year contribution threshold noted above. However, a second purpose of bilateral totalization agreements is to provide for social security benefits at a much lower threshold of participation. In the case of the United States, if a person has just six Social Security coverage credits but has at least 10 years of participation in the United States combined with that in a country that shares a totalization agreement with the United States, then the person will qualify for a U.S. retirement benefit.

> ***Example 5:*** *M* works in the United States for three years, 2020–2022, accumulating 12 coverage credits. Assume that *M* was born in 1965 and paid FICA tax on the maximum amount of wages subject to FICA in each year 2020–2022. She has no other work history in the United States over the course of her career but worked in Spain and paid Spain's social security tax over those years. Because she has more than six U.S. coverage credits and more than 10 years of coverage in the United States and Spain combined, she will qualify for a U.S. Social Security retirement benefit. Under current law, her monthly benefit upon reaching age 67 would be $289, stated in current dollars.

M's life expectancy upon reaching age 67, according to the U.S. Social Security Administration's actuaries, is 87.6 years (247 months), meaning that she would collect a total of more than $71,000 if she lives to that age, an annuity with a present value of more than $44,000 at age 67 (using a discount rate of 5%). This is not a bad return on her investment of $26,505 (the maximum OASDI tax for years 2020–2022).

Many variables, not all consequential

The answer to the question "What impact will working abroad have on my U.S. Social Security retirement benefit?" is "It depends." Among the considerations are how many years the person has already paid FICA tax; how many years after the work abroad he or she expects to pay FICA; and, particularly for an inbound foreign worker, whether the other country shares a totalization agreement with the United States. Often, the answer to that same "What impact …" question is — "Not as much as you might think."

From Robert Rothery, CPA, Portland, Ore.

Foreign Income & Taxpayers

No employer refund for tax payments made on employee's behalf

In a recent Chief Counsel Advice memorandum (CCA 202202010), the IRS determined that an employer funding an international assignee's federal income tax obligations under a tax equalization policy may not seek a refund of excess withholding on that employee's compensation after the close of the calendar year during which the compensation was paid.

This IRS memorandum is notable because it is one of the few pieces of IRS guidance addressing the impact of global mobility tax compliance processes on an employer's federal income tax reporting and withholding obligations, and it appears to be the first published guidance to consider whether an overpayment of tax based on a hypothetical tax estimate is an "administrative error" that may be corrected by an employer after the close of the calendar year during which it was paid.

Background

The IRS memorandum considers the scenario of a U.S. company sending an employee who is a U.S. citizen on an assignment to a foreign (host) country. Because there are both personal and economic costs to an employee who relocates to a host country, companies often provide these "assignees" with assignment allowances (such as cost-of-living adjustments, housing, and tuition for dependents) to mitigate the impact of an assignment on the assignee's pocketbook. However, these assignment allowances inflate an assignee's taxable earnings, and, in turn, increase the assignee's personal tax liability. Additionally, the assignee may be subject to tax in both the United States and the host country on this inflated income. Given the potential negative tax consequences for an assignee, many employers use a tax reimbursement policy known as tax equalization that attempts to approximate an assignee's personal out-of-pocket tax cost as if the assignee had not gone on assignment.

Tax equalization: Typical tax equalization policies divide an assignee's employment compensation into two categories. The first category, "assignment-related" compensation, includes assignment-related allowances. The company is responsible for all taxes on this income. The second category, "stay-at-home" compensation, includes amounts that would have been paid to the assignee regardless of whether the assignee was on an international assignment, such as base salary, annual bonus, vacation pay, and equity compensation. Tax equalization policies vary across organizations, but, in general, the assignee is responsible for the amount of tax that would have been incurred on this income had the assignee not relocated,

and the company is responsible for any additional tax incurred on this income because of the assignment.

Hypothetical tax: Tax equalization is accomplished by collecting "hypothetical taxes" from an assignee. At the start of an assignment or tax year, the company estimates the amount of taxes the assignee would incur in the United States had the assignee not been on assignment. The assignee's salary is then reduced by this "estimated hypothetical tax" amount, which the company uses to fund the assignee's actual tax liability on equalized income. This estimated hypothetical tax amount is not considered "wages" or income for federal tax purposes, and, accordingly, it reduces the amount of wages reported to the IRS and the employee on Form W-2, *Wage and Tax Statement*.

The company meets the assignee's actual U.S. and host country tax liabilities by paying the taxes directly to the relevant tax authority and including the tax payment in the assignee's reportable compensation (a tax gross-up). For federal tax purposes, all wages (including assignment allowances and tax payments) reduced by any hypothetical tax amounts are reported by the employer on Form 941, *Employer's Quarterly Federal Tax Return*.

After the calendar year ends, a hypothetical tax return is prepared to determine the amount of taxes the assignee would have incurred had the assignee not been on assignment, and a reconciliation is performed between this "actual hypothetical tax" amount and "estimated hypothetical tax" that had reduced the employee's wages over the course of the year. If the actual hypothetical tax amount is lower than the estimated hypothetical tax amount, the company pays the assignee the difference, and the amount is included in the assignee's taxable compensation in the year paid. However, if the actual hypothetical tax amount is greater than the estimated hypothetical tax amount, the assignee is required to repay that amount to the employer.

Overpayment of tax is not an administrative error

When an employee repays an employer for wages received in error in the current year, the employer may offset the repayment against current-year wages and may be able to report the repayment as an adjustment on Form 941-X, *Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund*, to recover any employment taxes withheld on those repaid wages. However, when an assignee is required to repay an amount to the employer under a tax equalization program, the repayment represents a return of wages received in a prior year. The employer may wish to report the repayment as an adjustment on Form 941-X to recover any employment taxes withheld on those repaid wages and issue a Form W-2c, *Corrected Wage and Tax Statement*, to remove the overpaid tax from the assignee's wages and withholdings, but, as the IRS memorandum details, this approach is not consistent with federal income tax wage withholding rules.

When a company funds an assignee's tax obligations through direct payments to the IRS, the tax payments made on the assignee's behalf represent income and reportable wages to the assignee. For employment tax purposes, these payments are deemed to have been withheld by the company from the employee's wages and are therefore reportable on the assignee's Form W-2 as both wages and tax withholding on those wages in the tax year paid. Because these tax payments are properly considered wages in the year paid, a company may not correct an overpayment based on a hypothetical tax estimate in a subsequent year.

An exception to this general rule applies when the overpayment is due to an "administrative error." Although from the employer's perspective, an overpayment of tax based on a hypothetical tax estimate may seem like an "administrative error," as the IRS details, this term is defined for employment tax purposes as an error that results in the inaccurate reporting of the amount withheld. While an employer may have overpaid tax based on the hypothetical tax estimate, the company accurately reported that overpayment in the year paid. As the overpayment does not result in a difference between the amount the employer reported as withheld and the amount actually withheld from the assignee's wages, there is no administrative error to be corrected in a subsequent year. Therefore, the employer may not seek a refund of this overpayment.

Recovery of the employer portion of FICA tax

While the company cannot recover overwithheld federal income tax that was paid on behalf of an employee through Form 941-X, the same is not true of Federal Insurance Contributions Act (FICA) tax, for which a refund or credit *can* be claimed by the employer in a subsequent calendar year. Prior to claiming a refund or credit for FICA tax, the company must make reasonable efforts to first repay or reimburse the employee for the employee's portion of FICA tax and secure the employee's consent for the employer to pursue the refund claim.

Additionally, the company must file a Form W-2c and Form W-3c, *Transmittal of Corrected Wage and Tax Statements*, with the Social Security Administration to correct the reported FICA wages. While filing a Form 941-X and issuing a Form W-2c may be administratively burdensome, especially considering that an assignee's remuneration is likely to remain above the Old-Age, Survivors, and Disability Insurance threshold even after the wage repayment, there is still an opportunity for companies to recover significant tax costs with respect to the Medicare portion of the FICA tax, which is not subject to a cap.

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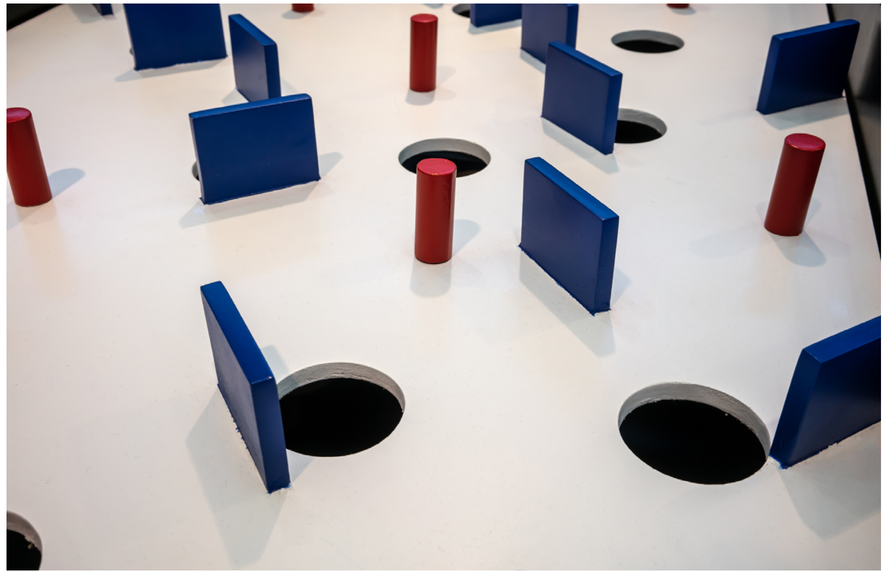
Recovery of overpayment via the assignee's tax return

Although recovery of the overpayment of federal income tax is not possible via Form 941-X, the employer is not without recourse, as the normal tax equalization process requires that the employee return to the employer a refund of tax that was paid by the employer on the employee's behalf. Because during the assignment the company is responsible for the assignee's actual tax liabilities, any reduction in tax on the assignee's return reduces the assignee's tax burden that the company has assumed.

From John T. Seery, J.D., LL.M., Washington, D.C.



OECD DEMPE and risk guidance in the US

Development, enhancement, maintenance, protection, and exploitation of intangibles (DEMPE) is a concept first introduced by the Organisation for Economic Co-operation and Development (OECD) in the 2015 Final Report on Actions 8–10, "Aligning Transfer Pricing Outcomes with Value Creation," part of its base-erosion and profit-shifting initiative.

The Actions 8–10 report provides guidance specifically tailored to determining arm's-length conditions for transactions that involve the use or transfer of intangibles between related parties under Article 9 of the OECD Model Tax Convention. This guidance, which has since been incorporated into the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Guidelines), addresses the opportunities for base erosion and profit shifting resulting from the transfer of intangibles among members of a multinational enterprise (MNE) group. Under this guidance, members of the MNE group are to be compensated based on the value they create through functions performed, assets used, and risks assumed in the development, enhancement, maintenance, protection, and exploitation of intangibles.

The present discussion explores DEMPE and points out significant differences between the OECD Guidelines and the Treasury regulations under Sec. 482, concerning DEMPE and risk.

DEMPE and the analysis of risk

As stated by paragraph 6.32 of the OECD Guidelines, in transfer-pricing cases involving intangibles, it is crucial to determine the entity or entities within an MNE group that are ultimately entitled to share in the returns derived by the group from exploiting intangibles. So too is determining which entity or entities within the MNE group should ultimately bear the costs, investments, and other burdens associated with the DEMPE functions. The OECD Guidelines also recognize that, while the legal owner of an intangible may receive the proceeds from exploitation of the intangible, other members of the legal owner's MNE group may have performed functions, used assets, or assumed risks that are expected to contribute to the value of the intangible. The members of the MNE group performing such functions, using such assets, and assuming such risks must be compensated for their contributions under the arm's-length principle.

The rationale behind DEMPE is to help both taxpayers and tax authorities achieve an accurate assessment of transactions, identify the entities performing DEMPE functions, and ensure an arm's-length return for them. To this end, paragraph 6.34 of the OECD Guidelines provides a precise analytical framework for analyzing intangibles in controlled transactions:

- Step 1: Identify the intangibles;
- Step 2: Identify the full contractual arrangement;
- Step 3: Identify the parties performing functions, using assets, and managing risks related to intangibles in relation to DEMPE;
- Step 4: Confirm the consistency between contractual arrangements and conduct of the parties through functional analysis;
- Step 5: Delineate the actual controlled transactions related to the DEMPE of intangibles; and
- Step 6: Determine arm's-length prices for the delineated transactions.

Before the DEMPE concept was introduced, the legal ownership of intangibles by an associated enterprise was

PHOTO BY VUDHIKUL OCHAROEN/ISTOCK

It is crucial to determine the entity or entities within an MNE group that are ultimately entitled to share in the returns derived by the group from exploiting intangibles.

often used to determine entitlement to returns from the exploitation of intangibles. Therefore, for example, an MNE could register its trademarks in a low-tax jurisdiction and take the position that the intellectual property (IP) owner could charge royalties to related entities in other jurisdictions, allowing the IP owner in the low-tax jurisdiction to be entitled to the income effectively generated in other jurisdictions.

In addition to the DEMPE rules, the 2015 Final Report on Actions 8–10 introduced updated guidance on the analysis of risk for transfer-pricing purposes. Historically, contractual arrangements between related parties were often used to determine which party bore relevant risks for transfer-pricing purposes. Under the updated guidance, the contractual allocation of risk remains relevant, but it will be respected only if it is consistent with the enterprises' conduct. Paragraph 1.60 of the OECD Guidelines provides an overview of the required risk analysis:

- Step 1: Identify the economically significant risks;
- Step 2: Determine how the risks are contractually allocated by the parties;
- Step 3: Based on a functional analysis, determine which entities perform risk control and risk-mitigation functions; which entities are exposed to the upside and downside; the consequences of a risk; and which entities have the financial capacity to assume the risk;
- Step 4: Determine whether the contractual allocation of risk is consistent with the parties' conduct by analyzing:
  - Whether the parties follow the contractual terms, and
  - Whether the party assuming the risk under the contractual terms exercises control over the risk and has the financial capacity to assume the risk;
- Step 5: If, under Step 4, the party assuming the contractual risk lacks the requisite financial capacity or control, apply the OECD Guidelines' risk allocation guidance (paragraphs 1.98–1.99) and allocate the risk to the entity that controls the risk and has the financial capacity to assume it; and
- Step 6: Price the transaction in question, taking into account the consequences of risk assumption as appropriately allocated and appropriately compensating risk management functions.

Now, after the base-erosion and profit-shifting initiative, it is clear under the OECD rules that contractual arrangements or funding alone does not entitle an entity to returns from intangibles or risk assumption. To earn returns from assuming risk or owning intangibles, an entity must have "substance," in the form of decision-makers' controlling the risks or performing important DEMPE functions. Entities funding intangible development or contractually assuming risks but with no significant people functions would not be entitled to the returns from economically significant risks and intangibles.

Even though the OECD Guidelines are clear that legal ownership or contractual terms alone do not entitle an entity to returns, the guidelines are less clear on the degree of substance required for an entity to earn the returns from risk assumption and intangible ownership. The OECD Guidelines are open to differing interpretation by tax authorities, leaving taxpayers with the challenge of determining the appropriate level of substance to satisfy the functional requirements for earning the rewards of risk assumption and intangible ownership.

DEMPE and the US

Several countries around the world have expressly incorporated the DEMPE concept and its analytical framework into their own domestic law, but that is not the case for the United States. In public pronouncements, U.S. government officials have said that the Sec. 482 regulations are consistent with the OECD Guidelines. However, the ambiguous language in the OECD Guidelines can trigger differences in interpretation between the United States and other tax authorities.

Although the OECD Guidelines and the DEMPE rules are occasionally referred to by the IRS in bilateral advance pricing agreements and competent authority cases as a common reference point for negotiation and resolution, they do not constitute binding authority for interpreting Sec. 482. However, as a member of the OECD, the United States seeks to follow OECD recommendations in interpreting its treaties with other member countries. In 2019, the IRS issued a memorandum titled "Interim Guidance on Mandatory Issue Team Consultations With APMA for Examination of Transfer Pricing Issues Involving Treaty Countries," which requires Large Business and International (LB&I) exam teams to consult with the IRS Advance Pricing and Mutual Agreement program (APMA) when auditing transfer-pricing transactions that involve counterparties in jurisdictions that are U.S. treaty partners.

This consultation requirement allows APMA to provide early input into transfer-pricing audits that could

become competent authority cases, including advising exam teams on whether a contemplated adjustment would likely be sustained in the competent authority process. Even though this guidance does not expressly refer to DEMPE, as a practical matter, APMA would take into account any DEMPE-based arguments that it anticipates the counterparty competent authority would make.

However, there remain significant differences between the Treasury regulations under Sec. 482 and the OECD Guidelines on DEMPE and risk. For example, regarding contractual arrangements, the U.S. transfer-pricing regulations respect allocations of risk pursuant to a written contract as long as they are consistent with the "economic substance" of the transaction (Regs. Sec. 1.482-1(d)(3)(ii)(B)). In considering the economic substance of the transaction, the following facts are relevant (Regs. Sec. 1.482-1(d)(3)(iii)(B)):

- Whether the taxpayer's conduct over time is consistent with the purported allocation of risk or, where the pattern is changed, whether the relevant contractual arrangements have been modified accordingly;
- Whether a controlled taxpayer has the financial capacity to fund losses that might be expected to occur as the result of the assumption of a risk, or whether, at arm's length, another party to the controlled transaction would ultimately suffer the consequences of such losses; and
- The extent to which each controlled taxpayer exercises managerial or operational control over the business activities that directly influence the amount of income or loss realized. In arm's-length dealings, parties ordinarily bear a greater share of those risks over which they have relatively more control.

Broadly speaking, the U.S. rules on risk allocation are conceptually similar to the OECD Guidelines, although the Sec. 482 regulations are less precise. In practice, the "economic substance" test under Sec. 482 may pose a higher bar for risk reallocation than the OECD Guidelines, and the IRS and U.S. Tax Court have generally respected contractual allocations of risk by taxpayers. In other ways, however, the U.S. regulations may prove harsher: The OECD Guidelines contemplate that contractual terms "may also be found in communications between the parties other than a written contract" (paragraph 1.42), while Regs. Sec. 1.482-1(d)(3)(ii)(B)(2), in the absence of a written contract, allows the IRS to impute contractual terms consistent with the economic substance of the transaction.

With respect to transactions involving intangibles, the apparent gap between the Sec. 482 regulations and the OECD Guidelines is broader. Regs. Sec. 1.482-4(f)(3) provides that for U.S. transfer-pricing purposes, the legal owner of an intangible will be considered its sole owner unless the ownership is inconsistent with economic substance. While a DEMPE analysis could be used to determine whether legal ownership is consistent with economic substance, the economic substance test remains a relatively high bar.

In *Coca-Cola Co.*, 155 T.C. 145 (2020), the Tax Court placed significant weight on the importance of contractual arrangements regarding intangible ownership and held that the taxpayer could not invoke the economic substance exception to prove that an entity other than the contractual owner possessed intangibles. In a clear divergence from the OECD Guidelines, the Sec. 482 regulations regarding cost-sharing arrangements allow cost-sharing participants to receive intangible-related returns without regard to operational control over DEMPE functions.

To conclude, even though U.S. government officials have maintained that the Sec. 482 regulations are consistent with the OECD Guidelines, actually, there are clear differences in application, and these differences are underscored when it comes to DEMPE and risk allocation. Therefore, MNEs and tax practitioners need to keep following and complying with the U.S. regulations but always keep an eye on DEMPE rules to be prepared when these two similar, but in practice not identical, approaches interact.

From Sean Foley, J.D., LL.M., Silicon Valley, Calif., and Cristian Faundez, LL.B., LL.M., Atlanta

Secondary transfer-pricing adjustments

Taxpayers facing transfer-pricing adjustments should be aware of rules requiring secondary adjustments. The purpose of these adjustments is to resolve discrepancies that arise from primary and corresponding adjustments. A primary adjustment occurs when a tax authority or a taxpayer adjusts taxable profits as a result of applying the arm's-length principle to transactions between related parties. A corresponding adjustment is the offsetting income reduction in the counterparty jurisdiction. Typically, getting a corresponding reduction to be recognized by the tax authority of the second tax jurisdiction affected requires

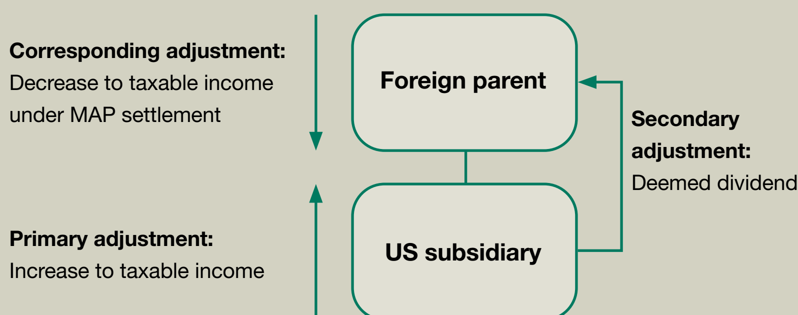
IMAGE BY HAPPYPHOTON/ISTOCK

a mutual agreement procedure (MAP) case under an income tax treaty.

A secondary adjustment reflects an inferred secondary transaction that resolves the discrepancy caused by the primary adjustment and the corresponding adjustment between the taxpayer's cash accounts and tax accounts. More specifically, the inferred secondary transaction is deemed to have taken place to produce the result that, if the primary transaction had been conducted at arm's length, the outcome in the cash accounts would be identical to the actual profit allocation between the related parties.

Secondary transfer-pricing adjustment rules vary among tax jurisdictions, and in fact, most jurisdictions do not impose secondary adjustments. For example, the United States, Canada, Germany, and India have secondary adjustment rules, but the United Kingdom, Japan, and Australia do not. This item focuses on the United States and rules promulgated under Regs. Sec. 1.482-1(g)(3) and Rev. Proc. 99-32. A global survey of secondary adjustment rules is provided by Foley, Taheri, and Sullivan, "Country-by-Country Survey of Global Secondary Adjustment Rules," 103 *Tax Notes International* 29 (July 5, 2021).

As discussed below, an inferred secondary transaction may be in the form of a deemed dividend, a deemed capital contribution, or a deemed loan.



Deemed dividend

For example, suppose a primary transfer-pricing adjustment increases the taxable income of a U.S. company. If the related party that recorded the excess income prior to the primary adjustment owns stock directly or indirectly in the U.S. company (e.g., a foreign parent company), then a deemed transaction that results in an identical outcome in the cash accounts would be a dividend distribution from the U.S. company to its related party. (See the diagram "Resolve Discrepancy Between Tax Accounts and Cash Accounts Through Secondary Adjustment.") The deemed distribution may have tax consequences. Under Sec. 881, the related party would be subject to a 30% tax liability on the distribution, and under Sec. 1442, the U.S. company would be a withholding agent required to withhold the tax.

Deemed capital contribution

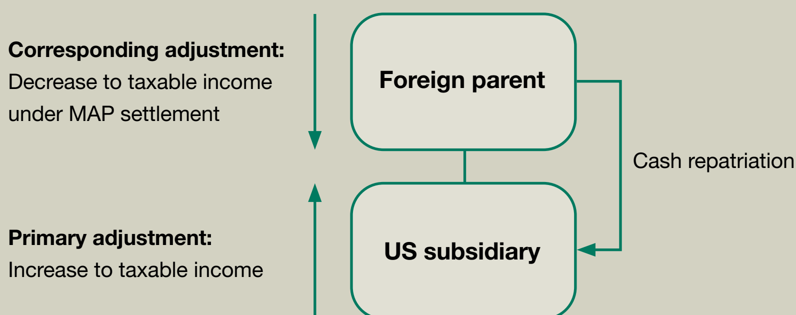
In contrast, if the U.S. company directly or indirectly owned stock in the foreign related party, then a deemed transaction that results in an identical outcome in the cash accounts would be a capital contribution from the U.S. company to its related party. The deemed contribution increases the U.S. company's basis in the related company's stock and can have an impact on subsequent distributions and capital gains income recognizable and reportable by the U.S. company.

If the U.S. company and the foreign related party are not related by direct or indirect stock ownership (e.g., "sibling companies" with a common stockholder or parent company), then a deemed transaction that results in an identical outcome in the cash accounts would involve both a distribution and a subsequent capital contribution. This would entail the direct and indirect tax consequences associated with the same. (In some jurisdictions, however, a distribution or contribution may be deemed directly between the parties regardless of the ownership structure; see Foley, Taheri, and Sullivan for further details.)

Deemed loan

An alternative characterization of a secondary transfer-pricing adjustment is a deemed loan. The taxpayer may treat the entity in the jurisdiction in which taxable income is increased by the primary transfer-pricing adjustment as having made a loan to the related party. The repayment of the loan to the entity with the increased income matches the cash and tax accounts. Importantly, as the repayment of a loan does not create income or a deduction, this deemed loan transaction together with the actual repayment eliminates most tax consequences of the secondary adjustment, particularly any withholding tax associated with a deemed dividend. In the United States, this characterization may be allowed under certain conditions in accordance with Rev. Proc. 99-32. The deemed loan must be repaid within a certain period, typically 90 days from the primary adjustment, and interest must be recognized over the deemed period of the loan, i.e., from the last day of the year to which the primary adjustment relates.

Direct and indirect tax consequences of secondary transfer-pricing



adjustments may be different depending on the jurisdiction of the related party, any applicable income tax treaties, or mutual agreements. The introduction of the U.S. participation exemption system as part of the law known as the Tax Cuts and Jobs Act, P.L. 115-97, may in certain cases mitigate adverse effects of secondary transfer-pricing adjustments. For instance, Sec. 245A may allow U.S. corporations to deduct 100% of dividends received from 10%-owned foreign corporations other than passive foreign investment companies. As a result, when the participation exemption applies, U.S. taxpayers may be able to avoid income tax on the inbound deemed dividend or a subsequent repatriation of the outbound deemed capital contribution.

Secondary adjustments are a highly technical and nonintuitive area of transfer pricing. In the United States, transfer-pricing adjustments typically create secondary adjustments. Taxpayers need to know about these secondary adjustments, understand the tax consequences, and consider possible planning opportunities, including those involving repatriation under Rev. Proc. 99-32. (See the diagram "Resolve Discrepancy Between Tax Accounts and Cash Accounts Through Cash Repatriation.")

From Sean Foley, J.D., LL.M., and Saurabh Dhanuka, CPA, Silicon Valley, Calif.

Transfer pricing and MAP: Common traps for the unwary

Transfer-pricing disputes have a tendency to protract themselves over a number of years and discrete stages. For one thing, the uncertainties inherent in questions of valuation and the highly factual nature of transfer-pricing inquiries lend themselves to a lengthy process. For another, the intrinsically bilateral or multilateral nature of a transfer-pricing adjustment means that transfer-pricing disputes are frequently resolved via the mutual agreement procedure (MAP) under an applicable bilateral tax treaty.

Where available, MAP is an attractive option: Statistics from the Organisation for Economic Co-operation and Development (OECD) demonstrate that MAP with most major U.S. treaty partners is very successful at eliminating double taxation. However, there are a number of pitfalls that beset taxpayers seeking to access MAP and to implement MAP resolutions. This item reviews some of the most common traps for the unwary.

Navigating the road map

Let us take the case of a transfer-pricing adjustment that arises from an IRS audit. The IRS's Transfer Pricing Examination Process guide contemplates that transfer-pricing exams should take two to three years to resolve. That timeline begins with the opening conference between the taxpayer and the examination team and thus does not include the planning and risk assessment work that the IRS exam team must do prior to meeting with the taxpayer. Exam teams are not bound to the timeline — contentious IRS transfer-pricing audits can take much longer.

MAP can be requested as soon as the IRS has issued a notice of proposed adjustment (NOPA), but many taxpayers wish to explore resolution options with the IRS before proceeding to MAP. When doing so, it is crucial to consider Rev. Proc. 2015-40's rules on coordination with IRS examination and the IRS Independent Office of Appeals.

The Appeals coordination rules pose a serious trap for the unwary. Historically, taxpayers were able to go through the IRS Appeals process before proceeding to MAP, and many opted to do so. Since the adoption of Rev. Proc. 2015-40, the ability to obtain Appeals consideration of an issue before seeking MAP relief has been severely curtailed. The U.S. competent authority will no longer consider issues that have been under Appeals' jurisdiction unless the MAP request is filed within 60 days following the Appeals opening conference, and then only if the taxpayer demonstrates that the MAP issues have been severed from any issues that remain under Appeals consideration. However, Rev. Proc. 2015-40 does provide a simultaneous appeals procedure through which a taxpayer can obtain Appeals consideration of issues under the competent authority's jurisdiction.

Minding the treaty

Just like IRS examinations, foreign transfer-pricing audits can take many years to resolve. With most U.S. treaty partners, this is not an issue. Consistent with the OECD Model Convention, many treaties require MAP requests to be presented within a certain time (often three years) following the first

notification of the adjustment giving rise to double taxation. While countries' interpretations of what exactly constitutes "first notification" vary, the general principle is clear: If a tax authority takes seven years to conduct an audit before notifying the taxpayer that it is proposing an adjustment, the timeline for presenting a case runs from that notification, not from the inception of the audit.

Because presentation time limits are generally not problematic, taxpayers can be taken by surprise when dealing with the handful of U.S. tax treaties that include a notification time frame in lieu of a presentation time frame. The two most notable examples are the Canada and Mexico treaties, with notification deadlines, respectively, six years from the end of the relevant tax year and 4½ years from the due date or filing date — whichever is later — of the return in the state receiving the notification.

If a U.S. or foreign transfer-pricing audit drags on too long, an adjustment may not be proposed until after the notification time frame has expired, and failure to comply with notification time frames can cost a taxpayer its chance at MAP. For vigilant taxpayers, however, this should not be a problem: A treaty notification may be submitted before an adjustment is proposed, and in the United States it must be updated annually in accordance with the rules of Rev. Proc. 2015-40. Notification issues are by no means insuperable, but they do mean that taxpayers need to be thinking about MAP before an exam concludes.

Planning for the endgame

Taxpayers' goals for the MAP process vary. Some are hoping that the leverage of the competent authority in the counterparty jurisdiction will induce a tax authority to withdraw or substantially reduce a proposed adjustment. Others agree with the proposed adjustment and are seeking correlative relief. Many simply want relief from double taxation and are agnostic as to how that is achieved. Whatever the goal, it is important to consider the likelihood of different outcomes. As a consensus-based process, MAP tends to facilitate compromises to eliminate double tax, rather than all-or-nothing determinations.

A secondary adjustment reflects an inferred secondary transaction that resolves the discrepancy caused by the primary adjustment.

Yet, simply thinking through the primary adjustment and any correlative relief is not enough. Many countries, including the United States, Germany, and India, also require secondary adjustments. (Many others — including China, Japan, and the United Kingdom — do not, making this a conceptually fraught area.) In countries that do recognize secondary adjustments, it is crucial to consider the impact they may have on potential resolutions and how they can be managed through the MAP process.

Secondary adjustments address the book-tax discrepancy that arises from a primary transfer-pricing adjustment: from a tax perspective, one entity's income has been increased, and its counterparty's income has been decreased; from a book perspective, the funds that correspond to the adjustment remain with the counterparty entity. In the United States, this discrepancy can be resolved in two ways. By default, one or more deemed transactions (i.e., deemed distributions or deemed capital contributions) will be inferred to align the tax treatment with the book treatment and explain, from a tax perspective, how the counterparty entity came into possession of the relevant funds. These deemed transactions can have significant consequences: Deemed distributions can trigger sizeable withholding tax obligations to the extent they qualify as dividends, and inbound deemed dividends that relate to years before passage of the law known as the Tax Cuts and Jobs Act, P.L. 115-97, can create U.S. taxable income.

The U.S. rules permit taxpayers to avoid these deemed transactions by instead aligning the book situation with the tax treatment, i.e., by electing to make a repatriation payment under Rev. Proc. 99-32 to move the funds from the counterparty to the adjusted entity. A repatriation payment must include an arm's-length interest component and must be accomplished within 90 days to avoid the default secondary adjustment treatment. If the primary adjustment relates to older years, the mandatory interest inclusion can be significant.

Thankfully, U.S. taxpayers are often able to avoid these issues in MAP. Under Rev. Proc. 2015-40, the taxpayer may request competent authority repatriation. Competent authority repatriation follows the same general principles as Rev. Proc. 99-32, but it is not bound by its specific rules, allowing the competent authorities to negotiate the terms of any repatriation obligation. Most notably, competent authorities commonly agree to the waiver of interest on repatriation payments, which is generally an ideal means of implementing the secondary adjustment from the taxpayer's perspective. Importantly, a request for competent authority repatriation must be submitted in writing before a tentative MAP resolution has been reached, making it crucial for taxpayers to consider these issues early in the process.

Thinking a step ahead

The traps for the unwary discussed above illustrate the importance of forethought and careful planning. In cases

when MAP relief may be desired, it is critical that taxpayers and their advisers carefully think through timing and procedural issues to ensure that effective relief is not imperiled.

From Thomas Bettge, J.D., Washington, D.C., and Theresa Kolish, J.D., LL.M., San Francisco

Gross Income

'Swag bags' are back: Influencers and noncash compensation

With the growth of "influencer" culture has come increased sophistication in companies' use of influencers as part of an overall marketing strategy. This has now moved beyond extending an invitation and free pass to an event to more extensive and explicit contractual obligations involving required presence and responsibilities at events, minimum numbers of social media postings showcasing or mentioning a product, mandatory interviews, and other duties as part of the expanding universe of social media marketing possibilities. And in return, influencers often receive little or no cash but rather some combination of access to events involving entertainment and meals and a series of free or discounted items and services related to the product they are being asked to market. But that could establish a relationship involving the receipt of compensation for services, and so the issue arises of whether and when these "freebies" or discounts result in taxable income to the influencer and possible limitations on deductions for the related expenses.

The typical service contract with an influencer creates an independent contractor relationship — the service recipient is requesting specific services, such as presence at specified events or a minimum number of social media postings, but is not directing and controlling the influencer in his or her production. To the extent the influencer is being paid in cash for these services, this generally would be taxable compensation subject to reporting on a Form 1099-NEC, *Nonemployee Compensation*. But, often, an influencer is "paid" in ways other than cash and often with the expectation (at least of the influencer) that these benefits will not be taxed.

Several years ago, the IRS engaged in some back and forth on the issue of gift bags provided to presenters at awards shows, commonly referred to as "swag bags." Ultimately, the IRS posted on its website an informal FAQ finding that the products and services claimed by the presenters were taxable as income and were not gifts, because "the organizations and merchants who participate in giving the gifts bags do not do so solely out of affection, respect, or similar impulses for the recipients of the gift bags" (see IRS, Gift Bag Questions and Answers; *Duberstein*, 363 U.S. 278 (1960)). Notably, the FAQs found that with respect to items like gift certificates and vouchers, an individual was taxable only to the extent the individual used those items, and similarly, with respect to a "free shopping room," an individual was taxable only to the extent of the individual's selected items. This would seem to address any potential constructive receipt issues, although the FAQs are not explicit about the analysis of the issue.

PHOTO BY ALEXSECRET/ISTOCK

This gift bag analysis would seem to apply to the items or services provided to an influencer, especially if the items or services are provided as part of a contractual obligation, in that the items or services are not provided "solely out of affection, respect, or similar impulses." And when specific services are outlined that the influencer must provide to earn the items or services, then the taxable income has been identified as compensatory in nature.

This then requires analysis of whether some or all of the items or services provided to the influencer may be excludable from income. The exclusions under Sec. 132 for working condition fringe benefits and *de minimis* fringe benefits may be applied to independent contractors. This is particularly relevant to travel and lodging expense reimbursements provided to an influencer, which will require substantiation of expenses similar to an accountable plan (see Regs. Sec. 1.132-5(a)(1)(v)). In addition, certain meal and entertainment expenses may be excludable from income but will be subject to the deduction limitations of Sec. 274, including the general

The issue arises of whether and when 'freebies' or discounts result in taxable income to the influencer and possible limitations on deductions for the related expenses.

disallowance of entertainment expenses in Sec. 274(a), with certain exceptions provided in Sec. 274(e). In contrast, the Sec. 132 exclusions for no-additional-cost services and employee discounts do not apply with respect to benefits provided to an independent contractor.

If there is no applicable exclusion, the compensation income should be reported on Form 1099-NEC and the entire process of obtaining a Form W-8, *Request for Taxpayer Identification Number and Certification*, and any other reporting process used by the service recipient for independent contractors will need to be applied. In addition, if some or all of the compensation takes the form of fringe benefits, consideration should be given to which party will be subject to any applicable deduction limitation.

For example, with respect to food and beverage expenses incurred by the service recipient, or incurred by the influencer and reimbursed by the service recipient, the service recipient's deduction for the related expenses may be limited by Sec. 274 if the amounts are not treated as compensation income to the influencer. Under Sec. 274(n)(2), the deduction of a food and beverage expense is limited to 50% of the deduction that would otherwise be allowable. (Section 210(a) of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE of the Consolidated Appropriations Act, 2021, P.L. 116-260, added Sec. 274(n)(2)(D), which provides a temporary exception to the 50% limitation for expenses for food or beverages provided by a restaurant. Sec. 274(n)(2)(D) applies to amounts paid or incurred after Dec. 31, 2020, and before Jan. 1, 2023. For more information, see IRS Notice 2021-25.) If the contract provides that the service recipient is taking the expense deduction, the contract should also require that the independent contractor provide sufficient receipts or other documentation necessary for the service recipient to substantiate the expenses (and that otherwise the amounts will be reported as compensation to the independent contractor).

In contrast, if the service recipient treats the cost of the food and beverages as compensation income to the influencer, then the service recipient's deduction will not be limited by Sec. 274, although in that situation, the influencer's available deduction for the expenses may be. If the tax treatment of the costs is expressly identified in the contract to provide services between a service recipient and an independent contractor, that will determine the party that generally would be subject to the deduction limitations. In the case of an arrangement between a service recipient and an independent contractor providing for reimbursements that does not expressly address the tax issue, if the influencer provides adequate documentation to the service recipient, the deduction limitation applies to the service recipient. If the influencer does not provide adequate documentation, the deduction limitation applies to the influencer.

The growth of celebrity influencers' services in marketing strategies and the formalization of these arrangements require these relationships to be reassessed from a federal tax perspective. Celebrities used to be invited to events with the hope only that they would attend and be photographed. The more modern arrangements with influencers often state explicitly what marketing services the influencer will provide to the customer and the benefits the influencer will receive in return. Under those circumstances, the influencer should be thought of as like any other independent contractor providing services to a customer. As a result, a best practice to avoid any surprises is to ensure that the federal tax consequences of the arrangement are understood by all the parties and explicitly addressed in the contract.

From Stephen Tackney, J.D., Washington, D.C.

Procedure & Administration

Early signs from Treasury on the scope of digital asset cost basis reporting

Information reporting is an important part of the U.S. tax system, given that the system relies in large part on self-reporting. Information reporting greatly increases tax compliance by making it easier for taxpayers to comply with their tax reporting obligations and by ensuring that they are aware a reportable transaction has occurred.

There is a perception in some corners that cryptoasset transactions are not being reported accurately by all taxpayers. Although there is likely some intentional underreporting, noncompliance is often a result of the novelty of the technology and the fact that many cryptoasset market participants are not aware of their tax obligations. To address this, Congress recently expanded the cost basis reporting rules of Sec. 6045 as part of the Infrastructure Investment and Jobs Act, P.L. 117-58 (the Infrastructure Act), to require "brokers" to provide cost basis reporting for "digital assets." For this purpose, a broker is defined as including "any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person" (Sec. 6045(c)(1)(D)). Digital assets include most instruments commonly referred

to as "cryptocurrencies" and are defined as "any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary" (Sec. 6045(g)(3)(D)).

Although Congress can hardly be faulted for seeking to promote tax compliance in the cryptoasset arena, the approach taken attempts to apply the existing cost basis reporting framework used for stocks and securities to digital assets, despite the fact that there are significant differences between the digital asset ecosystem and the stock and securities markets. This raises a number of significant issues (a few of which are considered below) that Treasury will have to grapple with when it provides cost basis reporting guidance.

Miners and stakers

The Infrastructure Act's cost basis reporting provisions prompted a great deal of consternation from the cryptoasset industry because reporting rules would (at least in the view of some tax practitioners) create a requirement that certain participants (including so-called miners and stakers) provide cost basis reporting information to other market participants, notwithstanding the fact that these participants would not have the information to do so.

To illustrate this issue, a bit of background is necessary. Generally, cryptoassets use a peer-to-peer model that is decentralized, in the sense that no single company or person operates the network. Instead, blockchain technology, which is sometimes referred to as distributed electronic ledger technology, enables this peer-to-peer model to function. Whenever a given cryptoasset transaction occurs, it is first broadcast to its network to be verified or validated.

Validation occurs using cryptography (that is, encryption and decryption) through a consensus process called mining or staking. Once confirmed, each transaction is then recorded with other transactions in a "block" of computer code and is then added and linked to previous blocks to form a chain — therefore, the term blockchain. The updated ledger is then distributed across the network, such that all computers on the network are constantly verifying that the blockchain is correct. Thus, the blockchain itself is, theoretically at least, both immutable and accurate.

Mining (through proof of work) is the original validation process and generally is associated with bitcoin. Essentially, the first "miner" to solve a crypto puzzle or algorithm to validate a given transaction and broadcast to the network is rewarded with newly minted/created bitcoin as well as transaction fees.

Staking (through proof of stake) is generally associated with the Ethereum consensus layer (formerly known as Ethereum 2.0). At a very high level, "validators" contribute and lock up (or "stake") their own crypto in exchange for a chance of getting the opportunity to validate a new transaction, update the blockchain, and earn a reward. If those validators are selected and successfully verify a given transaction, then the network updates the blockchain, and staking rewards (new tokens) are awarded.

Miners and stakers are the backbone of the blockchain, but they are not omniscient. They generally do not know the identities of the parties transacting on the blockchain and do not have detailed information regarding the gross proceeds or cost basis of the digital assets transferred. In short, they do not have the information required to provide cost basis information to parties transacting on the blockchain. Notwithstanding this fact, many were concerned that miners and stakers could be considered brokers because their validation activities could be considered "effectuating transfers of digital assets."

Congress did not help matters by putting forth two conflicting amendments (one would exempt only miners from broker status, and one would exempt both miners and stakers) before ultimately failing to pass either amendment. With that said, the primary drafters of the legislation have publicly stated that it was not intended to result in reporting responsibilities for miners and stakers and wrote a letter to Treasury Secretary Janet Yellen to that effect (Sens. Rob Portman, Mark Warner, Mike Crapo, Kyrsten Sinema, Pat Toomey, and Cynthia Lummis, Letter to Yellen (Dec. 14, 2021)). A subsequent legislative proposal — the Keep Innovation in America Act, H.R. 6006 — has echoed this interpretation.

Treasury offered encouraging signs in a letter released in February, which states that in "the Treasury Department's view … ancillary parties who cannot get access to information that is useful to the IRS are not intended to be captured by the reporting requirements for brokers. For example, persons who are just validating transactions through a consensus mechanism are not likely to know whether a transaction is part of a sale" (Jonathan Davidson, Treasury Assistant Secretary for Legislative Affairs, Letter to Sens. Lummis, Warner, Portman, Sinema, Toomey, and Crapo (Feb. 11, 2022)). Thus, it would appear that, consistent with congressional intent, miners and stakers will not be subject to cost basis reporting in forthcoming cost basis reporting regulations.

Wallet providers

Cryptoassets are held in "wallets." Some wondered if the creator of wallet software could be considered a broker because software is used to effectuate cryptoasset transfers. Again, the primary drafters of the legislation clearly indicated that wallet software providers were not intended to be covered. Treasury appears to agree with this interpretation and stated in its recent letter that "persons who are only selling storage devices used to hold private keys or persons who merely write

software code are not carrying out broker activities."

Decentralized finance protocols

The traditional cost basis reporting framework relies on persons with knowledge of the cost basis and gross proceeds of transactions to report cost basis and gross proceeds information to their customers and to other brokers in the event of a transfer. One of the more unusual aspects of the cryptoasset market is its decentralized network and smart contract capabilities. These have allowed the creation of a burgeoning "decentralized finance" (DeFi) ecosystem, where parties transact peer-to-peer using "decentralized exchanges" (DEXs). Unlike the traditional stock and securities exchanges, in a digital asset transaction carried out on a DEX, software code — not a person or legal entity — stands between the parties to the transaction. Although this software was developed by people, it is usually decentralized and is not "owned" in the traditional sense.

The definition mentioned above of a digital assets broker as "any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person" creates significant technical hurdles to requiring DEXs to provide cost basis reporting information. As defined, a broker is a "person." The term "person" is broadly defined for purposes of the Code by Sec. 7701(a)(1) to include an individual, trust, estate, partnership, association, company, or corporation. However, even that expansive definition does not include software. Assuming a DEX is not classified as a business entity (e.g., a partnership), it is not clear that DeFi protocols, as nonpersons, could be required to report transactions under the new statutory framework.

It also bears noting that DeFi protocols typically do not charge any fees to users — the fees that are charged are either paid to liquidity providers or network fees paid to miners/stakers, rather than paid to the protocol itself. Thus, it may be difficult for Treasury to make the case that a DEX is receiving consideration, which is another requirement for broker status.

On a more practical level, it is not clear how requiring DEXs to provide cost basis information to users could be implemented or enforced. Again, there typically are no real people who own a DEX who could be encouraged to comply by the threat of penalties for noncompliance. It is also noted that, although changes can be made to a DEX, it typically requires the holders of governance tokens to agree to the change. It may be difficult to secure sufficient support to implement a cost basis reporting infrastructure into a DEX, given the importance of anonymity to many users.

One could imagine, however, a scenario in which Treasury and other regulators could create a framework of adverse tax consequences for payments made through a DEX so as to (1) induce DEX token holders to adopt reporting procedures when there are significant U.S. participants; or (2) incentivize a U.S. participant to seek out DEXs that provide reporting. In other information reporting areas, for example, an absence of information could lead to presumption rules that require withholding or taxation at the highest applicable rate.

Notwithstanding the significant roadblocks to DeFi reporting on both a technical and practical level, it is not yet clear that DeFi will be exempted. Admittedly, a cost basis reporting regime that excludes DeFi transactions would exclude a sizable portion of cryptoasset transaction volume and might fall short of the improved tax compliance that Congress envisioned. Also, it should be noted that DeFi was not specifically addressed as an area that should be excluded from reporting in previous public statements by members of Congress, and in an early draft of the Infrastructure Act digital assets reporting amendments that was circulated to industry participants, the broker definition referenced decentralized exchanges and peer-to-peer marketplaces. For its part, Treasury does not seem to have ruled out DeFi reporting, stating in its recent letter that it would "consider the extent to which other parties in the digital asset market, such as centralized exchanges and those often described as decentralized exchanges and peer-to-peer exchanges, should be treated as brokers. …"

Diabolical details

Although there are some encouraging signs from Treasury, there still exists considerable uncertainty as to the nature and scope of the cost basis reporting rules as they apply to digital assets. The devil will be in the details, and, hopefully, the forthcoming guidance will take a measured approach and consider the unique nature of the digital asset markets. Provisions of the Infrastructure Act will require brokers to monitor cost basis for digital assets acquired on or after Jan. 1, 2023, and report for tax year 2023 at the beginning of 2024. Given the extremely short time frame for implementation, Treasury should also consider delaying the implementation of digital asset cost basis reporting, particularly for market participants that might have reasonably expected they would not be subject to the requirements.

From Pete Ritter, J.D., LL.M., San Francisco; Joshua Tompkins, CPA, Minneapolis; and Hubert Raglan, LL.B., LL.M., Detroit

State & Local Taxes

Tennessee taxation of passthrough entities

Tennessee's entity classification rules only partially conform to the federal entity classification rules. An insufficient understanding of the rules, like a little knowledge, can be dangerous to taxpayers when determining which entity has a filing responsibility in Tennessee.

Many entities that are disregarded for federal, and most other states', income tax purposes are regarded for Tennessee franchise and excise (FAE) tax purposes. Coupled with mandatory separate legal entity filing for most taxpayers, but required combined filing for captive real estate investment trust (REIT) affiliated groups and unitary groups of financial institutions, determining the proper Tennessee filer can be challenging.

Not only is ascertaining the proper filing entity in Tennessee more difficult because of the state's partially nonconforming rules on entity classification, but issues also arise in determining which entity reports the gain from selling interests in entities that are disregarded for federal purposes but regarded for Tennessee purposes. That can mean the difference between no Tennessee FAE tax on a transaction and substantial tax.

Starting with the basics, Tennessee imposes both an excise tax based on the apportioned net earnings (income) of taxable persons (taxpayers) and a franchise tax based on the higher of the entity's Tennessee property or apportioned net worth. Tennessee's FAE taxes apply to most limited liability entities — not just entities taxed as corporations for federal income tax purposes.

Tennessee taxable and disregarded entities

Under Tennessee law, "all persons, except those having not-for-profit status, doing business in [Tennessee] and having a substantial nexus in [Tennessee]" are subject to the franchise and excise taxes (Tenn. Code §§67-4-2007(a) and 67-4-2105(a)). Tennessee defines the term "persons" as "every corporation, subchapter S corporation, limited liability company, … limited partnership, … business trust, regulated investment company, REIT, … bank, or … savings and loan association" (Tenn. Code §67-4-2004(38)). Essentially, every nonexempt limited liability entity with one exception (described below) is subject to tax. Nonlimited liability entities, including general partnerships, are not subject to tax. Also, Tennessee has a number of specific exemptions contained in Tenn. Code Section 67-4-2009, including for venture capital funds and obligated member entities, that potentially could exempt otherwise taxable entities from Tennessee FAE taxes.

There is an exception, as noted above, to the general rule that limited liability entities are subject to the taxes: Limited liability companies (LLCs) are disregarded entities if (1) their single member is a corporation (or an entity treated as a corporation for federal income tax purposes) and (2) they are disregarded for federal income tax purposes (Tenn. Code §67-4-2007(d)). No other federally disregarded entities — no federally disregarded partnerships, no qualified REIT subsidiaries, no qualified Subchapter S subsidiaries, no disregarded single-member LLCs (SMLLCs) owned by individuals, partnerships, or other noncorporate entities — are disregarded for Tennessee FAE purposes (Tenn. Comp. R. & Regs. §1320-06-01-.40(2)).

A corollary to the exception discussed above is that in tiered LLC structures, LLCs indirectly wholly owned by corporations may also be disregarded. Tennessee regulations adopt a "top down" approach to determine whether an LLC indirectly owned by a corporation is disregarded (Tenn. Comp. R. & Regs. §1320-06-01-.40(3)). For example, *LLC3* is 50% owned by *LLC1* and 50% owned by *LLC2*. Both *LLC1* and *LLC2* are wholly owned by the same corporation. All three LLCs are disregarded for federal income tax purposes. In this situation, as *LLC1* and *LLC2* are both disregarded into the corporation for federal income (and Tennessee FAE) tax purposes, *LLC3* is wholly owned by the corporation and therefore disregarded for Tennessee FAE tax purposes.

Tennessee combined/ consolidated filings

Tennessee requires captive REIT affiliated groups (CRAGs) and unitary groups of financial institutions to file on a combined basis on Tennessee Form FAE 174, *Franchise and Excise Financial Institution and Captive Real Estate Investment Trust Tax Return*. The CRAG rules can trip up taxpayers, as the captive REIT combined filing includes all entities owned greater than 50% by the captive REIT, including entities that would otherwise separately file, including partnerships and SMLLCs owned by those partnerships (Tenn. Code §67-4-2004(8)). A captive REIT is a federal REIT in which an entity or individual, directly or indirectly, has an 80% or greater ownership interest, with a few exceptions (Tenn. Code §67-4-2004(7)).

Tennessee, in addition, allows certain affiliates to elect to determine franchise tax net worth on a consolidated basis (Tenn. Code §67-4-2103(d)). However, separate returns are generally required, and Tennessee property, the other measure of the franchise tax, is generally determined on a separate-entity basis. CRAGs do determine net worth on a

IMAGE BY OMERSUKRUGOKSU/ISTOCK

combined basis on Schedule F1, *Captive Real Estate Investment Trust Net Worth*, of Form FAE 174.

Nonflowthrough of nexus, taxable income, and apportionment for Tennessee passthrough entities

As a result of Tennessee's separately taxing many federal disregarded or passthrough entities, these separately taxed entities, with a few defined exceptions, do not flow through income or loss or apportionment factors to their partners or members. Instead, those entities themselves are subject to Tennessee tax. This affects the nexus, taxable income, and apportionment of the upper-tier entities.

Nexus: Regarding nexus, ownership of an interest in a limited liability passthrough entity taxable in Tennessee by itself will not create nexus. As stated in the Tennessee Department of Revenue's *Franchise and Excise Tax Manual* (ch. 3, pg. 51):

> Each taxable entity stands on its own attributes as to whether it is doing business and has substantial nexus in the state. An ownership interest in a passthrough entity (e.g., an LP, LLC, or S corp.) that operates in Tennessee does not create a franchise and excise tax filing requirement for the owner.

However, because corporate-owned SMLLCs are disregarded, an ownership interest in an SMLLC with Tennessee nexus will subject the corporate member to FAE taxes. The same is true of an interest in a general partnership doing business in Tennessee. And, of course, if the partner or member otherwise is doing business in or has substantial nexus with Tennessee, that could independently create nexus.

Taxable income: In computing Tennessee net earnings, a passthrough owner's federal taxable income must be adjusted for any item of income or loss attributable to a passthrough entity "which is subject to and files a return for the tax imposed by this part" (Tenn. Code §§67-4-2006(b)(1)(J) and (2)(L)). This is because the passthrough entity's taxable income does not flow through to the passthrough owner. No adjustment is made for income or loss attributable to general partnerships, because general partnerships are not subject to Tennessee FAE tax at the entity level.

In contrast, for federal income tax purposes, passthrough entities are not generally the taxpayer. The income or loss of passthrough entities generally flows through to the individual or corporate partners. As a result, Tennessee's conformity to federal taxable income differs based on whether the entity is taxed federally as a C corporation, S corporation, partnership, business trust, SMLLC owned by an individual or a general partnership, etc. (Tenn. Code §§67-4-2006(a)(1)–(9)).

For a federally disregarded but Tennessee regarded entity, Tennessee considers the classification of the federally disregarded entity to be the same classification as the entity it is regarded into (see, e.g., Tenn. Letter Ruling No. 11-46 (Sept. 12, 2011)). Therefore, if a federally disregarded LLC is disregarded into a partnership, the entity would compute federal taxable income for Tennessee excise tax purposes as if it were a partnership.

Apportionment factors: As with income or loss, apportionment factors do not flow through to upper-tier partners or members from limited liability passthrough entities that are subject to Tennessee FAE taxes and file the appropriate returns. In computing Tennessee apportionment, the statutes require only property, payroll, and sales related to general partnerships and to limited liability passthrough entities that are "not doing business in Tennessee and thus [are] not subject to Tennessee excise tax" to be added to the upper-tier partner's or member's factors (Tenn. Code §§67-4-2012(b), (e), and (g)).

Sales of interests in Tennessee regarded but federally disregarded entities

One of the many questions that arise due to the partial nonconformity to the federal entity classification rules concerns the Tennessee excise tax consequences of the sale of a federally disregarded, but Tennessee regarded, entity. Consider, for instance, an SMLLC owned by a limited partnership. For federal income tax purposes, the sale of a disregarded entity is treated as the sale of the entity's assets. However, does the same result ensue for Tennessee excise tax purposes?

In other words, on the sale of the LLC interest:

- Does the LLC report the gain as an asset sale (as it is reported for federal purposes); or
- Does the partnership report the gain respecting the legal form of the transaction as the sale of an interest in an LLC (as the LLC is a taxable entity for Tennessee FAE purposes)?

The answer may significantly change the taxability of the transaction, as the upper-tier partnership may not separately have nexus with Tennessee. Therefore, if the partnership is regarded as selling the LLC interest, this transaction may not be taxed by Tennessee. If the LLC is regarded as the seller, the transaction would be taxed by Tennessee.

Tenn. Rev. Rul. No. 11-53 (Sept. 22, 2011) appears to obliquely address the issue. The facts in this ruling are complicated, but the key fact is that, as part of an overall transaction, an entity taxed as a partnership for Tennessee excise tax purposes sold an interest in a French entity (not an LLC). The French entity was federally disregarded but regarded for Tennessee FAE tax purposes. The ruling states that the entity taxed as a partnership "will not include in its Tennessee net earnings any gain from the Transaction that is attributable to" the French entity.

For federal purposes, as the French entity was disregarded, the sale would have been treated as a sale of the assets

of the French entity. The revenue ruling might be interpreted as suggesting that the partnership's federal taxable income was determined based on the federal classification of the French entity as a disregarded entity and not on Tennessee's classification of it as a regarded entity. However, this is less than clear, and there is no explicit guidance from the Department of Revenue on this issue.

Therefore, taxpayers are advised to review their Tennessee filings closely to ensure the correct entity or combined group is filing and that sales of partnership or membership interests and other transactions with the federally disregarded or passthrough entities are properly analyzed for Tennessee FAE purposes.

From John Harper, CPA, Nashville

Tax Accounting

Foreign tax credit: Changing from cash to accrual basis

On Dec. 28, 2021, Treasury and the IRS issued final foreign tax credit regulations (T.D. 9959) that were officially published in the *Federal Register* on Jan. 4, 2022. These final regulations provide regulatory authority for Treasury's long-held position that an individual taxpayer who elects on a timely filed return to claim the foreign tax credit on the cash basis may not change to the accrual basis on an amended return.

This item discusses the background and application of this rule.

Background

Under Sec. 905(a), a cash-method taxpayer can elect to claim a foreign tax credit on either the cash basis or accrual basis (Regs. Secs. 1.905-1(c) and (d)). If such a taxpayer elects to claim a foreign tax credit on the accrual basis, that election is binding for all future tax years. However, prior to the 2020 proposed foreign tax credit regulations, neither the Internal Revenue Code nor the Treasury regulations addressed whether a cash-method taxpayer may amend a return to claim foreign tax credits on the accrual basis.

That issue was considered in *Strong v. Willcuts*, No. 2497 Law (D. Minn. 1935). The court denied a taxpayer's election to claim foreign tax credits on an accrual basis that was made on an amended return on two grounds. First, the court ruled that when the taxpayer claimed a foreign tax credit on the cash basis on his original, timely filed return, the taxpayer fixed the rights of both the taxpayer and the government. Therefore, the court held that the taxpayer could not change from claiming foreign tax credits using the cash method of accounting to claiming foreign tax credits using the accrual method of accounting on an amended return because of the doctrine of elections. Second, the court found that the foreign taxes at issue did not accrue in the relevant tax year (1929), so even if the taxpayer were allowed to elect to apply the accrual method, the foreign income tax in question could not be claimed as a foreign tax credit in the relevant tax year because the foreign income tax accrued in the subsequent tax year (1930).

In TAM 8332003, the IRS cited *Strong* in determining that once an election to take the foreign tax credit on the cash basis is made on a timely filed tax return, an election to take the credit on the accrual basis may not be made by filing an amended return. Treasury also cited *Strong* in the preamble to the 2020 foreign tax credit regulations when discussing proposed Regs. Sec. 1.905-1(e), which addressed the timing of making the accrual-basis election. Under the proposed regulations, an election to claim foreign taxes on the accrual basis must be made on a timely filed, original return. The proposed regulations also provided an exception for a taxpayer who has never previously claimed a foreign tax credit to elect to claim a foreign tax credit on the accrual basis on an amended return.

Final foreign tax credit regulations

Preamble: Treasury adopted Prop. Regs. Sec. 1.905-1(e) without modification. In the preamble of the final regulations, Treasury disagreed with a public comment suggesting that a taxpayer should be allowed to make an election on an amended return because the purpose of Sec. 905(a) was to match the timing of the U.S. tax and foreign tax on the same income and that the existing case law supported the retroactive election. The public comment relied on *Dougherty*, 60 T.C. 917 (1973), in which the court permitted an individual taxpayer to make an election under Sec. 962 to be subject to corporate tax rates on an amended return. The commenter further argued that *Strong* did not hold that an election to use the accrual method of accounting for purposes of claiming foreign tax credits may not be made on an amended return and that the court's discussion of the issue was dictum that did not represent legal authority.

In response, Treasury cited the statutory language of Sec. 905(a) that, by its terms, allows only a one-time change from the cash to the accrual method and pointed out that, though timing was of concern, Congress never amended Sec. 905(a) to allow taxpayers to be able to make the election on an amended return. Additionally, Treasury noted that a retroactive election would create more compliance burdens and administrative complexity as well as time bar collection of taxes due to different expiration dates of statutes of limitation for assessments and refunds for the foreign tax credit. Treasury disagreed with the commenter's interpretation of *Strong* and asserted that the case provided support for the regulations' disallowance of a retroactive election, rejecting the argument that the case provided little legal authority.

Furthermore, Treasury viewed the *Dougherty* court's holding to be consistent with an exception provided under Regs. Sec. 1.905-1(e)(2). As

Treasury explained, the *Dougherty* court interpreted prior case law to mean that when determining the timeliness of a delayed election, one should ask whether the original action or the failure to act was consistent with a taxpayer's final position.

Applying this approach, the *Dougherty* court had allowed a retroactive election because the taxpayer in the case did not take a position on an amended return that was inconsistent with the original return. Though not specifically discussed in the preamble, the taxpayer in *Dougherty* had not made a Sec. 962 election prior to the tax year at issue and made the election for the first time on his amended return. Thus, according to Treasury, the principle that *Dougherty* stands for is, in fact, reflected in the exception provided under the final regulations, which allows a taxpayer to make a retroactive election on an amended return if the taxpayer is claiming the foreign tax credit for the first time.

General application of the final regulations: Under Regs. Sec. 1.905-1(e)(1), an individual taxpayer who uses the cash method of accounting for income may elect to take a foreign tax credit in the tax year in which the taxes accrue in accordance with the rules for accrual-method taxpayers. An election to do so must be made on a *timely filed, original return* by checking the appropriate box on Form 1116, *Foreign Tax Credit*. Once the election is made, it is irrevocable and must be followed for purposes of claiming the foreign tax credit for all subsequent years.

> ***Example 1*:** *B* is a U.S. resident who has foreign-source income and pays foreign income taxes. In year 1, *B* claimed a foreign tax credit on the cash-basis method and filed her year 1 return by April 15, year 2. In year 3, she decided to change her method from the cash method to the accrual method on an amended year 1 return.

The election illustrated in Example 1 is not a valid election because *B* cannot retroactively elect the accrual method once she has chosen the cash method on her original return. Regs. Sec. 1.905-1(e)(1) does not allow *B* to change her election from the cash basis to the accrual basis on an amended return. *B* may elect the accrual-basis method on her timely filed original return for a subsequent year.

> ***Example 2:*** In year 1, *B* claimed a foreign tax credit using the cash method on her timely filed, original return. In year 2, *B* did not timely file her required return for year 2, and she did not pay any foreign income taxes. In year 5, *B* filed her year 2 original return and elected to claim the foreign tax credit on the accrual method. *B* believed her year 2 election with respect to the foreign tax credit to be a permissible election because she was making an election on her original return for year 2 and not on an amended return.

In Example 2, even though *B* made the election on her original return, it is not a valid election because that election must be made on a *timely filed*, original return.

Exception to the general rule: Under Regs. Sec. 1.905-1(e)(2), if a taxpayer claims a foreign tax credit for the first time, an election to claim the foreign tax credit on the accrual basis may be made on an amended return.

> ***Example 3*:** The facts are similar to Example 1, except that *B* has never claimed a foreign tax credit in any of her prior tax years, and she did not claim the foreign tax credit on her timely filed, original return in year 1. In year 2, *B* learned that claiming the foreign tax credit on the accrual method would benefit her greatly. She amended her year 1 return and claimed the foreign tax credit on the accrual method.

B's election is permitted under the regulations because *B* did not claim any foreign tax credits in her prior-year returns. On her timely filed, original return, she did not choose a method for purposes of the foreign tax credit, and the election made on the amended return is the first time she chose a method to claim the foreign tax credit. Unlike the two prior examples, the taxpayer in Example 3 is claiming the foreign tax credit for the first time on her amended return.

The exception illustrated in Example 3 is consistent with the *Dougherty* and *Strong* holdings because the taxpayer elects the accrual-basis method on an amended return as the first and the last method for purposes of the foreign tax credit. The taxpayer in Example 3 is not taking a position that is inconsistent with her prior position by changing from the cash to the accrual basis. Without a prior election claiming the foreign tax credit on the cash-basis method, the taxpayer's election on an amended return is a valid election under the final regulations.

Clear time frame

The final regulations provide a clear time frame for making an election to change from the cash basis to the accrual basis for purposes of the foreign tax credit. The ambiguity that existed before the 2020 proposed regulations is no longer an issue because the final regulations expressly state that the taxpayer's election, to be valid, must be made on a timely filed, original return, unless an exception applies.

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