TAX CLINIC

Practical advice on current issues.

Editor:
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In This Department

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The clean fuel production credit: A new incentive regime

Alternative and renewable fuel incentives have been administered by the IRS as part of the federal motor fuels excise tax regime for decades. A range of "legacy" incentives, which are allowed with respect to fuels that are produced from various qualifying feedstocks and meet exacting technical specifications, are set to expire at the end of 2024. The Sec. 45Z clean fuel production credit (CFPC), effective Jan. 1, 2025, appears to largely consolidate and replace the expiring legacy incentives in a technology-neutral fashion, provided the fuels meet emissions and production standards. The CFPC shifts these incentives to the income tax return. Among other changes, the CFPC is claimed by the producer and introduces different requirements and conditions to to qualify for the allowance. As with any change to the Internal Revenue Code, this change brings complexity and requires taxpayers and their advisers to plan ahead.

Motor fuel excise taxes and off-highway business-use fuel credits

To frame the discussion, federal excise tax is imposed on both conventional and alternative fuels. Sec. 4081 is typically imposed upstream on the physical transfer of gasoline, diesel fuel, or kerosene (taxable fuel) from a terminal at a truck rack, although additional events also trigger the tax, depending on the facts. A refund of the Sec. 4081 tax is available to purchasers that use taxable fuel in certain off-highway business uses (Secs. 4041(b)(1), 6421(a), and 6427(l)).

Sec. 4041 is typically a retail-level tax imposed on liquid fuels (other than those already taxed under Sec. 4081) and compressed natural gas (CNG) sold or used in a motor vehicle or motorboat, as well as liquid fuels sold or used in aviation (other than gasoline). The Sec. 4041 tax does not apply to liquid fuels used in certain off-highway business uses.

The Sec. 4041 and 4081 taxes and off-highway business-use credits are neither expiring nor affected by Sec. 45Z or other provisions of the Inflation Reduction Act of 2022, P.L. 117-169.

Under current law, fuels taxed under Sec. 4041 may also qualify for a legacy incentive. For example, biodiesel that is sold at retail and delivered into the fuel supply tank of a vehicle is subject to Sec. 4041 tax ($0.244 per gallon) but also qualifies for a $1 per gallon biodiesel credit. CNG that is sold at retail is subject to Sec. 4041 tax ($0.184 per gasoline gallon equivalent (GGE)) but also qualifies for a $0.50 per GGE alternative fuel credit. The legacy incentives more than offset the excise tax and thus are valuable to the claimant.

Expiring alternative and renewable fuel incentives are product-specific, not uniform

The legacy alternative and renewable fuel incentives are not uniform. They vary based on the feedstock used to produce the fuel, by technical specifications and statutory definitions, by claimant, and by the activity or use that gives rise to the credit. Although these incentives are all volumetric, the rates vary. In addition, some incentives require IRS registration to produce the fuel or claim the credit. In the case of biodiesel, agri-biodiesel, and renewable diesel, the fuel producer must provide certificates to its purchaser representing compliance with feedstock and technical specifications of the fuel.

Furthermore, most legacy incentives can be claimed in one of several ways: as nonrefundable general business credits, excise tax credits and refunds, excise tax payments, or refundable income tax credits. Those legacy incentives are:

Nonrefundable general business credits (Secs. 40, 40A, and 40B):

- Second-generation biofuel producer credit ($1.01 per gallon);
- Biodiesel and renewable diesel credit ($1 per gallon);
- Biodiesel and renewable diesel mixture credit ($1 per gallon);
- Small agri-biodiesel producer credit ($0.10 per gallon); and
- Sustainable aviation fuel credit ($1.25 per gallon, plus supplementary amounts).

These credits are claimed annually on Form 6478, *Biofuel Producer Credit*, or

The complexity of the computation and the required information is a dramatic shift from the prior simple credit computation of gallons multiplied by rate.

Form 8864, *Biodiesel, Renewable Diesel, or Sustainable Aviation Fuels Credit*.

Certain excise tax credits, refunds, payments, and refundable credits (Secs. 6426, 6427, and 34):

- Alternative fuel credit (liquid petroleum gas (LPG), P series fuels, CNG, liquefied natural gas (LNG), certain Fischer-Tropsch fuels, and certain liquid fuels derived from biomass) ($0.50 per gallon);
- Alternative fuel mixture credit (excludes LPG, CNG, and LNG) ($0.50 per gallon);
- Biodiesel and renewable diesel credit ($1 per gallon);
- Biodiesel and renewable diesel mixture credit ($1 per gallon); and
- Sustainable aviation fuel credit ($1.25 per gallon, plus supplementary amounts).

These credits are claimed quarterly as excise tax credits and refunds on Form 720, *Quarterly Federal Excise Tax Return* (Schedule C, *Claims*) (except the alternative fuel mixture credit); as often as weekly as excise tax payments on Form 8849, *Claim for Refund of Excise Taxes* (Schedule 3); or annually as refundable income tax credits on Form 4136, *Credit for Federal Tax Paid on Fuels*.

The legacy incentives are claimed at the entity level, based on activity that occurs at the entity level rather than in connection with a consolidated group (Regs. Sec. 301.7701-2(c)(2)(v)).

The clean fuel production credit

On Aug. 16, 2022, the Inflation Reduction Act was signed into law, enacting Sec. 45Z, the CFPC. Although Sec. 45Z does not on its face refer directly to any legacy alternative and renewable fuel incentives, a report by the Congressional Research Service notes that it is intended to consolidate and replace the expiring legacy incentives listed above (see "The Section 45Z Clean Fuel Production Credit," *In Focus*, Congressional Research Service (Sept. 27, 2023); also Joint Committee on Taxation, *List of Expiring Federal Tax Provisions 2024–2034* (JCX-1-24) (Jan. 11, 2024)).

The CFPC is a nonrefundable general business credit for qualifying transportation fuels. Among other things, a qualifying transportation fuel:

- Is suitable for use in a highway vehicle or aircraft;
- Has an emissions rate that is not greater than 50 grams of carbon dioxide equivalent per million British thermal units;
- Is not derived from coprocessing specific materials and feedstocks;
- Is produced by the claimant at a qualified facility;
- Is sold by the claimant to an unrelated third party for specified uses or for retail sale; and
- Is produced in the United States.

Additional certification rules apply to sustainable aviation fuel.

The amount of the CFPC is the product of the "applicable amount" per gallon of transportation fuel and its "emissions factor." The applicable amounts are adjusted for inflation. For each type of qualifying fuel, the amount is:

- Nonaviation transportation fuel: $0.20 per gallon ($1 per gallon if statutory wage and apprenticeship requirements are met); and
- Sustainable aviation fuel: $0.35 per gallon ($1.75 per gallon if statutory wage and apprenticeship requirements are met).

The emissions factor is calculated based on emissions rates for similar types and categories of fuels, to be published in an annual table, based on specific models identified in the statute. If it is not published in an annual table, the producer may submit a petition for determination.

The CFPC claimant must be registered by the IRS at the time of production to be eligible for the claim.

Sec. 45Z(e) requires the IRS to issue implementing guidance for the CFPC, including the calculation of emissions factors for transportation fuel and the table of emissions rates for similar types and categories of transportation fuels, by Jan. 1, 2025. As of the date this item was drafted, the IRS has not issued substantive Sec. 45Z guidance but has requested comments.

Changes ahead: Registration requirements, claimants, and claim mechanisms

In contrast, IRS guidance around the legacy incentives is long-established, and the procedures are well known to the set of taxpayers and claimants that currently claim these incentives. There are several key differences between the legacy incentives and the new CFPC, some of which appear to streamline the process. Other differences may result in a trap for the unwary taxpayer that has grown accustomed to the prior fuel incentives regime.

Registration: Under the legacy incentives, in most cases, both producers and claimants must be registered by the IRS. Each type of registration corresponds to an "activity letter" on Form 637, *Application for Registration (for Certain Excise Tax Activities)*. For example, producers of biodiesel and renewable diesel, agri-biodiesel, sustainable aviation fuel, and second-generation biofuel must be registered by the IRS, whether or not the producer is also the claimant under

Sec. 4101, or risk a penalty. Separately, claimants of the alternative fuel credit and alternative fuel mixture credit must be registered by the IRS, whether or not the claimant produced the alternative fuel.

For purposes of the CFPC, the clean fuel producer must be registered by the IRS at risk of penalty. As of the date this item was drafted, however, a Form 637 activity letter has not yet been specified. The Form 637 application and registration process entails a complete review by the IRS and usually takes several months, yet the window of time before the effective date of Sec. 45Z is narrowing. It is not clear, in fact, whether the IRS will even use the Form 637 application process for Sec. 45Z. The IRS may instead require clean fuel producers to use the newly created "clean energy account" portal on the IRS website to register.

Under either registration process, the Sec. 45Z requirement for the clean fuel producer to be registered by the IRS arguably presents a simplification because the CFPC is a producer credit that is technology neutral. On the other hand, even though the legacy incentives are expiring, the registration requirements in Sec. 4101 for various alternative and renewable fuel producers still stand. Failure to register exposes the producer to a penalty under Sec. 6719. Thus, a clean fuel producer that is also, say, a renewable diesel producer, would be required to obtain two registrations or risk a penalty, absent guidance from the IRS.

Identity of claimant and mechanism for filing claim: Two other key differences between the legacy incentives and the CFPC are the identity of the claimant and the mechanism for filing the claim.

Sec. 45Z is only allowed to the producer of the qualifying transportation fuel. In contrast, depending on the type of fuel, the legacy incentives could be claimed by a producer (e.g., second-generation biofuel producer); by a mixture producer (e.g., biodiesel mixture producer that is not the biodiesel producer); or by a user of the fuel (e.g., user of propane in forklifts). Thus, the shifting of the credit upstream to the producer in all cases for all types of fuel may disrupt current practices of other types of claimants.

Significantly, this shifting of the claim locus may result in important pricing considerations for all parties in the distribution chain.

Next, as noted above, the legacy incentives provide multiple mechanisms to file claims, allowing flexibility to claimants. Notably, most of the legacy incentives can be claimed as refundable credits and payments, some as frequently as quarterly or even weekly. This system generally has been beneficial for cash flow considerations. Although the statute of limitation in which to claim on a quarterly or weekly basis is quite short, the legacy incentives regime allows the claimant that misses the shorter filing period a "second bite at the apple" by filing an annual refundable claim as an alternative.

Sec. 45Z, in contrast, as a Sec. 38 general business credit, has only one option for claimants: an annual claim on the federal income tax return. Claimants accustomed to claiming cash payments on a quarterly, monthly, or even more frequent basis may not realize immediately that those options are no longer available. Moreover, the focus of the CFPC is on fuel production at a taxpayer's "qualified facility," not on a qualifying activity performed at the entity level, which could result in a change in eligibility for many claimants.

Planning considerations

Preparing for the transition to the CFPC involves many considerations:

- Is the taxpayer the correct claimant under Sec. 45Z?
- Does the taxpayer's fuel meet all requirements to be a qualifying transportation fuel, including feedstock and coprocessing limitations and suitability for use in a highway vehicle or aircraft?
- Has the taxpayer complied with all IRS registration requirements?
- Has the taxpayer determined the appropriate emissions rate and emissions factor of the transportation fuel?
- Is the taxpayer's facility a qualified facility that meets statutory wage and apprenticeship requirements?
- Has the taxpayer considered the applicability of other clean energy credits in connection with the facility?

The complexity of the computation and the required information is a dramatic shift from the prior simple credit computation of gallons multiplied by rate. Compliance costs, in turn, would increase dramatically as well.

Transition requires preparation

The transition to the one-size-fits-all, technology-neutral CFPC from the patchwork of legacy alternative and renewable fuel incentives, historically administered as part of the motor fuels excise tax regime, has the potential to introduce greater efficiency into administering tax incentives designed to promote production of transportation fuel with low greenhouse gas emissions. Taxpayers that produce alternative and renewable fuel are advised to begin preparing now.

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Expenses & Deductions

Rights for the R&D credit and Sec. 174

Taxpayers claiming research and development (R&D) tax credits for work performed under contract must contend with the exclusion for "funded research."

PHOTO BY ANUWAT/ADOBE STOCK

Whether R&D is funded involves a two-pronged analysis to determine whether the taxpayer possesses economic risk related to the success of the research and retains substantial rights to the research results. Given the popularity of the Sec. 41 R&D tax credit, the funded research exclusion has been discussed extensively in judicial opinions, regulations, notices, treatises, and more. However, whether a similar framework exists for specified research and experimentation (SRE) expenditures under Sec. 174 has, until recently, largely been left to speculation. While Regs. Sec. 1.174-2(b)(3) requires that any expense claimed under Sec. 174, when paid to a third party to create depreciable property, must be at the taxpayer's own risk, whether Sec. 174 also requires any intellectual property right to the research has been less certain.

To address this murkiness, the IRS released Notice 2023-63, which was quickly followed by Notice 2024-12. Though proposed regulations on the topic have yet to be released (as of the date of this item's writing), the notices formally introduce the concept that taxpayers performing research under contract, and recognizing those expenditures under Sec. 174, must have the right to exploit the results of the research performed. Notice 2023-63 explicitly states that it is "not intended to change the rules for determining eligibility for or computation of the research credit under §41 and the regulations thereunder." But how should taxpayers understand the similarities and differences between "substantial rights" required for the R&D tax credit and the right to exploit associated with Sec. 174?

History of Sec. 174

The law known as the Tax Cuts and Jobs Act (TCJA), P.L. 115-97, represented a substantial change in U.S. tax policy. Among its numerous provisions, the TCJA imposed the mandatory capitalization of SRE expenditures for tax years beginning after Dec. 31, 2021.

Originally enacted in 1954, Sec. 174 has historically allowed taxpayers to deduct SRE expenditures in the year incurred. Its original aim was to level the playing field for small businesses, those without dedicated research teams, that may be unable to deduct product development expenses under Sec. 162 because the costs were not ordinary and necessary expenses paid or incurred in carrying on a trade or business. The intent was to allow immediate deductions for such development costs and encourage innovation. Taxpayers enjoyed this treatment for nearly 70 years until the TCJA required the amortization of SRE expenditures over a period of either five or 15 years for domestic or foreign expenditures, respectively.

The change from deduction to amortization was included among several other changes in the TCJA as a means to offset the tax revenue loss from corporate tax cuts, in order to pass the act via budget reconciliation and avoid a filibuster. Most people aware of the change, including those at the IRS, thought it would be pushed out or reversed by legislation before the effective date. Since such legislation has not yet materialized, the IRS has made a concerted effort over the last year to provide guidance on what expenditures should or should not be recognized under Sec. 174. Because taxpayers have historically been afforded flexibility on how they treat Sec. 174 expenses and because other provisions such as Sec. 162 allow the deduction of ordinary and necessary business expenses, whether costs were properly claimed as experimental was rarely challenged and little guidance existed.

The guidance that did exist consisted largely of Regs. Sec. 1.174-2 and a modest body of case law discussing the requirement that expenses must be incurred for development "in connection with" a taxpayer's trade or business. For example, the Fourth Circuit in *Lewin*, 335 F.3d 345 (4th Cir. 2003), discussed the applicability of Sec. 174 to amounts paid by an investment group to fund the R&D activities of startups. In return for funding, the investment group secured certain rights to any intellectual property generated by the startups that it would then license back out for commercialization. At the time the expenses were incurred, the investment group lacked the infrastructure or specialized knowledge to commercialize the intellectual property in its own business. The court ultimately held that the amounts paid by the investment group could not be deducted under Sec. 174 because the investor group lacked any "realistic prospect of exploiting any discoveries in its own trade or business."

While the court in *Lewin* and other courts dealing with Sec. 174 — see, e.g., *Harris*, 16 F.3d 75 (5th Cir. 1994) — required that taxpayers claiming a deduction under Sec. 174 possess the intent and ability to exploit the results of research performed, the analysis focused on the purchasing party. The facts presented did not force those courts to consider what rights must be reserved by the research provider to satisfy the exploitation requirement should it have the means and desire to do so.

Notice 2023-63 attempted to address that ambiguity by including in the definition of SRE product "any pilot model, process, formula, invention, technique, patent, computer software, or similar property … *that is subject to protection under applicable domestic or foreign law*" [emphasis added], and that "mere know-how gained by a research provider … that is not subject to protection under applicable domestic or foreign law does not give rise to an SRE product in the hands of the research provider." The notice went on to say: "[I]f the research provider has a right to use any resulting SRE product in the trade or business of the research provider or otherwise exploit any resulting SRE product through sale, lease, or license, then costs paid or incurred … are SRE expenditures of the research provider."

Notice 2024-12 sought to further clarify the issue by defining "SRE product right" to mean "a right to use any resulting SRE product in a trade or business of the research provider or otherwise exploit any resulting SRE product through sale, lease, or license." Furthermore, that product right must exist without the need for separate consideration or authorization from an unrelated third party.

Substantial rights under Sec. 41

Similar to the requirements described in Notice 2024-12 that a research provider's right to exploit must be free of restrictions or additional payments, "substantial rights" in the context of the R&D tax credit requires a taxpayer to be able to use the results of its research without additional payment or approval. In the seminal case on this subject, *Lockheed Martin Corp.*, 210 F.3d 1366 (Fed. Cir. 2000), the Federal Circuit evaluated whether Lockheed Martin retained substantial rights to research it performed for the U.S. government. In reversing the Court of Federal Claims, the Federal Circuit reasoned that even though Lockheed Martin's right to use its research was not exclusive, it could use its results and technical data without paying the U.S. government for that right. Thus, it retained "substantial rights" for the purposes of the R&D tax credit.

In contrast to the court in *Lockheed*, the Tax Court in *Tangel*, T.C. Memo. 2021-1, was confronted with a situation in which the taxpayer conveyed all technical information to the buyer and was further restricted from using any technical information created at the buyer's expense. In that case, the taxpayer agreed in its contract with the buyer that all information created was a "work made for hire," and that all drawings, designs, equipment, and technical data would belong exclusively to the buyer. The court ultimately granted partial summary judgment in favor of the IRS, as the taxpayer failed to articulate any rights it retained, much less any substantial rights.

The most recent noteworthy discussion of "substantial rights" came from the Fifth Circuit in *Grigsby*, 86 F.4th 602 (5th Cir. 2023). Cajun Industries, a construction company out of Louisiana, entered into several construction contracts with various clients. Though less descriptive than some restrictions in *Tangel*, the only language in Cajun's contracts were affirmative conveyances of "all right, title, and interest" in any "work product," which included "documents, data, analyses, reports, plans, procedures, manuals, drawings, specifications, calculations, or other technical tangible manifestations of [Cajun]'s efforts (whether written or electronic) created while performing the contract." The court went on in its description, but, similar to the court in *Tangel*, ultimately ruled against Cajun on the basis that it failed to demonstrate any rights that it retained to the research.

Rights under Secs. 41 and 174

There is a great deal of overlap between the analyses surrounding Secs. 41 and 174. In fact, the first requirement for qualification under Sec. 41 is that an expense may be treated as an SRE under Sec. 174 (Sec. 41(d)(1)(A)). That said, the sections regulate fundamentally different concepts — while Sec. 174 was written to allow small businesses to expense costs that otherwise would have been capitalized, Sec. 41 grants a credit to incentivize research performed within the United States. Bearing that in mind, although the concepts of "substantial rights" and "right to exploit" are similar, they involve separate standards reflected by the distinct nature of each Code section.

The notices released by the IRS discussing the rights of research providers and the recognition of expenses under Sec. 174 focus on legally protectable rights and the ability to exploit the SRE product. As stated in Notice 2023-63, "if the research provider has a right to use any resulting *SRE product* in the trade or business of the research provider or otherwise exploit any resulting *SRE product* through sale, lease, or license, then costs paid or incurred by the research provider … are SRE expenditures of the research provider" (emphasis added). The purpose of Sec. 174 (as currently written) is to force the capitalization of costs incurred in the development of a research product, and the rights analysis justifiably focuses on the work product.

On the other hand, the Sec. 41 analysis of "substantial rights" extends beyond the work product to information and materials created throughout the research process. Though Lockheed Martin transferred the final product to the U.S. government, it nonetheless retained substantial rights for the purposes of the R&D tax credit because it retained access to the data and designs generated. Though the courts in *Tangel* and *Grigsby* ruled against the service providers in those cases, it is conceivable that if they had explicitly reserved some measure of rights to the underlying data or processes while still granting exclusive rights to the final product to the respective buyers, the courts may have ruled in their favor regarding substantial rights.

The focus of Sec. 174 is on the capitalizable asset, and the right to exploit is also tied to that asset. Meanwhile, Sec. 41 more broadly encompasses the discovery of information that is technological in nature. Though a taxpayer may lack a legally protectable right to exploit the ultimate product of its research activities, a right to use the associated technological information, without having to pay for that right, may nonetheless provide the taxpayer with substantial rights when applying for an R&D tax credit.

From Greg Sweigart, J.D., Denver

Individuals

IRS steps up enforcement of the individual expatriation tax

Each year, several thousand individuals renounce their U.S. citizenship or give up their green cards, which can trigger a substantial exit tax liability. Individuals who have expatriated or are considering expatriating should be aware that the IRS appears to be sharpening its enforcement efforts in these situations.

When the current individual expatriation tax regime was enacted in 2008, the Joint Committee on Taxation estimated that it would raise $411 million over the subsequent decade (Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 110th Congress* (JCS-1-09) (March 2009), Appendix, p. 594). Although the number of individuals who expatriate has increased significantly since 2008, a 2020 report by the Treasury Inspector General for Tax Administration (TIGTA), *More Enforcement and a Centralized Compliance Effort Are Required for Expatriation Provisions*, Rep't No. 2020-30-071 (Sept. 28, 2020), identified significant problems with enforcement and revenue collection under the expatriation regime (discussed more fully below). However, the IRS response to the TIGTA report, the inclusion of expatriation in the list of ongoing IRS compliance campaign initiatives, and the recent issuance of an IRS practice unit that focuses on the filing requirements applicable to covered expatriates all indicate that enforcement of the expatriation tax rules continues to be an area of focus for the IRS. This item provides a brief summary of the expatriation tax rules before analyzing each of these recent developments.

PHOTO BY ELLIOTT/ADOBE STOCK

The expatriation tax regime

The current expatriation tax was introduced in June 2008 as part of the Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART Act), P.L. 110-245. The HEART Act added Sec. 877A and certain other related provisions to the Internal Revenue Code.

The Sec. 877A expatriation tax generally applies to any U.S. citizen who relinquishes citizenship and any long-term resident (an individual who has held a U.S. green card in at least eight of the prior 15 years) who terminates green card status, if the individual meets any one or more of the following criteria:

- Average annual net income tax liability over the five years ending before the date of expatriation is greater than $201,000 (for expatriations occurring in 2024 — indexed annually for inflation);
- Net worth of $2 million or more on the date of expatriation; or
- Failure to certify their compliance with the U.S. tax laws for the five preceding tax years or failure to submit evidence of their compliance as required by the IRS.

If an individual is determined to be a covered expatriate, their worldwide property is considered to have been

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sold for its fair market value on the day before the individual's expatriation. The resulting gain from this "mark to market" transaction is subject to tax to the extent it exceeds an exclusion amount of $866,000 (for expatriations occurring in 2024 — indexed annually for inflation).

Certain assets, including deferred compensation items, specified tax-deferred accounts, and interests in nongrantor trusts, are excluded from the mark-to-market rule and are subject instead to special tax rules.

Compliance campaign initiatives

Commencing in 2017, the IRS Large Business and International Division (LB&I) has published and regularly updates a list of compliance campaign initiatives. Expatriation tax was added to the list of active campaigns on July 19, 2019, with the following statement:

> U.S. citizens and long-term residents (lawful permanent residents in eight out of the last 15 taxable years) who expatriated on or after June 17, 2008, may not have met their filing requirements or tax obligations. The Internal Revenue Service will address noncompliance through a variety of treatment streams, including outreach, soft letters, and examination.

Expatriation tax remains one of the 48 currently active campaigns. Other campaigns have been retired because they have either been fully implemented or discontinued for other reasons.

TIGTA report

The TIGTA report mentioned above was issued following an extensive review of the effectiveness of the IRS's efforts in ensuring compliance with the expatriation tax provisions. The report identified a number of problems, including: (1) the IRS lacked sufficient controls to ensure that taxpayers subject to expatriation tax are filing Forms 8854, *Initial and Annual Expatriation Statement*, and paying the requisite tax; (2) the IRS is failing to follow up with taxpayers who do not file Form 8854; (3) the data in the existing expatriate database is not being sufficiently tracked or leveraged to enforce the exit tax; (4) certain high-net-worth individuals appear not to be paying the expatriation tax that is due; and (5) there is a low examination rate of the tax returns of expatriating individuals.

The IRS responded to a draft version of the report by committing to take the following steps: (1) coordinating with the U.S. Department of State to add a Social Security number data field to the Certificate of Loss of Nationality so as to improve the tracking of individuals required to file Form 8854; (2) updating the standard form letters sent to individuals who have failed to file Form 8854; (3) updating Form 8854 so as to collect more detailed information on assets owned at the time of expatriation; (4) improving the procedures for transcribing data from Form 8854 and identifying when information is missing; and (5) establishing processes to compile information on all expatriating individuals and using this information to identify individuals with a high risk of noncompliance.

2023 IRS practice unit

The release of the IRS practice unit *Expatriation On or After June 17, 2008 — Mark-to-Market (MTM) Tax Regime* in July 2023 represents the latest manifestation of the IRS's ongoing focus on expatriation tax and its related compliance issues. Practice units serve as professional aids for IRS examiners and as internal training materials on general tax concepts and specific transactions. Although they are not official pronouncements on law or practice and cannot be relied on or cited as authority, they provide valuable insights into how the IRS views certain substantive and procedural issues.

This practice unit is noteworthy in that it provides significantly more detail than was available in previous guidance on the range of assets that could give rise to gain subject to expatriation tax and how these assets should be valued and reported on Form 8854. In addition to the more commonly held kinds of property — such as real estate, stocks, bonds, and mutual funds — it lists a number of less commonly held assets — such as life insurance on the life of a third party; leaseholds or reversionary or remainder interests; judgments and claims in litigation; and assets transferred for less than full and adequate consideration with certain retained interests.

The fact that the IRS has compiled such an extensive list indicates the level of detail required when completing Form 8854 and the kinds of questions that could be raised if a covered expatriate's income tax return is subjected to audit.

The practice unit provides detailed guidance on how to value properties subject to expatriation tax. In particular, it states that household and personal effects should be itemized room by room and named specifically, unless no articles in the same room have a value exceeding $100. Further, an expert appraisal is required for articles with artistic or intrinsic value exceeding $3,000, and that appraisal must be filed with the tax return. Beneficial interests in trusts and interests in life insurance policies are to be valued under gift tax valuation principles. Trusts generally require an examination of the terms of the trust and the pattern of prior distributions; life insurance policies require determination of the price at which the life insurance company would sell the contract or a similar contract.

The practice unit also includes guidance on jointly held property and property subject to community property rules. If jointly held property is held by a covered expatriate as a joint tenant with a right of survivorship with someone other than their spouse, the entire value of the property should be attributed to the covered expatriate, absent evidence supporting a different attribution. If it is held as a joint tenant with a right of survivorship between spouses, 50% of the value of the property should be attributed to the covered expatriate.

Property subject to community property law (which can apply under either U.S. state law or foreign-country law) is attributed to a covered expatriate under community property principles, which generally provide that both spouses have equal, undivided interests in any property acquired during a marriage. Thus, only the portion allocable to the covered expatriate should be included for purposes of the mark-to-market tax calculation.

Finally, the practice unit provides some guidance on calculating gain from the deemed sale of assets under Sec. 877A. It clarifies that the Sec. 121 exclusion of gain from the sale of a principal residence does not apply for purposes of a Sec. 877A deemed sale. Sec. 121 allows qualified taxpayers to exclude up to $250,000 of gain ($500,000 for married taxpayers filing jointly) from the sale of a principal residence that they have owned and occupied for at least two of the prior five years. There had been some dispute among commentators as to whether this exclusion could be claimed by covered expatriates in addition to the separate exclusion amount (currently $866,000) allowed for purposes of the mark-to-market rule, on the grounds that the deemed sale of the principal residence should be treated in the same way as an actual sale. The practice unit addresses the issue and sets out the IRS's position that only the Sec. 877A exclusion applies to offset the gain from the deemed sale.

The practice unit also clarifies that passive activity losses subject to the limitation of Sec. 469 are not triggered by the deemed sale of assets. The Sec. 469 passive activity rules generally require that any net losses from a passive activity in which a taxpayer holds an interest are suspended until the tax year in which the taxpayer disposes of their entire interest in the passive activity in a fully taxable transaction. It was previously open to question whether the deemed sale of assets under Sec. 877A triggered passive activity losses. However, the practice unit has clarified the IRS's position that such losses are not triggered but remain suspended until an actual sale of the passive activity occurs.

More exits, greater scrutiny

The number of individuals who renounce their U.S. citizenship or terminate their green card status has increased significantly since the enactment of the current expatriation tax regime in 2008. Lists of these individuals published quarterly by the IRS in the *Federal Register* show that the number of individuals expatriating has increased from 312 in 2008 to 3,260 in 2023, with a peak of 6,705 in 2020.

Individuals on assignment to the United States who are considering whether to retain or terminate green card status and any individuals considering giving up U.S. citizenship should be aware of their potential exposure to expatriation tax, given the IRS's ongoing focus on this issue.

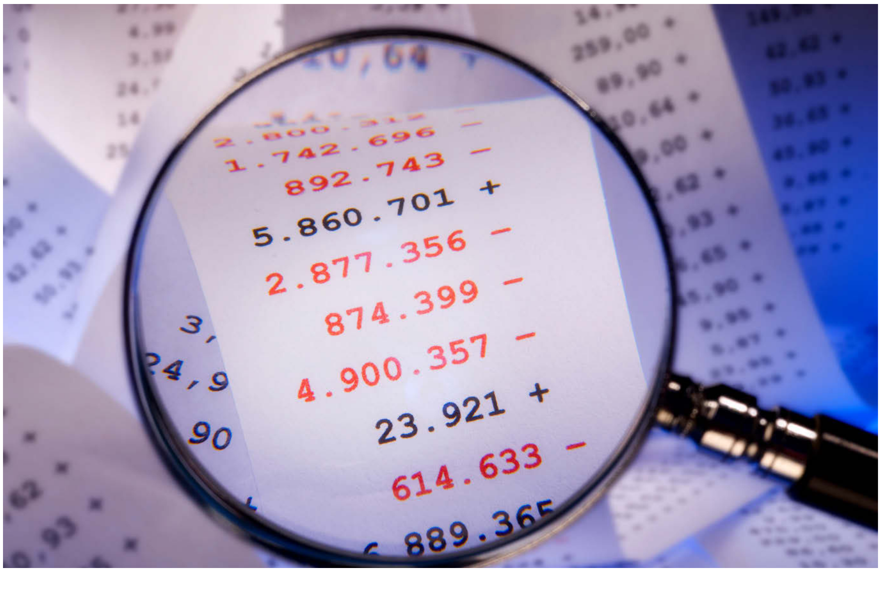
From Ben Francis, LL.M., Washington, D.C.

International

E-invoicing mandates and intercompany transactions

The global surge in continuous transaction control (CTC) systems is a trend that cannot be overlooked. These CTC systems manifest as electronic invoicing (e-invoicing) or digital reporting mandates, compelling taxpayers to submit all transactional data to tax authorities in real time or near real time. Specifically, over the past decade, more than 30 jurisdictions have enforced some form of e-invoicing mandate, and a majority of the Group of 20 economies have implemented or are planning to introduce such a mandate within the next few years.

Like all reforms, certain aspects create more challenges than others. While many commentators will point to the lack of harmonization and interoperability, which imposes significant



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burdens on businesses striving to comply with these mandates, this Tax Clinic item zeroes in on a specific transaction type that often causes complications for companies: intercompany transactions.

Intercompany transactions are commercial and financial exchanges between two or more entities within the same corporate group. These transactions can range from the exchange of goods and services to the transfer of resources or funds. They are a vital practice in multinational corporations with subsidiaries operating in different regions worldwide. For many years, tax authorities have focused on intercompany transactions, particularly in relation to corporate income taxes and the necessary transfer pricing adjustments.

Overview of CTC mandates

Under CTC mandates, every invoice issued by taxpayers must be validated or reported to the tax authority before being sent to the client. To facilitate this, e-invoices and digital reports must adhere to strict requirements that dictate their format, content, submission time frame, storage, and, if necessary, correction process.

Failure to meet any of these requirements results in rejection of the invoice by the official e-invoicing platform. Since only CTC-compliant invoices are deemed legitimate, this rejection effectively blocks the transaction. To further bolster the effectiveness of CTC systems, some jurisdictions have implemented legal provisions stipulating that any invoice not validated or reported to the government will be considered nonexistent for all tax purposes. In practical terms, noncompliance with these mandates often results in the buyer being unable to deduct the value-added tax (VAT) incurred on the purchase and, increasingly, not being able to deduct the expense for income tax purposes.

Under existing CTC mandates, the validation or reporting of an invoice to the tax authority does not imply that the transaction itself has passed all levels of scrutiny to confirm the total tax compliance of the issuer or recipient. It merely verifies that the transaction supported by that document has been duly reported to the authority. However, the ultimate goal of a CTC mandate is to empower tax authorities to accurately determine taxpayers' tax liabilities, with a current primary focus on transactional taxes such as VAT. For instance, in jurisdictions with VAT regimes, the data gleaned from CTC systems has enabled jurisdictions such as Chile, Italy, Mexico, and Spain to prepopulate large portions of taxpayers' VAT returns (primarily on the accounts receivable side).

The VAT treatment pertaining to intercompany services is often overlooked.

VAT and intercompany transactions

A VAT is a consumption tax levied in most jurisdictions across the world that applies to the sale of goods or services at each leg of the supply chain, with a credit provided when the item has been purchased for business purposes, until the item is purchased by the final consumer, who bears the ultimate burden of the tax. A VAT has formal invoicing requirements. In the absence of a valid invoice, a purchaser is unable to claim a tax credit. This creates an incentive for a purchaser to request an invoice. These invoices further create an auditable paper trail.

Since VAT applies at each stage of the supply chain, intercompany transactions generally fall within its scope even if no money is exchanged between entities (e.g., due to netting). This implies that each intercompany transaction should ideally be supported by its own invoice, even for cross-border transactions. However, in practice, especially for intercompany services, these transactions are often not recorded through the standard accounts payable and accounts receivable modules of enterprise resource planning systems that also record sales and purchase invoices. Instead, intercompany transactions are often treated as financial transactions, typically supported by summary documentation (e.g., spreadsheet calculations).

Consequently, the VAT treatment pertaining to intercompany services is often overlooked. While, in general, cross-border services should not bear any VAT in the seller's jurisdiction, this is not always the case. For instance, in Mexico, only a limited number of cross-border services are not subject to tax and then only if they are considered to be "enjoyed" abroad. Marketing services provided by a Mexican subsidiary to the foreign headquarters would be taxed if the marketing pertains to the Mexican territory.

In addition, to prevent tax evasion, ensure fair taxation, avoid double taxation, and promote transparency and fair competition, jurisdictions require prices on intercompany transactions to be at arm's length. This arm's-length standard is established based on local legislation, and the Organisation for Economic Co-operation and Development (OECD) has provided detailed guidance on methods to use to determine the arm's-length price. However, determining the VAT treatment applicable to transfer pricing adjustments in itself can be complicated. While VAT laws in a few jurisdictions refer to the wording of their corporate tax laws, the issue is often left silent. For instance, there is no clear VAT guidance established by the European Union (EU) or the various tax authorities of the 27 EU member states. Initial observations of the matter highlight that transfer pricing adjustments should only be considered within the scope of VAT if they can be attributed to a good or a service effected "for consideration." In this case, the transfer pricing adjustment should result in the issuance of a credit or debit note that formally documents the adjustment to the initial intercompany invoice.

Effects of CTC mandates on intercompany transactions

Since CTC mandates focus on VAT, and since intercompany transactions generally fall within the scope of VAT, these transactions should in principle be subject to CTC mandates. However, as the implementation of these mandates vary, businesses must first assess which transactions are in scope of the specific CTC mandate: domestic transactions, business-to-business transactions, cross-border transactions, etc. Therefore, intercompany transactions will be affected only in jurisdictions with broad mandates. In those jurisdictions, businesses will therefore have to update their systems to ensure that the required CTC data on intercompany transactions is communicated to the e-invoicing system.

Even in jurisdictions with a narrower CTC mandate, businesses should start ensuring that their intercompany transactions meet local VAT and invoicing requirements. Based on experiences with mature CTC systems, tax authorities tend to expand the scope of CTC mandates so that intercompany transactions can be caught at a later stage.

With respect to transfer pricing adjustments, translating these adjustments into individual invoices may be more or less difficult depending on the transfer pricing methodology used by the taxpayer and the local VAT law. An additional complicating factor is that under CTC mandates, price adjustments relating to an already issued invoice generally need to be reflected through debit or credit notes, which refer to the original e-invoice in the system.

Therefore, if the transfer pricing adjustments are the result of the application of traditional transaction methods, identifying the invoices that will need to be adjusted may not be that difficult. However, if the arm's-length prices are identified as a result of transactional profits methods, adjustments may not be that simple. This becomes further complicated when there are time limitations to modify e-invoices and when the adjustments are made for transactions that can be subject to different tax rates or treatments.

Moreover, even in countries where transfer pricing adjustments are not in scope of a VAT, making these adjustments only on the income tax side would disrupt the purpose of the e-invoicing/digital reporting systems. Tax authorities may therefore create specific e-invoices for such transactions. This happened in Mexico, where the tax authorities have established specific guidance on how to document transfer pricing adjustments via the e-invoicing system.

More data, new tools

Given the significance of intercompany transactions, companies cannot overlook the impact CTC mandates will have on the reporting of these transactions. As a preliminary step, companies can review their VAT treatment and begin issuing VAT-compliant invoices to be prepared when a jurisdiction implements a CTC mandate. This is a manageable initial step, as the transition to CTC mandates results in a substantial digital transformation for multinational enterprises, necessitating a strategic response, including comprehensive assessments of current tax-compliance processes, informed decision-making, and the implementation of a global strategy.

As CTC mandates are expanding, tax authorities around the world will gather an increasing amount of data allowing them, in the near future, to perform real-time audits of the transactions carried out by taxpayers. While the current focus is on improving VAT compliance, it is not inconceivable that the same data could be used for corporate income taxes. In this respect, intercompany transactions and related transfer pricing adjustments could be an ideal target for tax authorities.

By leveraging the data gathered through CTC systems in combination with new artificial intelligence tools, tax authorities could further scrutinize arm's-length prices adopted using the accepted methodologies, leading perhaps to an overall reconsideration of applicable transfer pricing methodologies. The rapid and constant flow of e-invoicing information could indeed help automate many of the processes needed by tax authorities and taxpayers to perform transfer pricing studies, audits, and overall compliance.

From Ramon Frias, J.D., Boston, and Philippe Stephanny, LL.M., Washington, D.C.

Taxpayer-initiated transfer pricing adjustments in MAP

The phrase "transfer pricing adjustment" typically calls to mind a rather bleak picture: a hard-fought audit spanning years, cash tax to be paid or net operating losses that will evaporate, possible penalties, and all the back-end complexity that comes with implementing the adjustment once it has been determined. Yet adjustments can also be made proactively by taxpayers, and without most of the gloomy trappings of an IRS-initiated adjustment. In the United States, taxpayers are permitted to use their timely, original U.S. returns to adjust the transfer prices on their books, if necessary to achieve an arm's-length result — an important concession that can ease operational transfer pricing pressures and help taxpayers avoid penalties.

In a perfect world, everything would dovetail, with a taxpayer-initiated upward adjustment in the United States

PHOTO BY DIANA SAMSON/WIRESTOCK/ADOBE STOCK

offset by a corresponding taxpayer-initiated downward adjustment in the counterparty jurisdiction. But we do not live in a perfect world, and not all jurisdictions permit post-year-end adjustments, so making a taxpayer-initiated transfer pricing adjustment often raises the specter of double tax. When the double tax is significant, taxpayers may be able to obtain relief via the mutual agreement procedure (MAP) under a relevant income tax treaty. This item provides an overview of the MAP process as it relates to taxpayer-initiated adjustments, as well as some collateral consequences that taxpayers need to consider.

MAP for taxpayer-initiated adjustments

Taxpayers may find a substantial benefit in initiating a transfer pricing adjustment before undergoing a government audit. The need for an adjustment may come to light due to undiscovered facts or an internal (or third-party) review that causes a reconsideration of the initial position. For many taxpayers, the reality is more pedestrian: The facts are what they were always understood to be, but just complying with established transfer pricing policies can be challenging at the operational level. By self-initiating an adjustment, a taxpayer can remedy operational transfer pricing challenges and mitigate penalty exposure as well as control its narrative.

In cases where the adjustment increases U.S. income, the foreign jurisdiction will generally lack incentive — and often a procedure — for allowing a post-year-end adjustment to reduce the foreign taxpayer's income. Historically, this was also true in the United States. Naturally, the IRS does not object to taxpayers' changing their transfer pricing results to report more U.S. income from a controlled transaction, but until the 1990s, there was no way for taxpayers to change the actual results of their controlled transactions to report less U.S. income. With the introduction of the transfer pricing penalty regime, however, a limited right to make taxpayer-initiated transfer pricing adjustments under Regs. Sec. 1.482-1(a)(3) was introduced, allowing taxpayers to adjust their transfer pricing on original, timely filed returns if necessary to achieve an arm's-length result (and thus avoid penalties). After the return is filed, however, taxpayers are still forbidden from filing amended returns to decrease U.S. taxable income under Sec. 482.

MAP procedures

In many cases, a taxpayer-initiated U.S. adjustment will create double tax, and seeking MAP relief will be necessary to effectively eliminate it. Rev. Proc. 2015-40 provides special procedures that must be followed in MAP cases arising from taxpayer-initiated adjustments. For these cases, taxpayers must submit a prefiling memorandum identifying the taxpayer (in contrast to prefiling proceedings related to a tax authority–initiated adjustment, which may be held on an anonymous basis). The memorandum must describe: (1) the factual and legal basis for the taxpayer's position; (2) any administrative, legal, or other procedural steps undertaken in the foreign jurisdiction (e.g., the filing and acceptance of a return with the adjusted transfer pricing); and (3) any previous communications with the foreign competent authority concerning the relevant issues. Taxpayer-initiated adjustment cases are also ineligible for treatment as small-case MAP requests, meaning a full MAP submission under Rev. Proc. 2015-40 is required.

Importantly, the U.S. competent authority may decline to provide assistance if the taxpayer failed to make a timely request or the taxpayer otherwise prejudiced or impeded full and fair negotiation of the issues by the competent authorities (see Rev. Proc. 2015-40, §7.02(3)(f)). Therefore, in most cases, taxpayers should promptly proceed to MAP when undertaking a taxpayer-initiated adjustment for which no corresponding self-help is available in the counterparty jurisdiction.

While the U.S. competent authority has shown it is willing to engage in MAP proceedings regarding taxpayer-initiated adjustments, other countries may not have the same willingness and may take the position that, since a tax authority has not made an affirmative adjustment, taxation not in accordance with the applicable income tax treaty has not occurred and MAP is unavailable.

However, the commentary to the Organisation for Economic Co-operation and Development (OECD) model treaty provides support for taxpayer-initiated adjustments triggering MAP:

> It should be noted that the mutual agreement procedure, unlike the disputed claims procedure under domestic law, can be set in motion by a taxpayer without waiting until the taxation considered by him to be "not in accordance with the Convention" has been charged against or notified to him. [Commentary on OECD Model Tax Convention on Income and on Capital ("OECD Model Convention") (2017), Article 25, ¶14]

Similar favorable statements are made regarding taxpayer-initiated adjustments in the commentary to Article 7 (Business Profits) and Article 9 (Associated Enterprises), providing that in cases where a taxpayer-initiated adjustment is made in one state:

> To the extent that taxes have been levied on the increased profits in the first-mentioned State, that State may be considered to have included in the profits of an enterprise of that State, and to have taxed, profits on which an enterprise of the other State has been charged to tax. In these circumstances, Article 25 enables the competent authorities of the Contracting States to consult together to eliminate the double taxation. [Commentary on OECD Model Convention (2017), Article 9, ¶6.1; see also Commentary on OECD Model Convention (2017), Article 7, ¶59.1]

However, not all income tax treaties follow the OECD model treaty, and not all jurisdictions subscribe to the views espoused in the commentary to the OECD model. Thus, it is important to communicate with the competent authorities of all affected jurisdictions prior to filing the MAP request.

Secondary adjustments in MAP cases

Because a primary adjustment is made to a single taxpayer's results, it in itself creates potential double taxation. Courts recognized early on that this was inappropriate, and Regs. Sec. 1.482-1(g)(2) now requires the IRS to make appropriate correlative allocations (e.g., if the foreign party's income is increased, the U.S. parties' income must be decreased). Of course, the U.S. correlative allocation does not mean that the counterparty can realize the benefit of an offsetting adjustment for foreign tax purposes. That is where MAP comes in.

The primary adjustment also creates a discrepancy between the taxpayer's book position (which reflects the results of its unadjusted transfer pricing) and its tax position (which reflects the adjustment). While this disparity is effectively ignored by many countries, the United States requires the disparity be addressed through yet another adjustment, referred to as a "secondary" or "conforming" adjustment. For a global survey of secondary adjustment rules by country, see Foley, Taheri, and Sullivan, "Country-by-Country Survey of Global Secondary Adjustment Rules," 103 *Tax Notes Int'l* 29 (July 5, 2021).

The U.S. secondary adjustment concept eliminates the book-tax discrepancy in one of two ways: (1) by inferring one or more deemed transactions that align the tax position with the book position, or (2) through the movement of funds aligning the book position with the tax position. These secondary adjustments can trigger significant tax consequences (e.g., withholding tax on a deemed distribution) and must be carefully considered.

In the absence of any action by the taxpayer, the creation of deemed transactions (specifically, deemed distributions and/or deemed capital contributions) is the default treatment under Regs. Sec. 1.482-1(g)(3). In lieu of this default treatment, eligible taxpayers can elect to repatriate funds under Rev. Proc. 99-32, thereby aligning book positions with adjusted tax positions. Repatriation accounts established under Rev. Proc. 99-32 bear interest from the beginning of the year after the year to which the primary adjustment relates and must be satisfied within 90 days to avoid application of the default treatment. When the primary adjustment is made after a lengthy audit and relates to an older year, the interest component can be significant. However, Rev. Proc. 99-32 does not directly apply to MAP or advance pricing agreement cases.

When taxpayers are in MAP, Rev. Proc. 2015-40 allows them to apply for "competent authority repatriation," which is effectively the same as Rev. Proc. 99-32 repatriation, with the potential for one substantial benefit: The terms of repatriation are whatever is agreed to by the competent authorities. In practice, this generally means that repatriation accounts established pursuant to MAP do not need to bear interest. Competent authority repatriation must be requested in writing before the competent authorities reach a tentative resolution. If it is not timely requested, normal repatriation under Rev. Proc. 99-32 remains available via Rev. Proc. 2015-40.

Alternatively, the U.S. competent authority may allow the primary adjustment to be "telescoped" into a current-year tax return, which effectively eliminates the need for a secondary adjustment. While telescoping is generally acceptable for years after the implementation of the law known as the Tax Cuts and Jobs Act (TCJA), P.L. 115-97 (i.e., years beginning after Dec. 31, 2017), telescoping can pose challenges when the years covered under the MAP span both pre- and post-TCJA years, as reflected in IRS telescoping guidance from 2020. It is important to discuss the possibility of telescoping the adjustment with the U.S. competent authority during the MAP proceedings to ensure all stakeholders' views are understood before negotiations are finalized.

Seeking the best option

Taxpayer-initiated adjustments are an important tool for avoiding potential transfer pricing penalties, and MAP is an important tool for addressing the double taxation that taxpayer-initiated adjustments can create. The collateral adjustments that follow from primary transfer pricing adjustments — whether they are IRS- or taxpayer-initiated — can themselves have material tax consequences, which must be carefully considered. In MAP cases, competent authority repatriation offers one means of addressing secondary adjustments with minimal tax consequences, but the best option for secondary adjustments will depend on the facts of the taxpayer's case.

From Thomas Bettge, J.D., Washington, D.C., and Addisen Reboulet, J.D., Kansas City

Trends in enforcement of VAT remote-seller rules

Before the advent of the internet, most value-added tax (VAT) laws were designed for domestic brick-and-mortar sales, with VAT applied where the vendor was located. However, the digital economy's rise, including the erosion of physical borders and the shift from tangible to intangible property, has challenged these traditional VAT rules, leading to potential revenue losses.

To address these challenges, governments, guided by the Organisation for Economic Co-operation and Development (OECD) 2015 *International VAT/GST Guidelines*, have begun to mandate that remote vendors or marketplaces facilitating sales register for, collect, and remit VAT on sales of digital services. A few jurisdictions have started to enforce similar rules for cross-border remote sales of low-value consignments. Currently, over 110 jurisdictions have implemented remote-seller VAT rules, with additional jurisdictions, predominantly in Africa, in the process of implementing similar rules.

The deployment of these measures can be succinctly divided into two phases: Phase 1 emphasizes the introduction of rules to tackle challenges in the digital economy, while Phase 2, which began recently, concentrates on enforcing the new rules against digital actors. As many articles have already been written on the complexities of Phase 1 (including differences in persons liable, scope, compliance requirements, etc.), this item focuses on Phase 2 — enforcement of the new rules.

Rationale behind the move toward enforcement

Phase 1 focuses on introducing VAT rules for remote sellers, educating taxpayers, and promoting voluntary compliance. Jurisdictions have recently shifted toward enforcing these rules, as they believe that taxpayers have now had ample time to understand the rules, and any current noncompliance may be viewed as potentially deliberate or even criminal. Phase 2, therefore, primarily emphasizes enforcing existing rules by identifying and pursuing noncompliant taxpayers. Observers of U.S. sales tax administration will recognize many of the steps being taken by VAT jurisdictions as bearing a striking similarity to steps taken by U.S. states in the wake of the U.S. Supreme Court case of *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080 (2018).

Generally, jurisdictions implementing VAT rules for remote sellers apply their general civil tax administration statutes' enforcement provisions to nonresidents. These often include standard penalties for violations such as nonregistration, late payments, and inaccuracies in returns. However, because of the unique challenges of enforcing tax laws against nonresidents, these standard penalties are increasingly supplemented by rules specifically designed for nonresident remote sellers.

Identifying noncompliant remote sellers

The primary challenge for foreign tax authorities typically lies in identifying noncompliant remote sellers, given the absence of a global register for these companies. In recent years, tax authorities have employed various measures to overcome this, including setting up specialized units to scour the internet, encouraging consumers to report noncompliant vendors, and identifying potential noncompliant remote sellers through purchases made by VAT-registered customers. However, two measures seem to yield the greatest success: (1) tracking the money and (2) exchanging information between tax authorities.

Digital economy transactions are, inherently, not cash transactions, rendering the data from financial intermediaries a valuable resource for tax authorities in their pursuit of noncompliant remote sellers. For instance, Australia was one of the first jurisdictions to leverage payment information obtained from its anti–money laundering authority to target remote sellers. In recent years, other jurisdictions, including Chile and Kazakhstan, have adopted similar approaches.

A significant shift, and a test of this method's effectiveness, will be the newly implemented payment services providers reporting rules in the European Union (EU). Starting Jan. 1, 2024, EU-based payment services providers must share information on cross-border payments and their beneficiaries with member state administrations. This requirement applies to those receiving more than 25 cross-border payments per quarter. The shared information will assist tax authorities in identifying potentially noncompliant taxpayers. This data will be stored in a European database, the Central Electronic System of Payment Information, and made accessible to anti-VAT-fraud experts via the Eurofisc network.

Besides leveraging financial data, tax authorities are also increasingly collaborating to identify noncompliant remote sellers. For instance, the tax authorities in Kenya and Tanzania proactively exchange information about registered remote sellers in their respective jurisdictions. The rationale is that if a nonresident is compliant in one of the jurisdictions, they are likely also selling and obligated in the neighboring jurisdiction.

In the EU, recent changes to the rules of administrative cooperation in the field of taxation require tax authorities to automatically exchange certain information. In this respect, Denmark has been actively sharing information with other tax authorities regarding any transaction that may be attributable to another jurisdiction.

In addition, tax authorities are increasingly leveraging the exchange-of-information clauses included in existing tax treaties and/or tax information exchange agreements that also apply to VAT. The French tax authorities, for instance, have recently leveraged these instruments to obtain information from their U.S. and Dutch counterparts while examining the VAT liabilities of remote sellers. South Africa and Australia have also recently announced that they might consider this option.

Enforcement: From gentle nudge to aggressive

Once noncompliant remote sellers are identified, the next step is to ensure they become compliant, starting with registration and continuing with accurate reporting of tax obligations. Because the nonresident seller is not physically present, traditional enforcement measures may not be effective, leading to the adoption of nontraditional enforcement measures.

An initial, gentle nudge may include reaching out to noncompliant taxpayers and requesting that they register, a practice adopted by several jurisdictions, including Australia, India, South Africa, and Singapore. Another approach is "naming and shaming," as practiced by Kazakhstan and Chile (and recently announced by Bosnia and Herzegovina), which involves publishing a list of noncompliant remote sellers. While this method is relatively mild, it carries reputational risks for nonresident remote sellers who may not want to be publicly labeled as tax evaders.

A slightly stronger measure is automatic registration, whereby a tax authority automatically and retrospectively registers a noncompliant remote seller and imposes penalties for noncompliant periods. This approach has been adopted by the United Kingdom, and South Korea recently incorporated this mechanism into its VAT legislation, effective Jan. 1, 2024.

Tax authorities are gaining more powers to address the noncompliance of remote sellers. Some jurisdictions, such as Egypt, France, and Mexico, may resort to a "kill switch," which involves blocking internet access to the noncompliant remote seller. Kazakhstan's version stipulates that if a company's name appears on the published list of noncompliant taxpayers three times, it may block internet access. However, this kill-switch measure has yet to be seen in practice. Alternative approaches are also being considered. For instance, Australia has indicated it may consider blocking the repatriation of funds by noncompliant remote sellers, and Egypt's law provides that noncompliance may result in registering the VAT debt in a court in the seller's jurisdiction of residence, which in practice will be difficult to implement.

As noncompliance with these remote-seller rules can be considered tax fraud under domestic laws, the most severe enforcement measure that jurisdictions may impose includes criminal penalties, potentially against individuals overseeing the company's taxes. While this approach remains limited so far, some jurisdictions have started to leverage this tool. In Germany, tax officers are required to share the files of noncompliant taxpayers with the prosecutor's office if the tax liability reaches a certain threshold. Additionally, Italy and Spain have recently started issuing formal criminal charge notifications to identified noncompliant remote sellers.

Regularization relief

While Phase 2 does not focus on voluntary compliance, many jurisdictions maintain efforts to promote voluntary compliance, with several jurisdictions running voluntary disclosure programs (VDPs). In the past year, Saudi Arabia, Singapore, Malaysia, Nigeria, and Kenya have implemented VDPs that also apply to remote sellers. Additionally, a few jurisdictions occasionally offer moratoriums when they recognize that compliance has been challenging and subsequently introduce a simplified compliance mechanism, as both Tanzania and Senegal have recently done.

Nevertheless, voluntary and timely compliance remains the most cost-effective approach, considering that VAT should be economically borne by the consumer and not the remote seller in charge of collecting the VAT on behalf of the government. While VDPs offer penalty relief, the tax liability remains with the remote seller, which, in practice, will not be able to recover the tax from its historical customers. Moreover, filing VDPs may be more costly and time-consuming than immediate compliance. For instance, EU remote sellers can comply with the remote-seller rules through a single EU-wide registration, the One-Stop Shop, but this mechanism is available only on a go-forward basis, and any historical liability must be cleared with each individual tax authority of the 27 EU member states.

What to expect: More data sharing and audits

In addition to enforcement actions against noncompliant taxpayers, there has been a notable increase in audit activity for registered remote sellers. Tax authorities are not merely accepting nonresident remote sellers' estimated tax obligations; they are scrutinizing them closely. For instance, several tax authorities, including those in Denmark and Taiwan, have started leveraging payment data to audit remote sellers. It is also likely that tax authorities in jurisdictions with more mature remote-seller regulations will start auditing whether the remote sellers are fully compliant with the rules, such as those related to invoicing, determining where customers are located, or distinguishing between business and nonbusiness customers.

Simultaneously, jurisdictions are adopting information-reporting requirements for digital platforms to combat tax evasion in the digital economy. These include the OECD's Model Reporting Rules for Digital Platforms and the Crypto-Asset Reporting Framework, which have been implemented in the EU under the EU's Directives on Administrative Cooperation DAC7 and DAC8. The aim of these rules is to enhance tax transparency, improve compliance, and encourage cooperation among tax authorities. These regimes focus primarily on income taxes, but they will grant tax authorities unprecedented access to information to identify noncompliant remote sellers. This implies that even if a nonresident remote seller is not directly required to provide information under an information-reporting regime, its income, customers, and the payments it receives may still be deemed a reportable transaction for another taxpayer and thus made available to tax authorities. Once the identification hurdle is cleared, tax authorities have the ability to enforce compliance.

Not 'if' but 'when'

The cross-border taxation of remote sellers is continually evolving. While the initial phase of this journey was primarily centered on voluntary compliance and clarifying the rules, the trend has shifted toward enforcement. In this context, tax authorities are adopting innovative measures to identify noncompliant remote sellers and to enforce compliance. This trend will persist as expanded information-reporting requirements provide tax authorities with greater access to taxpayer information.

The financial impact of these rules should not be underestimated; the average VAT rate, according to the OECD, is around 19%, and the average statute of limitation is around five years, with some jurisdictions extending it in cases of noncompliance. Consequently, companies subject to these remote-seller rules can no longer ignore them, as it is not a matter of "if" but rather "when" foreign tax authorities will start knocking at their doors.

From Chinedu V. Nwachukwu, LL.B., LL.M., Washington, D.C., and Philippe Stephanny, LL.M., Washington, D.C.

Partners & Partnerships

Filing an administrative adjustment request under the BBA

The Bipartisan Budget Act of 2015 (BBA), P.L. 114-74, introduced a new centralized partnership audit regime for IRS audits of entities required to file Form 1065, *U.S. Return of Partnership Income*. The BBA procedures also fundamentally changed the process for correcting a prior-year Form 1065 and its Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc*. For tax years beginning in 2018 and after, partnerships subject to the BBA regime that seek to adjust a partnership-related item reflected on an original Form 1065 or Schedule K-1 generally must file an administrative adjustment request (AAR) under Sec. 6227. This item briefly summarizes the BBA rules,

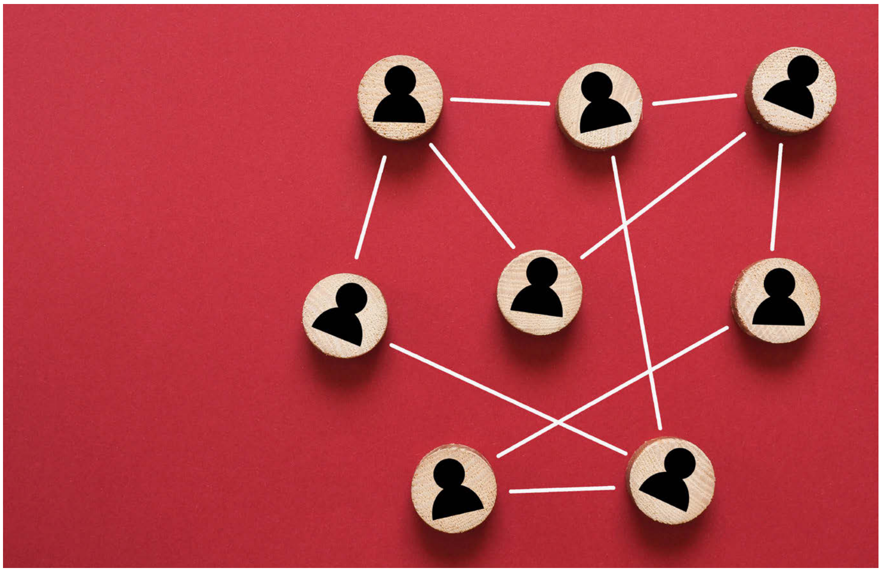

IMAGE BY ANDREAS BERHEIDE/ADOBE STOCK

discusses the requirements and forms for filing an AAR under Sec. 6227, and addresses the effects of filing an AAR on the partnership's partners.

BBA at a high level

The BBA procedures apply to partnership tax years beginning on or after Jan. 1, 2018. As a default rule, the BBA procedures provide that the partnership, not its partners, must pay any tax attributable to adjustments made by the IRS or reflected on an AAR. This amount is referred to as an "imputed underpayment." Very generally, the imputed underpayment is determined by multiplying the total amount of netted partnership adjustments by the highest rate of tax.

The partnership may elect an alternative to payment of the imputed underpayment and "push out" the adjustments to its partners, with the result that the partners pay the tax attributable to any partnership adjustments. However, rather than reporting that tax on an amended return for the reviewed year (i.e., the year subject to the adjustment), the partner includes the tax due (or reflects the tax benefit) on the partner's next-filed income tax return. Different rules apply for partners that are passthrough entities, as described below.

Basic rules when filing an AAR under the BBA

A partnership filing an AAR under the BBA must determine whether the adjustments made to the original return result in an imputed underpayment. If an adjustment results in an imputed underpayment, the partnership must pay the imputed underpayment when it files the AAR or, alternatively, may elect to push out the adjustment to the partners from the reviewed year. If paying the imputed underpayment, the partnership may use certain "modification" procedures to reduce the imputed underpayment amount by, for instance, demonstrating adjustments are allocable to a tax-exempt investor or to a C corporation partner taxable at a lower rate.

If the adjustment does not result in an imputed underpayment but instead results in a "favorable adjustment," the partnership *must* push out that favorable adjustment to the partners from the reviewed year. For example, if the AAR adjustment increases an amount of credit (i.e., a favorable adjustment), that additional amount of credit must be pushed out to the reviewed-year partners.

The determination of whether an adjustment results in an imputed underpayment is made on an item-by-item basis, and netting of favorable adjustments with unfavorable adjustments generally is not permitted. The imputed underpayment calculation effectively disregards any "negative adjustment," e.g., any adjustment that increases a deduction or credit or decreases an item of income. As a result, each "positive adjustment," e.g., an adjustment that increases an item of income or decreases an item of deduction or credit, is added together, and the sum of the positive adjustments is multiplied by the highest rate of tax in effect for the reviewed year to arrive at the imputed underpayment amount. For this purpose, adjustments to "non-income" items, i.e., those items that are not income, gain, loss, deduction, or credit, are treated by the regulations as positive adjustments. In certain cases, a positive adjustment may be treated as "duplicative" of another positive adjustment and thus be treated as zero for purposes of the imputed underpayment calculation.

A partnership generally has three years from the date of the filing of the original return to file an AAR. In the case of a foreign tax redetermination, the regulations under Sec. 905(c) provide that the partnership must file an AAR to notify the IRS of the foreign tax redetermination even if the normal three-year period to file an AAR has expired. (In that case, the AAR is limited to the adjustments required to be made under Sec. 905(c).) Once the IRS mails a Letter 5893, *Notice of Administrative Proceeding*, with respect to a partnership tax year, Sec. 6227(c) provides that a partnership may no longer file an AAR for that tax year.

In addition, the regulations provide that no partner may take a position inconsistent from the partnership for the partnership tax year for which the Letter 5893 is issued. Lastly, but perhaps most important, the filing of an AAR by a BBA partnership restarts the period of limitation under Sec. 6235 for the IRS to adjust partnership-related items for that tax year.

Forms for filing AARs under the BBA

The form used to file an AAR under the BBA depends on whether a partnership is filing on paper or electronically. To file on paper, the partnership uses Form 1065-X, *Amended Return or Administrative Adjustment Request (AAR)*. To file electronically, the partnership files a revised Form 1065, with the "Amended Return" box checked, and includes a Form 8082, *Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)*, identifying each change being made to the original Form 1065. The instructions to Form 1065-X and Form 8082 each provide that the partnership must include with the AAR a computation of the imputed underpayment amount that results from the AAR adjustments. Although the instructions provide a seven-step process for calculating the imputed underpayment, there is no prescribed form or schedule for this calculation. The imputed underpayment computation is required by the instructions regardless of whether the partnership is paying the imputed underpayment or pushing out the adjustments.

The partnership must pay the imputed underpayment when it files the AAR or, alternatively, may elect to push out the adjustment to the partners from the reviewed year.

When pushing out the adjustments, the partnership must furnish a Form 8986, *Partner's Share of Adjustment(s) to Partnership-Related Item(s)*, to each reviewed-year partner that is allocated a share of the AAR adjustments. A copy of the Form 8986 must be included with the AAR and filed with the IRS. The partnership must also file as part of the AAR a Form 8985, *Pass-Through Statement — Transmittal/Partnership Adjustment Tracking Report*, that shows the aggregate amount of adjustments reflected on the Forms 8986. If the partnership is paying the imputed underpayment and requesting modifications to the imputed underpayment amount, the partnership must include with the AAR a Form 8980, *Partnership Request for Modification of Imputed Underpayments Under IRC Section 6225(c)*.

An AAR must be filed and signed by the partnership representative (PR) as designated on the original reviewed-year return. When the partnership is pushing out the adjustments, the instructions to Form 8082 provide that a PR should "manually sign" the Form 8082 to attest that all Forms 8986 have been issued to the reviewed-year partners. If no PR was designated on the original Form 1065, one will need to be identified using a Form 8979, *Partnership Representative Revocation, Designation, and Resignation*, and attaching that Form 8979 to the AAR. The partnership may also use Form 8979 to revoke the current PR and to designate a new one (e.g., when the PR designated on the original return has retired or left the company). A partner from the reviewed year must sign the Form 8979, attesting that the partner has the authority to revoke the PR and designate a new PR for the reviewed year.

Effect on partners that are furnished a Form 8986 push-out statement

Passthrough partners: Assume a lower-tier partnership files an AAR (AAR partnership) and pushes out the adjustments to an upper-tier partnership. The push-out process is designed to allow for the AAR adjustments to flow up from the AAR partnership through each tier in the partnership structure and ultimately reach partners that are individuals or taxpaying entities. To accomplish this flow of adjustments, the BBA rules require any "passthrough partner" that receives a Form 8986 from a lower-tier entity to issue its own Forms 8986 to its "affected partners." The passthrough partner must file a copy of these Forms 8986 with the IRS together with a "partnership adjustment tracking report" on Form 8985. For these purposes, a "passthrough partner" includes an upper-tier partnership, an S corporation, an estate of a deceased partner, and a trust (other than a grantor trust). An "affected partner" is a person that held an interest in the passthrough partner at any time during the passthrough partner's tax year to which the adjustments in the Form 8986 relate.

In lieu of pushing out the adjustments, the passthrough partner may choose to pay an imputed underpayment with respect to any adjustments that are not favorable. That imputed underpayment is calculated using the highest rate of tax, and a passthrough partner cannot use any modifications to reduce that imputed underpayment. Similar to the AAR partnership, a passthrough partner *must* push out to its affected partners any AAR adjustments that are favorable, such as an increase in an amount of a deduction or credit.

In some cases, a passthrough partner that is itself a BBA partnership may find that the adjustments pushed up from a lower-tier partnership change the partner's own items in the reviewed year or subsequent years. For example, an adjustment increasing income may cause the passthrough partner's own allocations to change, or the increase in income may release a previously unused deduction or affect gain reported on a disposition of an interest in the lower-tier entity. In these cases, the passthrough partner may determine it needs to file its own AAR while simultaneously pushing out the adjustments from the lower-tier entity.

A passthrough partner has until the extended due date for the return for the adjustment year of the AAR partnership to file and issue its own Forms 8986. For example, if an AAR is filed in 2024 by a calendar-year partnership, the adjustment year will be 2024, and all Forms 8986 must be filed and furnished by each passthrough partner within the structure on or before Sept. 15, 2025. (The Sept. 15, 2025, deadline applies even if the AAR partnership did not actually obtain an extension for the 2024 tax year.) The instructions to Forms 8985 and 8986 require incoming and outgoing tracking numbers to be included on each Form 8985 and Form 8986 as the adjustments flow up through the tiers.

A failure to push out the adjustments timely (or to pay the imputed underpayment timely) will make the passthrough partner liable for an imputed underpayment based on its share of the AAR adjustments. Interest will be due on the imputed underpayment, starting with the return due date for the passthrough partner's reviewed-year return. Unless the passthrough partner can demonstrate reasonable cause existed for the filing failure, the passthrough partner also is liable for penalties under Sec. 6698 for the failure to file the Form 8985, under Sec. 6651(i) for the failure to pay the imputed underpayment timely, and under Sec. 6722 for the failure to timely furnish the Forms 8986. Therefore, in a multitiered passthrough structure, timely pushing out the adjustments is critical so that each passthrough partner has sufficient notice and time to push out the adjustments at its level, lest it be subject to an imputed underpayment liability and associated interest and penalties.

Individuals and taxable entities: A partner that is an individual or taxable entity (a "taxpaying partner") that is furnished a Form 8986 — either as a reviewed-year partner of the AAR partnership or as an affected partner of a passthrough partner — generally must pay any tax due or use any tax benefit arising from the AAR adjustments on the partner's reporting-year return. The "reporting year" is the partner's tax year that includes the date on which the AAR partnership filed the AAR and furnished Forms 8986 to its reviewed-year partners (i.e., the date reported in Part II, Item G, on Form 8986).

> ***Example 1:*** On Aug. 1, 2024, a calendar-year partnership files an AAR to adjust a 2022 return and furnishes Forms 8986 to its reviewed-year partners. The reporting year will be 2024 for all taxpaying partners in the chain of ownership (including reviewed-year partners and any affected partners) that operate on a calendar-year basis. This is the case even if an affected partner receives its Form 8986 from a passthrough partner in 2025. (Recall that a passthrough partner generally has until Sept. 15 of the year following the year in which the AAR is filed to issue its own Forms 8986.)

A taxpaying partner determines the tax due or tax benefit arising from the AAR adjustments by determining the "additional reporting-year tax." In general, the additional reporting-year tax is computed by determining for each tax year affected by the adjustments a "correction amount," starting with the partner's first affected year (the year that includes the end of the partnership's reviewed year) and ending with the tax year preceding the reporting year. The correction amount is the amount by which the partner's Chapter 1 income tax would have increased or decreased, taking into account any necessary adjustments to partner-level attributes (e.g., a loss carryforward), had the AAR adjustments been properly reported on the partner's first affected-year return (including any amended return filed for the first affected year).

The correction amounts are summed together to arrive at the additional reporting-year tax. A partner reflects the additional reporting-year tax on Form 8978, *Partner's Additional Reporting Year Tax*, with the adjustments themselves appearing on Form 8978, Schedule A, *Partner's Additional Reporting Year Tax (Schedule of Adjustments)*. The instructions to Form 8978 provide that the partner should include a statement showing the partner's calculation of the correction amounts and the additional reporting-year tax.

A positive amount of additional reporting-year tax generally will increase the partner's Chapter 1 tax for the reporting year. In contrast, a "negative" amount of additional reporting-year tax operates similar to a nonrefundable credit in that it may decrease the partner's reporting-year tax to zero, thereby allowing the refund of any overpayment for the reporting year. However, it is the IRS's position that a negative additional reporting-year tax cannot independently generate a refund as a refundable credit would.

> ***Example 2:*** Partner *A* receives a Form 8986 reflecting an AAR adjustment that would cause a $500 decrease in *A*'s Chapter 1 tax for 2022. Partner *A*'s 2024 reporting year is 2024, and *A*'s Chapter 1 tax is $100. The $500 decrease reduces *A*'s 2024 Chapter 1 tax to zero, allowing *A* to claim a refund of any amounts paid toward Chapter 1 tax for 2024. However, the IRS's position is that the remaining $400 left over of the 2022 decrease in tax does not give rise to a refund of $400 for the 2024 tax year. Furthermore, the IRS takes the position that there is no ability to carry back or forward that leftover decrease in 2022 tax, creating a stranded overpayment in the amount of $400.

Effects on partners can be varied

This item discusses the general requirements and forms used for filing an AAR and highlights some of the effects filing an AAR may have on the partnership's partners. However, the facts and circumstances will dictate the application of the general AAR rules to a particular partnership or partner. Careful consideration should be given to both the general rules discussed above and the facts specific to a particular taxpayer when determining the steps for filing an AAR and the consequences on the partnership's partners.

From Greg Armstrong, J.D., LL.M., Minneapolis

State & Local Taxes

Inconsistency in state conformity to the Code

State conformity to the federal Internal Revenue Code is not a new topic, but it continues to challenge states and taxpayers whenever Congress amends the Code. This item aims to look beyond the more routine conformity issues and explore some overlooked complexities imposed by state incorporation of the Code. It also highlights recent examples of why paying close attention to the nuances of how states conform to the Code can meaningfully inform taxpayers' state tax positions.

PHOTO BY CAGKAN/ADOBE STOCK

What is conformity?

The concept of one jurisdiction adopting another's law — commonly referred to as "incorporation" — is not unique to state adoption of the Code. Voluminous scholarship addresses interjurisdictional incorporation of law in both the domestic and international context. While state tax practitioners are familiar with the concept of incorporation (likely under the term "conformity") as a standard facet of the state income tax landscape, some specific underlying aspects of incorporation of the Code into state law may fly under the radar. These peculiarities posed by broad incorporation of the Code can present more than just academic curiosities.

At its base, incorporation of extraterritorial law by a jurisdiction — including state adoption of the Code — either by specific provision or more broadly, is treated "as if the referenced material were set out verbatim in the referencing statute" (*Artistic Entertainment, Inc. v. City of Warner Robins*, 331 F.3d. 1196, 1206 (11th Cir. 2003)). Under this general rule, a state's adoption of the Code has the effect of writing the entire Code into state law (see *Jam v. International Finance Corp.*, 139 S. Ct. 759 (2019) (stating that a reference statute "in effect cuts and pastes the referenced statute")). Thus, when a state adopts specific provisions or chapters of the Code for purposes of computing its income tax, that has the effect of rewriting the referenced portion of the Code into state law.

Why do states conform and what are the limitations on conformity?

States generally conform to the Code to simplify the calculation of taxpayers' income taxes and to make the administration of the state tax system simpler and more efficient. These efficiencies of conformity, however, often butt up against other state policy concerns such as state budgets and state-specific incentives that do not necessarily align with those of the federal government. Further, as Congress inevitably continues to amend the Code, the federal policy goals animating those amendments may change over time, causing states to adjust their conformity to the Code or limit their adoption of future changes.

While all states appear to permit incorporation, they generally provide some limitations on the practice. For example, some states do not allow for dynamic incorporation (i.e., "rolling" conformity) pursuant to anti-delegation provisions contained in their state constitutions, which bar the delegation of legislative power to any persons or bodies other than the state legislature (leading to "static" conformity). Even the desire for administrability does not and seemingly cannot override a prohibition against delegation. Additionally, the desire for administrability does not stop states from decoupling from specific Code provisions for various policy or budgetary reasons.

Even within the specific categories of static or rolling conformity to the Code, the use of varied language in conformity statutes can create complexities. For instance, some static-conformity states adopt the Code "as amended" on a certain date, while other static-conformity states adopt the Code as "in effect" on a certain date. While it may be easy to gloss over these subtle distinctions, the specific words make a difference.

Curious complications of conformity

While determining and tracking state conformity to the Code can present numerous practical issues, substantive issues can arise even after the conformity rule of a given state is determined.

First, a practical concern is issues caused by Congress's adopting retroactive tax provisions. For example, when the Coronavirus Aid, Relief, and Economic Security (CARES) Act, P.L. 116-136, was enacted in 2020, it amended the treatment of excess business loss deduction limits by suspending them retroactively for 2018 and 2019. The Colorado Department of Revenue (DOR) interpreted its rolling conformity statute to apply only prospectively and denied a taxpayer's claim for refund filed for 2018 and 2019, applying the CARES Act retroactive amendments. The Colorado Court of Appeals overturned the DOR's refund denial and held that Colorado's conformity statute requires conformity to retroactively effective amendments to the Code (*Anschutz v. Colorado Dep't of Rev.*, 524 P.3d 1203 (Colo. App. 2022) (holding, in part, that Colorado's conformity statute "includes 'the provisions of the [Code], as amended … for the taxable year,' without any limitation as to when any amendment is enacted or goes into effect")). Other states with conformity statutes that include limitations based on when the amendments to the Code are "in effect" could reach different conclusions as to whether and when retroactive changes to the Code apply for state purposes.

Second, when states decouple from provisions of the Code for policy reasons, it can frustrate the efficiency goal of administrability both directly and indirectly, depending on the way sections of the Code interrelate with each other. For instance, many states decouple from the federal bonus depreciation provisions for budgetary reasons. This decoupling creates significant compliance costs for taxpayers, as it requires taxpayers to maintain multiple depreciation schedules. Because depreciation affects the basis in an asset for purposes of computing gain and loss on the sale of the asset, taxpayers may also have to track both a federal and state basis in depreciable assets for many years, arguably defeating the goal of administrability.

The specific ways in which states decouple from bonus depreciation can create additional complexities. Most states begin the calculation of state taxable income with a taxpayer's federal taxable income determined under the Code and then make modifications from that starting point. In Michigan, however, the Code is statutorily defined as excluding Sec. 168(k), which provides for bonus depreciation. This distinction makes a difference. Because Michigan adopts a version of the Code without Sec. 168(k), taxpayers must recompute interest limitations under Sec. 163(j) of the Code as if bonus depreciation did not exist. This results in taxpayers' having to track Michigan-only interest limitations and related carryforwards in years when bonus depreciation affects the calculation of interest limitations for federal purposes.

Third, incorporation can also cause complexities and hinder the goal of administrability when certain federal concepts are *not* carved out from a state's general incorporation of the Code. The complexity caused by such conformity relates to the natural friction between the federal tax regime and some state tax regimes. For example, issues can arise when states that require taxpayers to file on a separate-entity basis adopt an unmodified provision of the Code that is adjusted for federal purposes due to a taxpayer's consolidated filing at the federal level.

For example, the regulations under Sec. 385 treat members of a federal consolidated group as one corporation for purposes of the debt-equity recharacterization rules codified at Regs. Sec. 1.385-3. This "one corporation" treatment may not carry over to separate-return states. Therefore, it is possible that an indebtedness could be recharacterized under the federal Sec. 385 regulations as equity for state purposes while no such recharacterization would occur for federal purposes under the consolidated one-corporation fiction. Similar complexities arise in the context of the Sec. 163(j) limitation when it is computed on a consolidated-group basis for federal purposes but on a separate-entity basis in separate-company (and some combined-return) states.

Finally, there is also the issue of states, through general adoption of the Code, incorporating provisions they are likely prohibited from adopting as original legislation. For instance, in *Beatrice Cheese v. Wisconsin Department of Revenue*, the Wisconsin Tax Appeals Commission determined that a Wisconsin law disallowing accelerated depreciation under federal accelerated cost recovery system rules for property located out of the state while allowing accelerated depreciation for in-state property violated the Commerce Clause by discriminating against business done outside Wisconsin (*Beatrice Cheese, Inc. v. Wisconsin Dep't of Rev.*, Nos. 91-I-100, 91-I-102 (Wis. Tax App. Comm'n 2/24/93)). The commission found that the effect of this differential treatment was to impose a higher franchise tax burden on a business solely because its depreciable property was located outside Wisconsin. Similarly, in *R.J. Reynolds Tobacco Co. v. City of New York Department of Finance*, the Appellate Division of the New York Supreme Court found that a New York City ordinance discriminated against out-of-state property holders in violation of the Commerce Clause because it disallowed an accelerated depreciation deduction for a corporation's property placed in service outside New York, while allowing such a deduction for property located in

New York (*R.J. Reynolds Tobacco Co. v. City of New York Dep't of Fin.*, 237 A.D.2d 6 (N.Y. App. Div. 1997)).

Courts have also held that discriminatory tax provisions adopted by reference similarly violate the Commerce Clause. In *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance*, 505 U.S. 71 (1992), the U.S. Supreme Court held that Iowa's corporate income tax unconstitutionally discriminated against foreign commerce because it "impose[d] a burden on foreign subsidiaries that it [did] not impose on domestic subsidiaries." Specifically, through its conformity to the Code, Iowa disallowed a deduction for dividends received from foreign subsidiaries but allowed a deduction for dividends received from similarly situated domestic subsidiaries, which discriminated against foreign commerce.

Notwithstanding the relevant case law, states have broadly adopted the version of Sec. 174 amended by the law known as the Tax Cuts and Jobs Act (TCJA), P.L. 115-97, which discriminates against foreign commerce in favor of domestic commerce. In fact, the House Ways and Means Committee report for the TCJA states that Congress intended that "research and experimentation expenditures that are attributable to research conducted outside of the United States should be amortized over a longer period so as to encourage research and experimental activities inside the United States" (H.R. Rep't No. 115-409, 115th Cong., 1st Sess., at 282 (2017)). While Congress is free to discriminate against foreign commerce via its power to regulate such activity under the Commerce Clause, state adoption and application of such rules — either as original legislation or by reference — would seem to violate the Commerce Clause, similar to the discriminatory provisions addressed in *Kraft*, *Beatrice Cheese*, and *R.J. Reynolds Tobacco*.

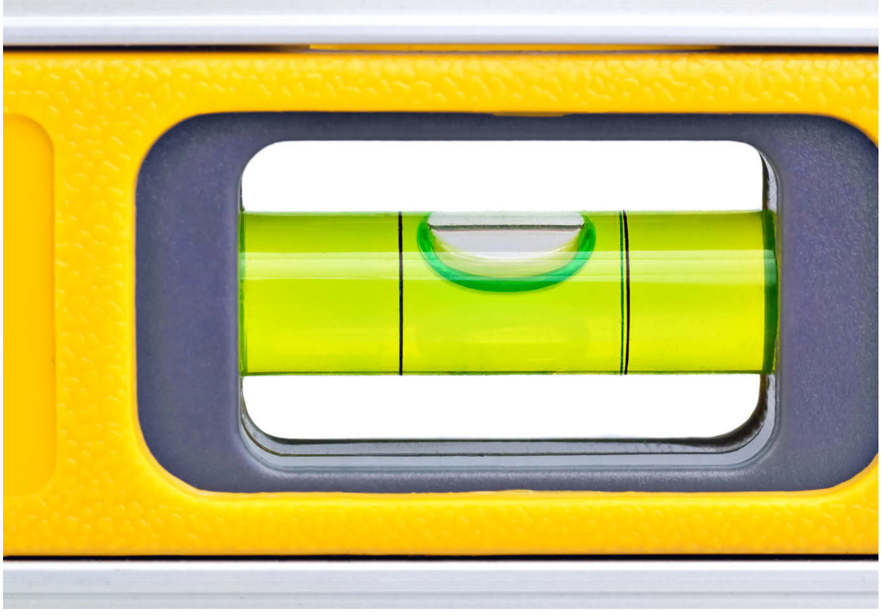
PHOTO BY KMIRAGAYA/ADOBE STOCK

More changes ahead

Undoubtedly, Congress will continue to make changes to the Code to achieve policy goals that will shift over time. As of this writing, a bill is being considered by the 118th Congress that would amend the treatment of certain research and experimental expenses retroactively (H.R. 7024). The application of these provisions and others sure to be seen in the future will require states and taxpayers to look closely at whether, when, and how states, through their conformity to the Code, will apply those changes. The state tax amounts related to these changes can be substantial, making familiarity with state conformity to the Code critical.

From Daniel De Jong, J.D., LL.M., Washington, D.C., and Andrew Grace, J.D., Atlanta

Is Illinois's sales tax playing field really level?

Since the U.S. Supreme Court's decision in *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080 (2018), a few lawsuits have alleged that the sales tax collection and remittance obligations imposed by a state or locality post-*Wayfair* were unduly burdensome. A recent suit, filed with the Illinois Tax Tribunal, is *PetMed Express, Inc. v. Illinois Department of Revenue*, No. 23 TT 104 (Ill. Indep. Tax Trib. 11/28/23) (petition filed). PetMed Express, also known as PetMeds, a Florida-based remote retailer of pet medications, asserts that the Leveling the Playing Field for Illinois Retail Act (35 Ill. Comp. Stat. 185/5-1) violates the Commerce Clause of the U.S. Constitution and the Uniformity Clause of the Illinois Constitution. The lawsuit also asserts a separate Taxpayer Bill of Rights issue stemming from the procedure of the audit. This discussion focuses on PetMeds' Commerce Clause argument, which contends that the act discriminates against remote retailers compared to retailers that have a physical presence in Illinois.

Illinois's sales tax is called the retailers' occupation tax (ROT) and consists of a state-level ROT and locally imposed ROTs. A separate state use tax applies, but local use taxes generally do

The case may raise awareness as to when differential treatment of in-state retailers and out-of-state retailers may be unconstitutional.

not exist (Chicago is the exception). Prior to the act, remote retailers with economic nexus were required to collect the flat 6.25% state use tax, while in-state retailers collected not only the 6.25% state ROT rate but also local ROT. This allowed consumers to purchase goods more cheaply from remote sellers because there was a higher tax rate for sales by in-state retailers. The act was intended to correct this disparity.

Effective Jan. 1, 2021, the act requires the following:

- *In-state retailers:* Collect ROT at the origin rate.
- *Remote retailers (i.e., retailers with no physical presence in Illinois):* Collect ROT at the destination rate, assuming the retailer has economic nexus.
- *Out-of-state sellers with physical presence in Illinois:* If selling activities occur in Illinois for the particular transaction, collect ROT at the origin rate. Otherwise, collect the 6.25% state use tax rate.

In its lawsuit, PetMeds argues primarily that requiring remote retailers to use destination sourcing is an unfair burden because sellers with a physical presence in Illinois can use much simpler origin sourcing.

For background, "origin sourcing" requires retailers to collect the tax rate for a particular transaction based on the seller's in-state location or ship-from location. "Destination sourcing" requires retailers to collect the tax rate based on the location where the customer takes possession of the item sold, which is generally the customer's ship-to location. Most U.S. state sales taxing jurisdictions implement destination sourcing for all retailers.

PetMeds' position

PetMeds sells pet medications, food, supplements, and other items that are shipped from out of state via common carrier directly to customers in Illinois. For Illinois ROT purposes, PetMeds is considered a remote retailer. Pursuant to the act, PetMeds was required to collect and report ROT based on each Illinois local jurisdiction where products were delivered to customers. PetMeds stated in its petition that it delivered goods to over 900 destinations in Illinois and incurred significant expenses by engaging a third-party software provider to assist with the calculation and remittance of Illinois local ROT. From a local ROT compliance perspective, remote retailers are required to: (1) identify the location code for each destination to which a taxable sale is delivered; (2) register each individual location code onto the taxpayer's MyTax Illinois account; and (3) remit the local ROT for each jurisdiction on a separate form (Form ST-2, *Multiple Site Form*) from the tax return form (Form ST-1, *Sales and Use Tax and E911 Surcharge Return*). Identification of location codes requires manually inputting the address of each purchaser and validating the address with a nine-digit ZIP code to conduct a location code inquiry, according to the petition.

Count I of the petition addresses the Commerce Clause challenges, and, at heart, PetMeds is asserting that it is treated unfairly under the act as compared to retailers that have some Illinois presence. First, PetMeds alleges that the act discriminates against interstate commerce by imposing destination-based sourcing on sales by remote retailers and origin-based sourcing on sales by similarly situated retailers with an Illinois presence (minimal or otherwise). This disparate treatment, PetMeds alleges, discriminates against remote retailers by imposing a different and more onerous scheme than is imposed on retailers with physical presence.

PetMeds likewise asserts that the act imposes undue burdens on remote retailers as compared to similarly situated in-state retailers. Specifically, as noted above, PetMeds is required to separately determine and report local ROT for over 900 Illinois jurisdictions. In contrast, retailers with some amount of in-state presence are required to do so only for one or significantly fewer local tax jurisdictions under the origin-based sourcing rules.

PetMeds persuasively cites the U.S. Supreme Court case *Associated Industries of Missouri v. Lohman*, 511 U.S. 641 (1994), for the proposition that the burdens on interstate and intrastate commerce must be equal. While not the main focus of its petition, PetMeds is also required, at times, to collect a higher rate of tax as compared with in-state retailers that collect a lower origin rate, or as compared with out-of-state retailers with a physical presence in Illinois that are required to collect the flat 6.25% use tax rate only. This type of difference in rate collection was the crux of the inequality addressed in *Associated Industries of Missouri*.

How to resolve this issue

Although this case is in its infancy, the question arises as to how Illinois's ROT regime could be fixed if

PetMeds is successful. Ultimately, this is a question for the legislature; however, a couple of possible solutions come to mind.

The first option: Reimplement the 6.25% use tax collection for remote retailers. This is a potential temporary solution; however, the result would be disparate treatment against in-state retailers, which was what the act was intended to fix in the first place. While disparate treatment against in-state retailers does not violate the Commerce Clause, it is problematic nonetheless. At the time of this writing, the average local ROT rate in Illinois is approximately 8.82%, in comparison with the 6.25% use tax rate remote retailers used to be required to collect. This would again prompt Illinois consumers to make their purchases online.

A second option is to implement destination sourcing for all retailers making sales in Illinois, whether they be in-state, out-of-state (with physical presence in Illinois), or remote retailers. This would mean that retailers with a physical presence would no longer look to the location of selling activities as the means of sourcing a sale, which would preclude them from planning where their "selling activities" occur to avoid collection of the local use tax. This option, of course, would not remove the compliance burdens identified in PetMeds' petition; instead, it would impose the same burdensome rule on all sellers. Arguably, the compliance burden felt by in-state sellers may be of no actual effect, particularly in scenarios of brick-and-mortar retail stores lacking an e-commerce platform and not making deliveries. In these scenarios, sales under destination sourcing would still be sourced to the taxpayer's store location (i.e., where the customer takes possession of the item sold), which is the same result as with origin sourcing.

In conjunction with option 2, a third option would be a wholesale overhaul and simplification of Illinois's overall sales tax regime. The current regime has been referred to by the executive director of the Illinois Chamber of Commerce's Tax Institute as "incomprehensible" (Staats, Illinois CPA Society, "Illinois' Incomprehensible Sales Tax Law," *Insight* (Fall 2019)).

What are the potential implications stemming from this decision?

In *Wayfair*, the U.S. Supreme Court observed that although the physical presence requirement was repealed, "other aspects of the Court's Commerce Clause doctrine can protect against any undue burden on interstate commerce." The Court did not set forth any particular test for determining when a state's taxing regime would be unduly burdensome, and the application of the "undue burdens" test in this context is untested. However, the Court cited with approval several aspects of South Dakota's sales tax regime that it believed alleviated any concerns with respect to the situation at hand. Since *Wayfair*, the question many sales tax practitioners have raised is: When will compliance with a state or local tax regime be unduly burdensome so that the Commerce Clause is implicated? The PetMeds dispute may provide guidance on this important question.

The case may also raise awareness as to when differential treatment of in-state retailers and out-of-state retailers may be unconstitutional. PetMeds' suit should be monitored closely by states that apply differing sales or use tax sourcing regimes for in-state versus out-of-state or remote retailers, such as California, Tennessee, Texas, Utah, and Virginia. Similar to Illinois, these states require in-state retailers to collect tax based on the origin of the sale, while remote retailers must collect tax based on the destination of the sale. In sum, to the extent that these state regimes favor in-state retailers, the state similarly runs the risk of lawsuits.

Texas offers an election for remote retailers to collect a single local use tax rate of 1.75%; this removes a remote retailer's compliance burden. However, one could point out that this is disadvantageous for certain remote retailers because some Texas local jurisdictions have a zero local use tax rate, a benefit for in-state retailers in such jurisdictions.

Wrapping it up

Unequal treatment of remote retailers potentially violates the Commerce Clause. Under the complex sales and use tax sourcing regimes implemented in Illinois and some other states, questions arise about equal treatment of remote retailers, flipping the concerns raised in *Wayfair* about equal treatment of in-state retailers. Remote retailers are, in fact, treated differently in these states, which the Court in *Wayfair* noted could potentially have the effect of discriminating against interstate commerce.

From Sarah McGahan, J.D., LL.M., Houston, and Cory Van Arnum, J.D., LL.M., Jacksonville, Fla. ■

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