TAX CLINIC

Practical advice on current issues.

Editor:
Mary Van Leuven, J.D., LL.M.

In This Department

Contributors are members of or associated with KPMG LLP.

For additional information about these items, contact Van Leuven at mvanleuven@kpmg.com.

IMAGE BY PIXEL_DREAMS/ISTOCK

Clean fuel production credit: Regulatory roadblocks ahead

The Sec. 45Z clean fuel production credit is a significant initiative introduced by the Inflation Reduction Act of 2022, P.L. 117-169. This credit aims to incentivize the production of clean transportation fuels, including either sustainable aviation fuel (SAF) or non-SAF transportation fuel, within the United States by offering tax credits to producers that meet specific environmental criteria.

To be eligible for the credit in a specific tax year, taxpayers must produce a qualifying transportation fuel within the United States for sale to an unrelated party for certain specified purposes. A non-SAF transportation fuel must be produced in accordance with certain feedstock requirements, must be suitable for use in highway vehicles or aircraft, and must have a lifecycle greenhouse gas (GHG) emissions rate of no more than 50 kilograms per carbon dioxide equivalent (CO_2e) (based on relative global warming potential) per million British thermal units (mmBTU) (Secs. 45Z(b)(1)(A) and (d)). Alternatively, SAF must adhere to specific industry standards, meet a separate set of feedstock requirements, and be sold for use in aircraft.

On Jan. 10, 2025, Treasury and the IRS issued Notice 2025-10, which contains draft forthcoming proposed regulations for the Sec. 45Z clean fuel production credit, and Notice 2025-11, which includes the Sec. 45Z annual emissions rate table. Also in January, the Department of Energy released the 45ZCF-GREET model, with a user manual and other information, to calculate emissions for non-SAF transportation fuel. Overall, the guidance provides helpful information but ultimately neglects several crucial industry issues. Therefore, taxpayers in the clean fuel industry are evaluating how to apply the notices, given their nonbinding and somewhat ineffective nature.

Overall, the guidance provides helpful information but ultimately neglects several crucial industry issues.

This item explores two key issues among many that are puzzling industry participants: imported used cooking oil (UCO) and the definition of a qualifying sale, particularly for clean fuel producers selling to wholesalers. The lack of clarity in these areas could significantly affect the clean fuel industry's ability to generate the Sec. 45Z credit.

Imported UCO

The forthcoming proposed regulations do not provide specific guidance on the use of imported UCO as a feedstock eligible for the Sec. 45Z credit, specifically with respect to non-SAF transportation fuel. Notice 2025-10 contemplates concerns regarding the identification and market implications of imported UCO, particularly the risk of mislabeling substances such as virgin palm oil as UCO. Compared to palm oil, genuine UCO has a significantly lower GHG emissions rate, meaning that producing biodiesel from UCO generates considerably fewer carbon emissions than producing it from palm oil. This is primarily because UCO is considered a waste product that would otherwise be discarded, while palm oil production is often linked to large-scale deforestation, leading to high GHG emissions. Therefore, this mislabeling could potentially lead to higher emissions impacts than genuine UCO. Due

to these concerns, the notice provides that pathways using imported UCO are currently unavailable in the 45ZCF-GREET model until further guidance is issued. When the current 45ZCF-GREET model does not include certain feedstocks such as imported UCO in its production pathways, the taxpayer must request a provisional emissions rate (PER) to establish an official emissions rate for its product.

This guidance fails to provide a specific PER process for taxpayers to follow, which creates significant uncertainty for industry participants that have relied on imported UCO as a sustainable feedstock, and this lack of a defined process will lead to difficulties in ensuring compliance and claiming the Sec. 45Z credit. To complicate this further, there is not an anticipated date for further guidance under the new administration; therefore, taxpayers that use imported UCO will be left searching for answers in the interim, making it difficult to estimate this incentive's benefits.

Qualifying sale

Next, a contentious issue is the impact of Notice 2025-10's limiting definition of a "qualifying sale." Sec. 45Z(a)(4) provides three ways a taxpayer can demonstrate a qualifying sale. One is a sale to an unrelated person "for use by such person in a trade or business" (Sec. 45Z(a)(4)(B)). This statutory language has been interpreted by many industry participants to give a broad application of the term "use" to a purchaser's business activities, including wholesaling. The initial guidance, however, refines this definition by clarifying that a sale "for use in a trade or business" means "sold for use *as a fuel* in a trade or business *within the meaning of section 162 of the Code*" (emphasis added). The introduction of the limiting requirement that the purchaser's use be exclusively as a fuel within the meaning of Sec. 162 is a clear deviation from the statutory language but appears intentional. The narrowly applied definition provided in the draft text of the forthcoming proposed regulations

PHOTO BY ARADAPHOTOGRAPHY/ADOBE STOCK

consequentially appears to exclude sales to wholesalers by clean fuel producers.

This proposed interpretation is significant because wholesalers play a crucial role in the supply chain by purchasing large quantities of fuel from producers and then distributing it to retailers or directly to end users, allowing producers to reach a broader market. This arrangement benefits producers by providing a steady demand for their products and reducing the complexity and costs associated with direct sales and distribution logistics. Hence, the additional language in the forthcoming proposed regulations leaves a gap in understanding whether these transactions qualify for the credit, potentially excluding a significant portion of the market from the benefit of the Sec. 45Z credit. Taxpayers are wondering if Treasury and the IRS intended this result, because the inclusion of a wholesaler in the supply chain would seemingly negate the credit for the producer's sale of otherwise eligible fuel.

Gaps in the guidance

Overall, taxpayers have several concerns about the notices. While these notices offer some guidance, there is uncertainty about how much of the forthcoming proposed regulations will be finalized and enforceable as drafted in their present form. Most significantly, as outlined above, there are several gaps in the guidance, leaving the industry concerned and unable to adequately plan for how to apply the Sec. 45Z credit.

From Kelsey Latham, CPA, Houston; Julie Chapel, J.D., Oklahoma City; and Taylor Cortright, J.D., LL.M., Washington, D.C.

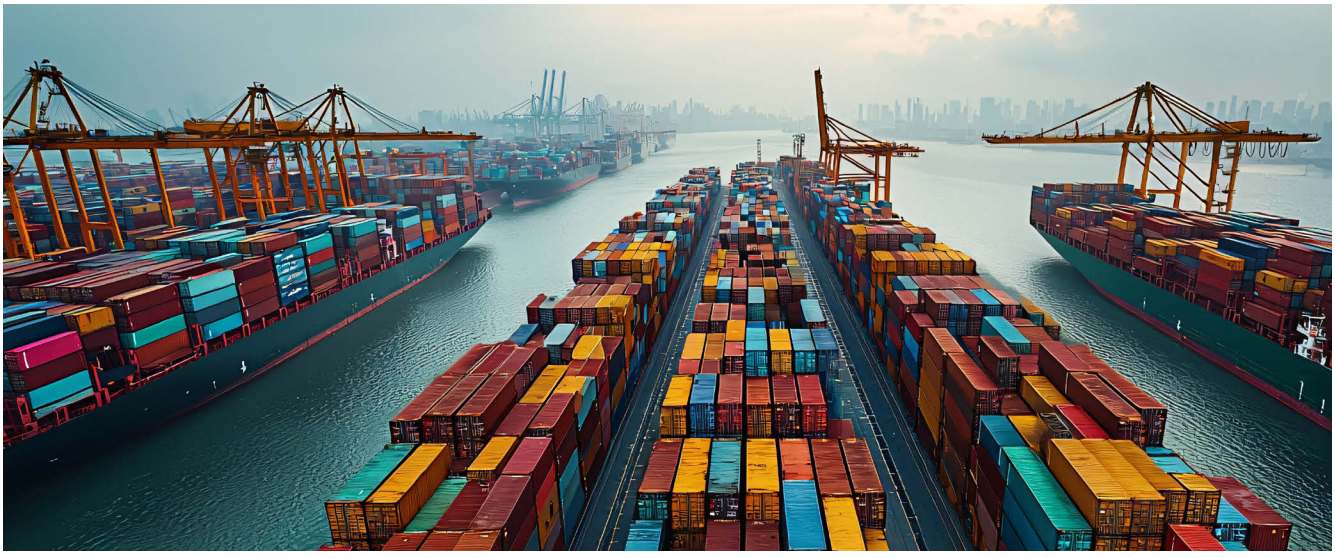
Treaty-based foreign tax credit and net investment income tax

The U.S. Court of Federal Claims, a court of national jurisdiction, issued two rulings in favor of U.S. citizens living abroad by allowing a treaty-based foreign tax credit (FTC) to offset the net investment income tax (NIIT) (*Bruyea*, 174 Fed. Cl. 238 (2024), and *Christensen*, 168 Fed. Cl. 263 (2023)). Both cases are pending appeal in the Federal Circuit (*Bruyea*, No. 25-1563 (Fed. Cir. 3/20/25) (appeal docketed); *Christensen*, No. 24-1284 (Fed. Cir. 12/22/23) (appeal docketed)). If upheld, the outcome of these cases could help alleviate the burden of double taxation for many U.S. citizens living abroad. This item explores practical considerations for taxpayers while these cases are being litigated.

Background

U.S. citizens are subject to U.S. federal income tax on their worldwide income regardless of their country of residence or source of income and may be subject to double taxation (Sec. 1; Regs. Sec. 1.1-1(b)). Double taxation is generally mitigated by claiming an FTC provided either under the domestic rules or a provision of an applicable treaty providing relief from double taxation (Secs. 27 and 901–909; see, e.g., 2006 and 2016 United States Model Income Tax Convention, Article 23). In addition to federal income tax, U.S. citizens and residents are subject to the NIIT, which is imposed on certain net investment income, such as interest, dividends, capital gains, and rents (Sec. 1411). Under the domestic FTC rules, a credit for foreign taxes cannot offset the NIIT, codified in Chapter 2A of the Internal Revenue Code, because the credit may only be applied against taxes codified in Chapter 1 (Secs. 27, 901, and 1411).

One of the questions presented in *Christensen* and *Bruyea* is whether the treaty-based FTC is subject to the same limitations imposed by the FTC domestic rules. The taxpayers in both cases argue that the treaty-based FTC at issue is not subject



to the same limitations of the Code; thus, the treaty-based FTC can be used to offset the NIIT. In contrast, the U.S. government asserts that the relevant treaty provisions require the credit to be in accordance with the provisions of and subject to the same limitations of U.S. law. Therefore, the treaty-based FTC is limited to Chapter 1 taxes and cannot be used to offset the NIIT.

The Court of Federal Claims held in favor of the taxpayers in both cases. However, the court took different paths to reach its decisions, with different implications (for a discussion of both cases, see also Brennan et al., "Current Developments in Taxation of Individuals: Part 2," 56-4 *The Tax Adviser* 36 (April 2025)). If upheld by the Federal Circuit, the holding in *Christensen* would apply to a small number of U.S. citizens relying on a specific paragraph of the U.S.-France income tax treaty provision, while the holding in *Bruyea* would have a broader impact on taxpayers seeking a treaty-based credit. In addition to the potential for refunds and the reduction of a future tax liability, any future taxpayer-favorable appellate decision could provide much-needed clarity for U.S. citizens residing abroad with respect to a treaty-based FTC and its applicability to the NIIT.

Practical considerations

A taxpayer-favorable decision by the Federal Circuit would provide support for individual taxpayers claiming a treaty-based credit provided under an applicable treaty against the NIIT. However, the government could appeal to the Supreme Court, prolonging the final judgment for years. In the interim, the IRS is likely to reject the claims of individual taxpayers taking such a position. With this in mind, a taxpayer could choose to (1) claim a treaty-based FTC against their NIIT on their current return; (2) file a protective refund claim for open years approaching the end of the statute of limitation; or (3) take no action until the law is settled. With the exception of the wait-and-see approach, the taxpayer will face both procedural and practical obstacles and should weigh the options carefully before taking a position.

Option 1. Claim the treaty-based FTC on a current U.S. return: A taxpayer keen on offsetting the NIIT with a treaty-based FTC should be made aware that there is no clear process allowing for such a position

PHOTO BY WIS/ADOBE STOCK

to be taken on a U.S. return. To claim a treaty-based FTC on a U.S. return, the taxpayer may have to modify Form 8960, *Net Investment Income Tax — Individuals, Estates, and Trusts*, by adding additional lines to show the reduction of the NIIT by a treaty-based FTC (see, generally, *Toulouse*, 157 T.C. 49 (2021)). In addition to modifying Form 8960, a disclosure on Form 8833, *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)*, would be required, as claiming an FTC against the NIIT is a treaty position that modifies U.S. law, and it is not specifically waived from the disclosure requirement (see Sec. 6114 and Regs. Sec. 301.6114-1). As indicated above, the IRS is likely to disallow the credit while the cases are being litigated in court. If the claim for the credit is denied, the taxpayer may appeal the denial to the IRS but ultimately may not have much recourse other than to file their own refund suit in a federal court.

Option 2. File a protective refund claim: The statute of limitation on a refund claim related to an FTC is 10 years rather than the general three-year period (Sec. 6511(d)(3); Regs. Sec. 301.6511(d)-3(a)). A taxpayer may choose to file a protective refund claim for open tax years to preserve their right to a refund before the refund period expires. A protective refund claim is a claim that is "contingent on future events and may not be determinable until after the statute of limitations expires" (Chief Counsel Advice memorandum 200848045). The IRS will generally accept a protective claim even if a specific refund amount is not stated, so long as the claim is sufficiently clear to inform the Service of the nature of the claim and for which year(s) a refund is sought. However, the IRS has discretion in deciding how to process protective claims. The IRS may delay action on the protective claim until the contingency (pending litigation, in this case) is resolved or simply process the claim and disallow the refund (id.).

If upheld, the outcome of these cases could help alleviate the burden of double taxation for many US citizens living abroad.

If the latter, the IRS will issue a certified notice of disallowance to the taxpayer that will start a two-year clock on the taxpayer's right to file suit in U.S. district court or the Court of Federal Claims (Secs. 6532(a)(1) and 7422(a)). If this two-year period expires without a refund suit being filed and the taxpayer has not obtained an extension on the two-year clock by getting the IRS to sign a Form 907, *Agreement to Extend the Time to Bring Suit*, the taxpayer loses their right to obtain the refund, even if the taxpayer's position ultimately prevails (Secs. 6532(a)(2) and 7422(a)).

Option 3. Wait and see: The last option for the taxpayer is to take no action other than to have the patience and willingness to wait out the judicial process. If a taxpayer-favorable ruling is decided, then the taxpayer may be allowed to claim a treaty-based FTC on their current return or amend a prior return for any tax year that is within the 10-year statute of limitation to claim a refund (see Sec. 6511(d)(3) and Regs. Sec. 301.6511(d)-3(a)).

Beyond *Christensen* and *Bruyea*

If the lower court's rulings are upheld in the Federal Circuit and the government acquiesces, the IRS must modify certain forms and schedules to provide a way for taxpayers to claim a treaty-based FTC against the NIIT. Additionally, because a taxpayer's

NIIT is determined based on the lesser of the net investment income or the amount in excess of the statutory threshold (based on filing status), clarity around which category of FTC (e.g., general, passive, or a combination of both) applies to offset the NIIT would be needed (see Secs. 904 and 1411(a)(1); Regs. Secs. 1.861-20 and 1.904-6). Thus, even with a resolution of the controversy, until the IRS issues guidance concerning the treatment of a treaty-based FTC, uncertainty around proper application of the credit is likely to continue.

From Yoori Sohn, J.D., LL.M., Washington, D.C.

Excise taxes

Federal excise tax traps for the unwary

The U.S. government imposes federal excise taxes that can affect a surprising variety of companies. These taxes include the foreign insurance excise tax, the Patient-Centered Outcomes Research Institute (PCORI) fee, and the relatively new stock repurchase excise tax. Compliance with these taxes can be complicated, creating many traps for the unwary. This item discusses recently observed compliance trends to highlight some potential traps and provides suggestions to mitigate penalties and interest.

Introduction: What are excise taxes?

Excise taxes are imposed on a wide variety of sales, uses, activities, and transaction types, potentially spanning across many commodities, services, and industries. The taxpayer can be various parties in the supply chain, such as the manufacturer, the importer, the retailer, or the consumer. Congress periodically amends or adds federal excise taxes to the Internal Revenue Code for a variety of policy reasons. For example, some federal excise taxes fund specific trust funds (e.g., the Highway Trust Fund, Airport & Airway Trust Fund, and Superfund). Other federal excise taxes are so-called sin taxes designed to influence consumer behavior (e.g., excise taxes on alcohol, tobacco, firearms, and wagering). Federal excise taxes are imposed on such a wide variety of activities that a constant awareness and review of developments and a program of active coordination among information owners is needed to avoid accidental noncompliance.

Most federal excise taxes are reported on Form 720, *Quarterly Federal Excise Tax Return*. Failure to file Form 720; pay federal excise tax timely; and, in some cases, submit deposits of tax on a semimonthly basis can lead to assessment of penalties and interest. Therefore, companies must understand their federal excise tax obligations and establish a process to timely file Form 720 and pay tax.

Form 720 filing, payment, and deposit rules

Form 720 is a quarterly return that is due on the last day of the month following the close of the calendar quarter, subject to special rules for weekends and holidays (Regs. Sec.

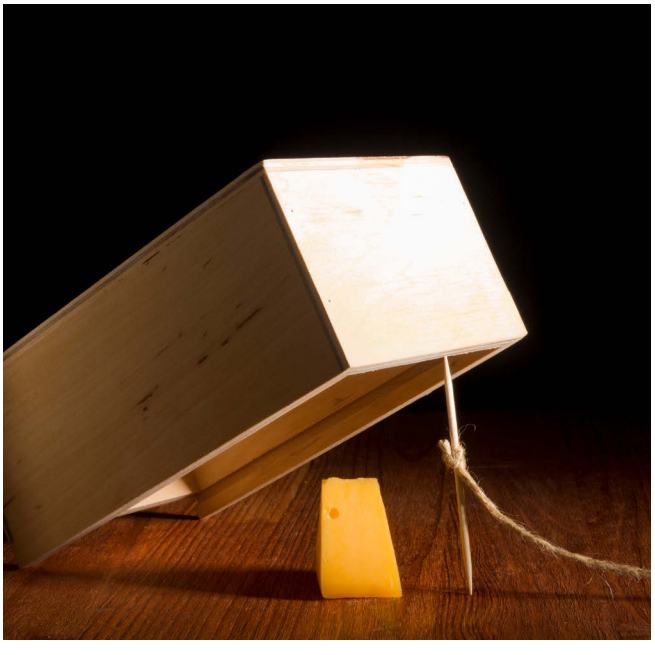


PHOTO BY ART OF SUCCESS/ADOBE STOCK

40.6071(a)-1(a)). Any liability not already satisfied by a deposit, overpayment, or other type of payment must be paid in full on the return's due date.

Form 720 is not a consolidated return. Generally, federal excise taxes must be reported on Form 720 on an entity-by-entity basis, even if the entity is disregarded from its owner for income tax purposes (Regs. Secs. 301.7701-2(c)(2)(v)(A) and (B)). In other words, if an entity disregarded from its owner has its own federal employer identification number, it will have its own Form 720 filing obligation. Taxpayers must ensure that the correct entity or entities within the corporate structure are filing Form 720 and remitting excise tax based on the activities occurring in each legal entity. Importantly, Form 720 is a composite return, meaning multiple types of federal excise taxes can be reported on a single form each quarter.

Many federal excise taxes are subject to semimonthly deposit requirements in addition to a quarterly return of tax (Regs. Sec. 40.6302(c)-1(a)). Each semimonthly deposit must equal at least 95% of the taxpayer's net tax liability for the period, come within a safe harbor, or meet the *de minimis* exemption (Regs. Secs. 40.6302(c)-1(b) and (e)). Deposits are generally due on the 14th and the 29th of the month for the preceding two-week period, subject to special rules for weekends, holidays, and an extra September payment. They must be made by electronic funds transfer (Regs. Secs. 40.6302(c)-1(c) and (d)), and failure to timely deposit when required may be subject to penalty (Sec. 6656). Failure to timely file or pay may also be subject to penalty (Sec. 6651).

Foreign insurance excise tax

Sec. 4371 generally imposes the foreign insurance excise tax (FIET) on premiums paid to foreign insurers and reinsurers to insure or reinsure U.S. risks. Depending on the type of insurance at issue, the rate of tax is either 1% or 4% of the premium paid (Sec. 4371). The person liable for tax is generally the insured who pays the premium to any nonresident broker, agent, solicitor, or insurer, although the regulations allow the IRS to collect the tax from any of these parties (Regs. Sec. 46.4374-1). In some cases, a broker's statement will include information about the tax.

Premiums paid to foreign insurers and reinsurers in certain countries may be exempt pursuant to a tax treaty between the United States and the country concerned. In many cases, a foreign insurer will obtain a closing agreement with the IRS to substantiate its exempt status (see Rev. Proc. 2003-78, as amended by Rev. Proc. 2015-46). Premiums paid to foreign insurance companies located in countries that do not have a treaty-based exemption, such as Bermuda, are typically taxable.

The decision around the type of insurance to obtain and the insurer from whom to obtain it is often not made within a company's tax department, which would normally have federal excise tax responsibilities. Instead, professionals in companies' treasury, risk, human resources (HR), or other departments may control insurance relationships. Therefore, some due diligence may be required to identify a company's potential liability for FIET. In addition, FIET is subject to the deposit requirements described earlier, meaning a taxpayer has only about two weeks to make a deposit of tax after a premium is paid. Communication between the procurement team and the tax team is essential to establish a process to meet all FIET deposit, payment, and filing requirements. Any failures to timely deposit, file, or pay may expose the company to penalties and interest.

Federal excise taxes are imposed on such a wide variety of activities that a constant awareness and review of developments and a program of active coordination among information owners is needed to avoid accidental noncompliance.

The following practices may streamline the tax reporting process and limit exposure to penalties and interest:

- Consider whether U.S. risks are covered by a group insurance policy;
- Coordinate within the company to identify the timing and amount of premium payments;
- Classify the type of insurance to ensure the correct rate of tax;
- Consider whether payment to a foreign insurer may be entitled to a treaty benefit and identify whether additional reporting for adopting a treaty-based position is necessary; and
- Review the broker statement and coordinate with the broker, if needed.

Patient-Centered Outcomes Research Institute (PCORI) fee

The PCORI fee is a federal excise tax established to fund the PCORI, an independent, not-for-profit organization that funds and promotes health care research (Secs. 4375 and 4376). Sec. 4376 imposes an excise tax on the average number of covered lives over a plan year for certain self-insured health plans. The regulations provide three methods by which a taxpayer can compute the average number of covered lives for a given plan year (Regs. Sec. 46.4376-1). Although the PCORI fee is reported and paid using Form 720, it is reported annually on the second-quarter return (i.e., the quarter ending June 30, due July 31). The PCORI fee is not subject to the deposit requirements (Regs. Sec. 40.6302(c)-1(e)(1)(iv)).

The information needed to calculate the PCORI fee is often held within a company HR or benefits department. As a result, the responsibility for filing Form 720 may reside outside the tax department, and the responsible professionals may not be trained in or experienced with Form 720, resulting in errors. Any failures to timely file or pay may be subject to penalties and interest.

The following practices may streamline the tax reporting process and limit exposure to penalties and interest:

- Identify internal stakeholders with knowledge of the company health plan;
- Determine a method to compute the average number of covered lives; and
- Develop a standard process to report the PCORI fee on the second-calendar-quarter Form 720.

Stock repurchase excise tax

Sec. 4501 generally imposes an excise tax of 1% of the fair market value (FMV) of any stock of a corporation that is repurchased by the corporation during the tax year, subject to special rules, exemptions, and offsets. IRS guidance provides four methods by which a taxpayer can compute FMV (Prop. Regs. Sec. 58.4501-2(h)). The stock repurchase excise tax is not subject to the deposit requirements (Regs. Sec. 40.0-1). As with the PCORI fee and the FIET, the information needed for compliance with the stock repurchase excise

AD

tax resides outside the tax team — in many cases, companies' finance, accounting, treasury, or HR departments.

The final procedural rules became effective on June 28, 2024, and provided guidance on when, where, and how to file returns for the stock repurchase excise tax (T.D. 10002). A return is required for any covered corporation that makes a repurchase or is treated as making a repurchase pursuant to Sec. 4501. The tax is reported on the Form 720 due for the first full calendar quarter after the end of the covered corporation's tax year, with an attached Form 7208, *Excise Tax on Repurchase of Corporate Stock* (a new form) (Regs. Secs. 58.6011-1(a) and (b)). There was a special rule for the very first filing due after promulgation of the final procedural rules. The special rule provided that the filing would be due by the due date of the Form 720 for the first calendar quarter after June 28, 2024, or in other words, it would be filed on the third-quarter Form 720, due on Oct. 31, 2024 (Regs. Sec. 58.6071-1).

The nuance between the period of the stock repurchases being reported (the taxpayer's income tax year) and the period of the Form 720 quarterly filing (the first full calendar quarter after June 28, 2024) caused confusion for many taxpayers. Many taxpayers mistakenly marked Form 720 with the date of their tax year end rather than the calendar quarter of the Form 720 on which it was reported. This triggered a wave of failure-to-file and failure-to-pay penalty and interest notices. Any taxpayer in this situation had to work with the IRS to reprocess the stock repurchase excise tax return to the correct quarter to reverse the penalties and interest.

The following practices may streamline the tax reporting process and limit exposure to penalties and interest:

- Identify internal stakeholders with knowledge of the company's stock repurchases, issuances, and other activities that may be relevant;
- Coordinate data collection and assign tasks between internal teams;
- Determine a method to compute FMV; and
- Develop a standard process to report stock repurchase excise tax.

Coming into compliance

If a company discovers that it is in arrears in its federal excise tax obligations for any reason, it will want to get into compliance as soon as possible. Furthermore, it is advisable to get into compliance voluntarily and expeditiously, ideally, before the IRS discovers the issue or opens an audit of Form 720. Generally, the preferred approach is to file the returns and pay the excise tax as soon as the failure to file or pay is discovered. Additionally, companies may consider regularly conducting a self-audit of potential excise tax liabilities and filing obligations to ensure that no items are being inadvertently missed. Excise tax is a complicated area that is always evolving, so it is important to stay educated and up to date.

From Taylor Cortright, J.D., LL.M., Washington, D.C., and Rachel Smith, J.D., Washington, D.C.

Expenses & Deductions

Sec. 181: Will 2025 be the series finale?

The impending expiration of Sec. 181 (providing special expensing rules for certain film, television, and live theatrical productions), the continuing phasedown of bonus depreciation (under Sec. 168(k)(6)), and the interplay with the new corporate alternative minimum tax (corporate AMT)

create significant planning opportunities in 2025 for taxpayers in the film, television, and live theater industries.

Background

Under Sec. 181, for costs incurred prior to 2026, a taxpayer can elect to deduct up to $15 million ($20 million in the case of productions in certain low-income communities or distressed or isolated areas) of the aggregate costs of producing a qualified film, television, or live theatrical production in the year the costs are paid or incurred, rather than capitalizing the costs and recovering them through depreciation over a number of years once the production is placed in service. A qualified production is placed in service at the time of initial release or broadcast or initial live staged performance (Sec. 168(k)(2)(H)). Depreciation of a qualified production is typically a combination of bonus depreciation and the income-forecast method (both discussed below).

For purposes of Sec. 181, a qualified film or television production is one for which at least 75% of the total compensation is for services performed within the United States by actors, production personnel, directors, and producers, not including participations and residuals (i.e., costs that vary by contract with the amount of income earned in connection with the production) (Sec. 181(d)). In the case of a television series, only the first 44 episodes are taken into account, and both the production-cost limitation and the 75% domestic qualified compensation requirement are determined on an episode-by-episode basis.

A qualified live theatrical production means any live staged production of a play (with or without music) that meets the 75% domestic qualified compensation requirement, is derived from a written book or script, and is produced or presented by a taxable entity in a venue with an audience capacity of not more than 3,000 or in a series of venues the majority of which have an audience capacity of not more than 3,000. In addition, qualified live theatrical productions include any live staged seasonal production that is produced or presented by a taxable entity no more than 10 weeks annually in any venue with an audience capacity of not more than 6,500 (Sec. 181(e)).

Eligible production costs include the costs paid or incurred by an owner in producing the production that are required (notwithstanding Sec. 181) to be capitalized under Sec. 263A, or would be required to be capitalized if Sec. 263A applied to the owner (e.g., participations and residuals paid for property rights, compensation paid for services and property rights, premiums paid to obtain a completion bond for the production, etc.). Production costs do not include costs paid or incurred to distribute or exploit a production (such as advertising and print costs), costs incurred to prepare a new release or broadcast of an existing production, or costs that the production owner has already deducted or began amortizing prior to the tax year for which the owner makes a Sec. 181 election (Regs. Sec. 1.181-1(a)(3)).

PHOTO BY NISARA/ADOBE STOCK

Depreciation of productions

As discussed above, while Sec. 181 provides a small reprieve with a deduction for a limited amount of costs incurred in the production phase of film, television, and live theatrical productions, the remainder of the capitalized production costs is generally depreciated using the income-forecast method (see Sec. 167(g)), a straight-line method (see Regs. Sec. 1.167(b)-1), or a unit-of-production method (see Regs. Sec. 1.167(b)-0(b)).

Under the income-forecast method, a taxpayer generally determines its depreciation deduction for a production by multiplying the capitalized production costs (after reduction for any costs expensed under Secs. 181 and 168(k), discussed below) by a percentage equal to the production's actual income for the tax year divided by the total projected income for the production estimated to be generated within 10 years of the production being placed in service (with the full recovery of any remaining capitalized costs in the 10th year). Note that a taxpayer that uses the income-forecast method for depreciating production costs is generally required to apply the lookback method, which requires the taxpayer to pay or receive interest by recalculating depreciation deductions (and the resulting increase or decrease in tax) using newly revised forecasted total income from the production and applies to any "recomputation year" (i.e., generally the third and 10th tax years after the tax year the production was placed in service, unless the revised forecasted total income is within 10% of the income earned from the production before the close of the potential recomputation year).

Under the straight-line method, capitalized production costs (after reduction for any costs expensed under Secs. 181 and 168(k), discussed below) are generally depreciated over the production's estimated useful life, which may be difficult to determine and has been the subject of controversy.

Alternatively, many taxpayers with streaming content depreciate productions using a unit-of-production method (after reduction for any costs expensed under Secs. 181 and 168(k)) under which streaming content is generally recovered based on recorded views of the streaming data, i.e., usage of the property or units of production. Under such a method, a taxpayer will project the "viewership curve" it expects based on projected streams, which generally start out high when released and then drop significantly. This generally results in cost recovery similar to the income-forecast method but without the potential application of the lookback method.

Bonus depreciation

Favorably, for qualified productions placed in service since the last quarter of 2017, bonus depreciation may be claimed in the placed-in-service year. Specifically, the Tax Cuts and Jobs Act (TCJA), P.L. 115-97, created new categories of qualified property as part of extending and modifying Sec. 168(k) generally for property acquired and placed in service after Sept. 27, 2017, and before 2027. The new categories include qualified film, television, and live theatrical productions that meet Sec. 181's applicability requirements, without regard to the production-cost limitation or commencement-of-production requirement. For taxpayers producing qualified productions, the revisions made to Sec. 168(k) by the TCJA create a continued expensing opportunity for the qualified production costs of such productions not previously expensed under Sec. 181. Further, the TCJA generally increased the applicable bonus depreciation percentage to 100% for qualified property placed in service before 2023, with a 20-percentage-point phasedown per calendar

The impending expiration of Sec. 181 and the eventual phaseout of bonus depreciation (unless extended or made permanent) has created an interesting opportunity for film, television, and live theatrical production taxpayers in 2025.

year for property placed in service before 2027. In general, for qualified productions placed in service during 2025, the applicable bonus depreciation rate is 40%.

The combination of expensing under Sec. 181 for productions commencing before 2026 and bonus depreciation for any production costs not expensed under Sec. 181 that are placed in service prior to 2027 provides a favorable expensing opportunity, since the timing of cost recovery for the applicable percentage of costs may be accelerated into the placed-in-service year, with the remaining unrecovered costs (e.g., 60% if placed in service in 2025) recovered under the income-forecast method, straight-line method, or a unit-of-production method, as applicable.

Corporate AMT considerations

The corporate AMT was enacted by the Inflation Reduction Act of 2022, P.L. 117-169, effective for tax years beginning after 2022 (see Secs. 55, 56A, and 59). Corporate AMT generally imposes a 15% minimum tax on the adjusted financial statement income (AFSI) of large corporations whose three-year average annual AFSI exceeds $1 billion. AFSI is calculated based on numerous modifications made to the taxpayer's financial statement net income or loss. These modifications are based on both financial reporting and tax rules.

At a high level, AFSI generally reflects tax rather than financial statement depreciation (see Sec. 56A(c)(13)). Under the proposed corporate AMT regulations that were released in 2024 (REG-112129-23, as corrected by 89 *Fed. Reg.* 104909), qualified film, television, and theatrical productions are treated as Sec. 168 property eligible for the Sec. 56A(c)(13) AFSI adjustment regardless of whether a taxpayer claims or elects to forgo bonus depreciation for these productions, but only to the extent of depreciation allowed under Sec. 167 (i.e., any portion of the cost of a qualified film production that is expensed under Sec. 181 is not part of the Sec. 56A(c)(13) AFSI adjustment). This results in any book expensing of production costs that are not capitalized and depreciated under Secs. 167 and 168(k) not being added back to FSI in calculating AFSI for corporate AMT purposes.

Planning considerations

The impending expiration of Sec. 181 and the eventual phaseout of bonus depreciation (unless extended or made permanent) has created an interesting opportunity for film, television, and live theatrical production taxpayers in 2025. It is important to note that a priority of the Trump administration and the GOP is extending or making permanent the provisions in TCJA that are set to expire. This could potentially include the extension and modification of bonus depreciation; however, what remains unclear is what such an extension may look like. Further, although expiring for productions commencing after 2025, Sec. 181 is not a provision that was enacted or modified by the TCJA. Thus, it

is unclear if its future will be part of the TCJA negotiations. To take advantage of the current interplay between Sec. 181, bonus depreciation, and corporate AMT, taxpayers should plan and act accordingly in 2025. Further, although historically, Sec. 181 has been extended multiple times (eight, to be exact), taxpayers and practitioners alike should not rely on history repeating itself and instead actively expedite qualified production activities into 2025, if they are able to, to take advantage of the upfront deduction offer before the provision expires for productions commencing after 2025.

From Jennifer Frost, Esq., J.D., LL.M., Washington, D.C.; Lynn Afeman, CPA, Washington, D.C.; Natalie Tucker, CPA, Washington, D.C.; and Benson Berro, CPA, Los Angeles

International

Global expansion of e-invoicing and digital reporting obligations for nonresidents

In an increasingly interconnected world, jurisdictions are continually adapting their tax and regulatory frameworks to ensure compliance and improve efficiency. One significant trend in recent years is the expansion of e-invoicing and digital reporting obligations to nonresidents that have value-added tax (VAT) obligations in the jurisdiction. A primary driver of this movement is the ability of retailers and resellers of goods and services in the digital economy to access local markets throughout the world without a physical presence in a country. Tax authorities have identified an increasing number of online retailers selling into countries without adhering to the same tax obligations as local stores as a significant reason for the VAT compliance gap.

VAT systems rely heavily on invoices to evidence the VAT charged by vendors; they are also necessary for business customers to recover VAT incurred on expenditures, thus creating a self-enforcement mechanism. By implementing electronic invoicing (e-invoicing) and digital reporting mandates, jurisdictions build on the linchpin of the invoice to enhance transparency and combat tax evasion.

E-invoicing and digital reporting: From domestic to global

Through e-invoicing, a public authority (generally the tax authority) mandates all or certain taxpayers to issue, receive, and store invoices electronically in a structured manner based on technical specifications established by the authority. While these mandates may be limited to exchanges between taxpayers, they increasingly include a requirement for authorities to prevalidate invoices, thus allowing authorities real-time access to key data. Digital reporting mandates require taxpayers to periodically submit their invoice data to the tax authorities, using the format and channels established by the authorities.

The scope of e-invoicing and digital reporting mandates varies by jurisdiction. Countries often introduce the mandates with a somewhat limited scope, such as focusing on revenue thresholds (e.g., Saudi Arabia, Germany, France, etc.); parties involved (e.g., suppliers in public procurement in the European Union (EU)); or, more commonly, to domestic business-to-business transactions between resident taxpayers. Once the mandates are in place, authorities generally expand the scope to capture more transactions. The expansions can include previously excluded VAT transactions, such as business-to-consumer transactions, but often go beyond the scope of VAT to include electronic waybills, payroll receipts, transfer pricing receipts, etc.

Expansion to cross-border transactions

E-invoicing and digital reporting obligations have expanded in recent years to cover cross-border import and export transactions originally excluded from the requirements. For example, many countries in Latin America and some in Europe (e.g., Italy) require taxpayers to issue electronic invoices (e-invoices) for export transactions. While no VAT is due on these transactions, mandating the issuance of e-invoices on exports allows the tax authorities to obtain a more complete picture of the taxpayers' transactions and the tax credits they have the right to recover.

The Philippines recently enacted a regulation requiring any seller of goods shipped into the country to issue e-invoices to the local client before the goods arrive, thus allowing the authorities to identify goods entering the jurisdiction and improve customs procedures. This new mandate is particularly noteworthy, as it requires foreign exporters with no physical presence in the Philippines to issue e-invoices through the Bureau of Customs portal when shipping goods to the country. Although the responsibility for paying the applicable import taxes rests with the local importer of record, the e-invoice provided by the foreign exporter will serve as the basis for determining these taxes before the goods are released from customs.

In the EU, e-invoicing and digital reporting have long been the purview of each member state as part of their right to establish VAT compliance requirements. The VAT in the Digital Age (ViDA) package introduces mandatory e-invoicing and digital reporting requirements for intra-EU transactions, effective July 1, 2030. E-invoices relating to intra-EU transactions will be required to meet the EU e-invoicing standards so that they can be easily exchanged between taxpayers in different EU member states. In addition, the data on cross-border sales and sales subject to the VAT self-assessment requirements, as well as the mirroring purchases, will be subject to a five-day digital reporting requirement. This new requirement will replace the current European Community Sales List through which VAT-registered businesses communicate their intra-EU sales of goods and services every filing period. Once in place,

PHOTO BY NITHID18/ADOBE STOCK

the EU mandate will be the first-of-its-kind interoperable system between jurisdictions.

Expansion to nonresident taxpayers

Historically, e-invoicing and digital reporting mandates have applied to resident taxpayers. However, as the VAT nexus rules have adapted over time to address the digital economy, tax authorities may now be tempted to expand their e-invoicing and digital reporting mandates to nonresident businesses selling digital services and/or low-value goods (i.e., shipment of goods with a value lower than the normal customs duty threshold) to local customers. So far, most jurisdictions with VAT rules aimed at the digital economy are excluding nonresident providers, as, for example, in Kenya and Malaysia. In both jurisdictions, the tax authorities made clear that nonresident digital services providers are not subject to the local e-invoicing mandate.

Some jurisdictions, however, have applied e-invoicing rules to nonresident digital services providers, perhaps providing a model for other jurisdictions. For instance, Taiwan requires foreign suppliers of digital services selling to Taiwanese consumers to issue electronic government uniform invoices (eGUIs) using the Ministry of Finance platform within 48 working hours of the transaction. Interestingly, Taiwan does not have a domestic e-invoicing mandate for local taxpayers, meaning that mandatory e-invoicing is limited only to foreign suppliers of digital services.

The application of e-invoicing and digital reporting mandates to nonresidents may be more complicated when the laws are broadly written so that nonresidents are caught by the mandate even if they are not in the digital economy. For example, since Jan. 1, 2025, Romania requires foreign businesses registered for VAT to submit monthly Standard Audit File for Tax (SAF-T) reports, known in Romania as *Declarației Informative*, in XML format. In Albania and Serbia, nonresident suppliers of goods and services must comply with the e-invoicing mandate and appoint a fiscal representative for tax matters. Similarly, the Filipino and EU examples above will apply to nonresidents even though they are aimed specifically at the digital economy.

In recent years, some jurisdictions have rolled out VAT rules aimed at the digital economy and announced the implementation of e-invoicing mandates without addressing the interaction between the two obligations. For instance, Niger's last finance bill requires nonresident digital services providers to register for VAT; it also imposed a new e-invoicing mandate that is left to the tax authorities to implement and administer. In the absence of clear exclusions, nonresident digital service providers should likely assume that once they are registered for VAT, they will also need to issue government-compliant e-invoices. E-invoicing is becoming the tool of choice for tax authorities to ensure tax compliance, and cross-border transactions are the last frontier. Imposing these mandates is thus the logical next step.

Compliance challenges and opportunities

The global shift toward mandatory e-invoicing and digital reporting for nonresidents reflects the broader trend of digital transformation in tax administration. While this presents challenges, it also offers opportunities for businesses to streamline operations and improve compliance. As more countries adopt these measures, nonresident entities must stay informed and adapt to thrive in this evolving regulatory environment.

Nonresident businesses face two key challenges: compliance costs and navigating diverse regulations. Compliance costs include system upgrades to meet local e-invoicing

The global shift toward mandatory e-invoicing and digital reporting for nonresidents reflects the broader trend of digital transformation in tax administration.

requirements, software investments, and potentially hiring local tax experts. Navigating diverse regulations involves understanding and adhering to each country's unique set of rules and standards and can be time-consuming, costly, and challenging.

Successfully navigating the complexities of e-invoicing and digital reporting requires robust technical and legal support. A strong technical support team can assist in integrating new software solutions and adapting existing systems to meet local requirements, ensuring seamless operations and data accuracy. Meanwhile, a knowledgeable legal support team can provide insights into the regulatory landscape, helping businesses interpret and comply with local laws. By investing in the right technology and expertise, companies can ensure compliance, minimize risks, and capitalize on the opportunities presented by the global digital transformation in tax administration.

From Ramon Frias, LL.B., Boston

Strategic trade management in 2025: Navigating and mitigating tariffs

As the United States settles into a new presidential administration, a focus on trade policy and tariffs remains a critical issue for businesses. President Donald Trump's emphasis on increasing tariffs (also referred to as customs "duties") threatens to upend the low-tariff global trade landscape businesses are accustomed to. The administration can leverage several legal mechanisms to implement these tariffs, including the International Emergency Economic Powers Act (IEEPA), P.L. 95-223; Sections 122, 201, and 301 of the Trade Act of 1974, P.L. 93-618; Section 232 of the Trade Expansion Act of 1962, P.L. 87-794; and Section 338 of the Tariff Act of 1930, P.L. 71-361. Each of these tools provides a pathway for imposing tariffs, whether for national security reasons, to counteract unfair trade practices, or to protect domestic industries from surges in imports.

On Feb. 1, 2025, Trump announced a series of executive orders that sought to impose significant new tariffs on Canadian, Mexican, and Chinese goods, invoking the IEEPA as authority. The tariffs on Chinese goods took effect Feb. 4. Those on Canadian and Mexican goods have been subject to various modifications since the initial announcement and may continue to evolve as the Trump administration's tariff policy remains fluid.

In addition, on Feb. 11, 2025, Trump announced an expansion of the tariffs on steel and aluminum imports that he had previously imposed during his first administration, invoking Section 232 of the Trade Expansion Act of 1962. These executive orders terminated all previously granted country exemptions and product exclusions and set the tariffs on affected steel and aluminum products at 25%, effective March 12, 2025.

The president may potentially impose additional tariffs with respect to other countries. Thus, importers should consider the following strategies that can help mitigate the duty exposure and maintain cash flow.

IMAGE BY QUALITY STOCK ARTS/ADOBE STOCK

Duty mitigation/cash flow strategies

Mitigation strategies can include taking advantage of the following principles, programs, and features inherent in international trade systems, to be assessed on a case-by-case basis, depending on the specific applicable tariff:

First-sale-for-export principle: This strategy involves applying a principle whereby duties are assessed on a prior sale in the supply chain rather than the final sale to the U.S. buyer (e.g., the price paid by a foreign middleman to the foreign manufacturer). By ensuring that the prior (or *first*) sale is a bona fide sale for export to the United States, establishing that the goods are clearly destined for exportation to the United States, and complying with customs arm's-length requirements, companies can potentially lower the dutiable value of their imports. To effectively implement this strategy, companies must maintain thorough documentation of the transaction chain, including commercial documentation and proof of payment, to demonstrate that the first sale meets all legal requirements. This customs valuation strategy should be strongly considered alongside potential direct tax benefits when implementing or reorganizing international supply chain or tax structures.

Duty drawback: This program allows importers to receive a refund, or "drawback," of duties paid on imported goods that are subsequently exported or destroyed (whether the goods are unused or further manufactured in the United States). Companies can use duty drawback to recover up to 99% of the duties paid, thereby reducing overall costs. To maximize benefits from duty drawback, businesses should establish robust tracking systems to monitor the movement of goods and ensure compliance with all filing requirements. This includes maintaining accurate records of import and export transactions and understanding the timelines for filing drawback claims.

Cost unbundling: By separating dutiable and nondutiable costs (such as international

AD

freight and insurance) in the import transaction, companies can reduce the dutiable value of their goods. This may also require coordination with tax departments, for instance, to potentially remove the costs of intangibles embedded in the cost of imported goods that may not necessarily be dutiable. This may be accomplished in various ways, ranging from separately stating and paying the royalty for intangibles to reallocating ownership or the rights to the intangible. Proper documentation and compliance with customs regulations, and understanding tax implications, are essential to effectively implement this strategy. Businesses should conduct a detailed analysis of their product pricing and supply chain costs and work closely with suppliers to ensure that invoices clearly delineate between dutiable and nondutiable charges.

Foreign trade zones (FTZs): FTZs offer significant cash flow benefits by allowing companies to defer customs duties on imported goods, with the added benefit of saving entry filing fees. Goods can be stored, processed, or assembled in an FTZ without incurring duties until they enter U.S. commerce. This can improve liquidity and reduce carrying costs for inventory. To take full advantage of FTZs, companies should evaluate their supply chain operations to identify opportunities for utilizing these zones and ensure compliance with all FTZ regulations, including physical security and recordkeeping requirements.

Supply chain diversification and country-of-origin-based planning: Tariffs are generally assessed based on a product's country of origin. To plan for potential cost increases due to tariffs, it is necessary to evaluate an import supply chain, identifying where the goods are produced or "substantially transformed," where the components and raw materials are sourced, and what level of production occurs in the various countries. This strategy could include renegotiating supplier contracts, adjusting pricing, exploring alternative sourcing options, or partially modifying production operations to confer a new country of origin.

As customs duties are typically assessed on an *ad valorem* basis, the correct customs value of imported goods is crucial in determining duty costs.

Downward transfer pricing adjustments: Importers in related-party transactions may require compensating adjustments to bring their profits up to a level acceptable to tax authorities. While upward adjustments to the cost of goods sold generally require paying additional duties to U.S. Customs and Border Protection (CBP), a retroactive decrease to the price of previously imported goods may result in a refund of customs duties because the U.S. importer, in theory, initially overpaid customs duties (see Abad and Hok, "Transfer Price Adjustments Don't Necessarily Increase Import Duty Costs," 52 *The Tax Adviser* 356 (June 2021)). To obtain a refund, CBP requires, prior to the importation of the goods, that an "objective formula" be in place. Establishing this formula requires satisfying five factors:

1. A written "intercompany transfer pricing determination policy" is in place prior to importation, and the policy is prepared taking Sec. 482 into account;
2. The U.S. taxpayer uses its transfer pricing policy in filing its income tax return, and any adjustments resulting from the

transfer pricing policy are reported or used by the taxpayer in filing its income tax return;
3. The company's transfer pricing policy specifies how the transfer price and any adjustments are determined with respect to all products covered by the transfer pricing policy for which the value is to be adjusted;
4. The company maintains and provides accounting details from its books and/or financial statements to support the claimed adjustments in the United States; and
5. No other conditions exist that may affect the acceptance of the transfer price by CBP (i.e., the adjusted price must be at arm's length from a customs perspective; CBP, *Customs Bulletin and Decisions*, Vol. 46, No. 23 (May 30, 2012), page 13).

Importers should consider their transfer pricing arrangements in advance, based on the totality of the circumstances, in order to obtain a refund of duties based on the adjusted prices of imported goods.

Customs compliance and reasonable care

The Trump administration has signaled that it intends to enhance scrutiny of import transactions and step up enforcement of existing trade and customs laws to avoid tariff circumvention by importers. For instance, with respect to the steel and aluminum tariffs, the presidential proclamation provides that CBP "shall prioritize reviews of the classification" of imported goods, including product alterations, and "assess monetary penalties in the maximum amount permitted by law" for misclassifications resulting in revenue loss (The White House, "Adjusting Imports of Aluminum Into the United States," Feb. 11, 2025).

Thus, as companies implement these strategies, they should exercise due diligence to ensure they comply with all requirements. In addition to duty savings, importers should also consider whether their declared customs values are accurate and sufficiently documented to avoid customs penalties and to avoid overpaying duties or unnecessarily paying the new origin-based tariffs.

For example, importers should review off-invoice payments and costs related to imported goods and ensure compliance with customs valuation rules by identifying potential additions or deductions to customs value, such as royalties, assists, and selling commissions. This requires a comprehensive review of all import-related financial transactions to ensure accurate reporting and compliance with customs regulations.

As customs duties are typically assessed on an *ad valorem* basis, the correct customs value of imported goods is crucial in determining duty costs. In transactions between unrelated parties, the customs value is presumed to be at arm's length. However, related-party transactions require a "circumstances of sales" test to ensure the relationship does not influence the price. Importers should consider documenting their customs valuation method in a "reasonable care" study and confirm annually that transactions are at arm's length to avoid potentially costly penalties. This involves a detailed analysis of the transaction terms and pricing strategy to ensure compliance with customs regulations.

In situations where post-entry adjustments between related parties may be required, those adjustments may necessitate reporting changes in the customs value of imported goods. Depending on the nature of the adjustment, importers may owe additional duties or be eligible for refunds. Companies should ensure their transfer pricing policy aligns with declared customs values in order to recover potential duty refunds. This requires close collaboration between

tax and customs departments to ensure consistent application of pricing policies and accurate reporting to customs authorities.

Competing in the global market

While the tariffs under the Trump administration pose challenges, businesses can employ various strategies to mitigate their impact. By leveraging duty mitigation techniques and ensuring compliance with customs regulations, companies can navigate the complexities of international trade and maintain their competitive edge in the global market. It is critical to start modeling these tariffs' potential impact on the bottom line, calculate the return on investment of potential tariff mitigation strategies, and implement a game plan.

From Luis A. Abad, J.D., New York City, and Donald C. Hok, J.D., Orange County, Calif.

Legislation

A proposal to end citizenship-based taxation for US citizens living overseas

On Dec. 18, 2024, U.S. Rep. Darin LaHood, R-Ill., introduced the Residence-Based Taxation for Americans Abroad Act (H.R. 10468), which would change the current system under which all U.S. citizens are subject to U.S. income tax regardless of their country of residence. If enacted, the bill would provide significant relief for qualifying U.S. citizens living abroad in relation to both their U.S. tax liability and their information-filing requirements.

Background

Since its inception, the U.S. income tax has applied to the worldwide income of U.S. citizens without regard to where they live. However, in recent years there have been a number of legislative proposals to mitigate or amend this rule. In 2018, Rep. George Holding, R-N.C., introduced the Tax Fairness for Americans Abroad Act of 2018 (H.R. 7358). In 2021, Rep. Donald S. Beyer Jr., D-Va., introduced the Tax Simplification for Americans Abroad Act (H.R. 6057), and in 2023 he introduced a similar version of the same bill (H.R. 5432). Each of these bills would have modified the rules under Sec. 911 (which provides an exclusion for the foreign earned income of U.S. citizens and residents living abroad) so as to expand the exclusion to cover unearned income and to make other changes to the reporting requirements applicable to U.S. citizens living abroad.

None of these bills moved forward through the legislative process and thus have not been enacted into law. However, the issue of ending worldwide taxation for U.S. citizens living abroad achieved a new level of urgency during the 2024 presidential campaign when Donald Trump released a campaign video on Oct. 20, 2024, in which he pledged to end double taxation on overseas citizens.

The introduction of the Residence-Based Taxation for Americans Abroad Act by LaHood in December 2024 is the first step toward implementing Trump's proposal. The bill represents a comprehensive overhaul of the tax regime applicable to U.S. citizens abroad that departs significantly from the previous bills outlined above. The bill's proposals are analyzed in detail below.

The bill's proposals

Election to be treated as a nonresident: Under current law, the rules for determining whether an individual is a resident or nonresident of the United States for income tax purposes apply only to "aliens" — individuals who are not U.S. citizens. The bill would amend the residency rules in Sec. 7701(b) to enable U.S. citizens to be treated as nonresidents.

PHOTO BY ALICE_PHOTO/ADOBE STOCK

The current residency rules treat any individual who is not a U.S. citizen or green-card holder as a U.S. resident only if they meet the substantial-presence test (or make a first-year election under Sec. 7701(b)(4)). Under the substantial-presence test, an individual is a U.S. resident with respect to any calendar year if: (1) the individual is present in the United States on at least 31 days during the current calendar year and (2) the sum of the number of days of U.S. presence during the current calendar year, plus one-third of the U.S. days during the first preceding calendar year, plus one-sixth of the U.S. days during the second preceding calendar year, equals or exceeds 183 days (Sec. 7701(b)(3)(A)). The bill would enable the substantial-presence test to be applied to U.S. citizens, with the result that U.S. citizens who live abroad and meet certain other specified conditions could elect to be treated as U.S. nonresidents for income tax purposes without having to renounce their U.S. citizenship.

To make the election, U.S. citizens would have to pay or validly defer the tax due (if any) under the special departure tax rules described below and must certify their compliance with all U.S. tax obligations for the five years prior to the year of making the election. The bill further provides that the benefits of the election are not available for any year in which the individual is not a tax resident of a foreign country, or if the individual is an employee of the federal government at any time during the tax year.

The timing and other procedures for making the election (such as the required forms to be filed) would be determined by the IRS.

After making the election, taxpayers would be subject to U.S. tax only on their U.S.-source income and gains, including income from the performance of services in the United States, income from ownership of a U.S. business, distributions from U.S. retirement and deferred compensation plans, and income from assets physically

located in the United States (such as rent from real estate investments).

Once the election is made, it would be effective for the current and all future tax years until terminated by the electing individual or if the individual again becomes a U.S. resident for income tax purposes. To obtain the benefit of the election, electing individuals would be required to live abroad for at least three years (the year of making the election and at least two full tax years thereafter), failing which the election would be reversed with retroactive effect. In addition, any individual who had been subject to the departure tax (described below) would not be entitled to a refund of any tax paid under this rule.

A special rule would apply to U.S. citizens born (and still residing) outside the United States, whereby they would be treated as electing individuals until such time as they establish residency in the United States. In other words, such individuals would not be required to affirmatively make the election to claim the benefits available to electing individuals.

Benefits under income tax treaties: Electing individuals would be entitled to claim the benefit of income tax treaties between the United States and their country of residence, notwithstanding the fact that they would remain U.S. citizens. This would be accomplished by a provision in the bill that requires a waiver of the treaty saving clause in relation to electing individuals. Under a standard saving clause, the United States reserves the right to tax its citizens and residents as if the treaty were not in effect, with certain exceptions.

Exemption from certain reporting requirements: The bill would provide electing individuals with an exemption from certain information-filing requirements, including those of Form 8938, *Statement of Specified Foreign Financial Assets*; Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*; and FinCEN Form 114, *Report of Foreign Bank and Financial Accounts* (FBAR).

The bill would amend the residency rules in Sec. 7701(b) to enable US citizens to be treated as nonresidents.

Certificate of nonresidency for foreign financial institutions: Electing individuals and any U.S. citizen born in a foreign country after the date of enactment of the bill would be permitted to apply to the IRS for a certificate of nonresidency. This provision would permit such individuals to establish that they are not "specified United States persons" for purposes of the Foreign Account Tax Compliance Act (FATCA), P.L. 111-147. Hence, foreign financial institutions would not need to undertake FATCA's financial reporting requirements, which frequently discourage those institutions from offering banking services to U.S. citizens living and working abroad.

Departure tax for certain high-net-worth individuals: The bill provides that electing individuals would not be treated as renouncing their U.S. citizenship. Hence, making the election would not subject an electing individual to the existing expatriation tax under Sec. 877A. However, the bill would introduce a special mark-to-market departure tax applicable to certain high-net-worth individuals. Under this provision, electing individuals would be required to pay tax on a deemed sale of all their property as if it were sold for its fair market value (FMV) on the day before they make the election.

The departure tax would not apply to individuals who meet any of the following exceptions:

- Their net worth is less than the applicable estate and gift tax basic exclusion amount ($13.99 million for 2025);
- They are tax residents of a foreign country where they normally or customarily lived for three of the past five years, and they certify that they have been in compliance with their U.S. tax requirements for the three years prior to the bill's introduction; or
- They have not been U.S. residents at any time since turning 25 years old, or after March 28, 2010 (the date that FATCA was enacted), through the date of enactment of the bill.

Certain property and income items would not be subject to the deemed-sale rule: deferred compensation items (including U.S. and foreign retirement plans); specified tax-deferred accounts (including Sec. 529 qualified tuition plans, Coverdell education savings accounts, health savings accounts, and medical savings accounts); interests in nongrantor trusts; real property located in the United States; and foreign real property that has been owned and used as the individual's principal residence for periods aggregating at least two of the prior five years.

Affected individuals' basis in each asset subject to the departure tax would be stepped up to its FMV at the date of the election.

Foreign financial institutions prohibited from discriminating against U.S. citizens: The bill would add a provision to Sec. 1471(b), which sets out the FATCA reporting requirements applicable to foreign financial institutions. The provision would require that any agreement in effect between a foreign financial institution and the IRS should require the foreign financial institution to agree not to have policies or practices that discriminate against opening or maintaining financial accounts for individuals who are U.S. citizens and residents of the country in which the financial account is to be opened or maintained.

This provision would apply to all U.S. citizens living abroad and would not be limited to those who elect to be taxed as nonresidents under the procedures discussed above.

What the bill does not address

While the bill would enable electing individuals to be treated as U.S. nonresidents for income tax purposes, it does not address their potential exposure to U.S. gift and estate taxes. Thus, U.S. citizens living abroad would continue to be subject to U.S. gift and estate tax on their worldwide assets.

The bill is also silent in relation to green-card holders living abroad. These individuals are, like citizens, required to report and pay U.S. income tax on their worldwide income and can be subject to the same obstacles as U.S. citizens when seeking to open financial accounts in foreign countries.

Outlook uncertain

Estimates vary as to the total number of U.S. citizens living overseas. The U.S. government's Overseas Citizen Population Analysis estimated that in 2022 approximately 4.4 million U.S. citizens were living overseas (U.S. Department of Defense, Federal Voting Assistance Program, "Overseas Citizens"), while a nongovernmental entity estimates the number currently to be 5.5 million (Speer, "How Many Americans Live Abroad?" The Association of Americans Resident Overseas (updated October 2024)). Without a change in the law, these individuals will continue to be subject to the anomalous rule of citizenship-based worldwide taxation.

Globally, very few countries impose tax on their citizens living outside their borders (e.g., Eritrea imposes a "diaspora tax" and Myanmar taxes its nonresident citizens).

There appears to be a degree of bipartisan support for such legislation, given that bills addressing the issue have been introduced by both Republicans and Democrats over the years (as outlined above). However, passage of LaHood's bill is significantly uncertain, given the numerous other legislative proposals and priorities confronting the 119th Congress.

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

Partners & Partnerships

Powers of attorney for partnerships

Tax practitioners need a valid Form 2848, *Power of Attorney and Declaration of Representative*, to practice before the IRS on behalf of a taxpayer. Form 2848 allows (1) IRS personnel to disclose taxpayer information to the listed representatives and (2) listed representatives to act on behalf of the taxpayer before the IRS.

When the taxpayer is a partnership, who should sign Form 2848 for the partnership? Surprisingly, this can be a fraught question. This item examines two sets of rules that govern who can sign Form 2848 for a partnership: the conference and practice requirements, set forth in Regs. Secs. 601.501 through 601.509 (and collected as IRS Publication 216, *Conference and Practice Requirements*), and the centralized partnership audit regime established by the Bipartisan Budget Act of 2015 (BBA), P.L. 114-74. A third set of rules under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), P.L. 97-248, which was supplanted by the BBA, is referenced when applicable but is not discussed in detail.

Conference and practice requirements

A Form 2848 for an extant partnership "must be executed by all partners, or if executed in the name of the partnership, by the partner or partners duly authorized to act for the partnership, who must certify that he/she has such authority" (Regs. Sec. 601.503(c)(5)). The regulations do not specify how a partner must certify. While line 7 of Form 2848 provides that a signature by an individual other than the taxpayer constitutes certification that that individual has the legal authority to sign the form, the instructions for Form 2848 (revised September 2021) further require that, if one partner is acting on behalf of the partnership, a copy of that partner's authorization (such as the relevant provision in the operating agreement) must be included with the Form 2848.

As most tax practitioners realize, the conference and practice requirements and instructions for Form 2848 oversimplify partnership operations in the 21st century. Partnerships can often be part of tiered partnership structures. Determining who signs Form 2848 in these situations can be challenging. For example, in Chief Counsel Advice memorandum (CCA) 201522005, the IRS considered who should sign a Form 2848 on behalf of a non-TEFRA limited liability company (LLC) with two members, where one member, the member-manager (Member 1), was a subsidiary corporation included on the consolidated return of a parent corporation.

The IRS recognized that, ordinarily, an officer of Member 1 would sign Form 2848. However, because the parent corporation was the "sole agent [with limited exceptions] for each member of the [consolidated] group for all matters related to income tax liability for the consolidated return year," the IRS determined that an officer of the parent corporation must sign Form 2848 on behalf of a non-TEFRA LLC. The CCA recommended

PHOTO BY FENG/ADOBE STOCK

that the Form 2848 should be signed in the following format: "[John Doe], [Corporate Office Title] Parent (EIN) [employer identification number], as the common parent and agent for Parent and Subsidiaries, including Member 1, as Member Manager of LLC Partnership."

Even if the proper signatory for a partnership is identified as a partner under the regulations, securing the signature of that individual may not be appropriate in all cases. For example, an LLC that is not managed by its members may delegate authority to bind the entity to named officers (either in the operating agreement or pursuant to a separate legal document). These officers typically handle the partnership's day-to-day operations. Recognizing this reality, the IRS has considered nonpartners signing Form 2848 in a few instances:

- In Field Service Advisory memorandum (FSA) 2236 (Dec. 15, 1997), the IRS considered who could sign a Maryland LLC's Form 2848. The LLC's operating agreements provided that (1) only a board of directors controlled the affairs of the LLC and (2) the board of directors could appoint officers to manage the LLC's day-to-day business. The IRS concluded that the current members of the board of directors and the current officers of the LLC could sign Form 2848 because both groups could act for the company.
- In CCA 201316018 (April 19, 2013), the IRS acknowledged that, because an LLC may be managed by a nonmember, "the requirements in the Conference and Practice Requirements do not match up with state law provisions as to who has the authority to act for an LLC." While acknowledging that it had not researched the relevant state law, the IRS relied on the taxpayer's LLC agreement to conclude that the taxpayer's tax matters partner (TMP, a TEFRA concept) could sign Form 2848 because the TMP had the general authority to bind the

LLC as an LLC member and manager. By contrast, the IRS concluded that the CFO of the taxpayer could not sign Form 2848 because the taxpayer's LLC agreement did not appear to give the CFO "authority to enter into agreements or other written instruments on behalf of the LLC."

- Similarly, Generic Legal Advice Memorandum AM 2015-004 (April 3, 2015), which primarily addressed disclosure issues in a TEFRA examination, discussed the application of Regs. Sec. 601.503(c). In particular, the IRS stated the following in a footnote:

  The operating agreement of the partners or members of the entity, as approved under state or foreign law where the entity was formed, will generally dictate who is authorized to act for (i.e. manage) the entity itself and the extent of any authorization. A manager may operate under many potential titles such as president, general partner, tax director, chief executive office [sic], board of directors, etc. However, it is the operating agreement that ultimately dictates whether the pertinent titled position has authorization to act for the entity.

- Legal Advice Issued by a Field Attorney (LAFA) 20153901F (released Sept. 25, 2015), which incorporated AM 2015-004 by reference, discussed the Delaware law relevant in determining who has the authority to manage an LLC.

While the above guidance is instructive, tax practitioners may struggle to explain these concepts to an IRS Practitioner Priority Service line customer-service representative when presenting a Form 2848 to the customer-service representative. Accordingly, to facilitate acceptance of a partnership's Form 2848, the partnership might consider drafting its operating agreements to specify (1) the titles of the individuals delegated authority to bind the partnership and (2) signing Form 2848 as one of the delegated powers. Tax practitioners should have this documentation in hand when preparing Forms 2848 for partnerships.

As most tax practitioners realize, the conference and practice requirements and instructions for Form 2848 oversimplify partnership operations in the 21st century.

In the case of a dissolved partnership, Regs. Sec. 601.503(c)(6) generally requires all former partners to sign Form 2848 (except in circumstances when a former partner is deceased). While the formality of this provision may be difficult to overcome, a partnership may also consider drafting its operating agreements to address this situation as well.

Centralized partnership audit regime

For partnership tax years beginning after Dec. 31, 2017, Sec. 6223 requires a partnership subject to the centralized partnership audit regime under the BBA (a BBA partnership) to designate "a partner (or other person) with a substantial presence in the United States as the partnership representative who shall have the sole authority to act on behalf of the partnership" with respect to an examination of the BBA partnership. Regs. Sec. 301.6223-2(d)(1) allows a partnership representative to "authorize a person to represent the partnership representative,

AD

in the partnership representative's capacity as the partnership representative, before the IRS under a valid power of attorney" in an examination of the BBA partnership.

For centralized partnership audit regime matters (i.e., a BBA partnership examination), the instructions for Form 2848 require the partnership representative (or, if the partnership representative is an entity, the designated individual) to sign Form 2848. If the partnership representative is signing the Form 2848, they must use the title "Partnership Representative." If a designated individual is signing Form 2848, they must use the title "Designated Individual of [name of Partnership Representative]." These rules also apply to an examination of a dissolved BBA partnership.

In sum, a partnership representative only signs Form 2848 for BBA partnership examinations. By contrast, a "partner" (as contemplated under the conference and practice requirements) signs Form 2848 for all other matters (such as obtaining IRS transcripts and discussing partnership return information with IRS Practitioner Priority Service line representatives). One cannot help but wonder whether a partnership representative could be allowed to sign a Form 2848 for all matters. The disclosure considerations in a BBA partnership examination would appear to be comparable to matters outside the BBA partnership examination context. Moreover, a partnership representative arguably makes decisions with greater potential economic consequences than those occurring during calls to the IRS Practitioner Priority Service line. Nevertheless, until these two regimes are reconciled, tax practitioners should be aware of the nuances of preparing Forms 2848 for partnerships to avoid unnecessary delays when contacting IRS personnel.

From Matthew Weiss, J.D., LL.M., New York City

State & Local Taxes

Retail delivery fees generate some bumps in the road

In most states, fuel tax revenues are the primary funding source for the construction and upkeep of highways and other transportation modes. The continued growth in fuel-efficient vehicles on the road has had a negative impact on the role of fuel tax revenues in the transportation funding structure. As states have struggled to identify alternative revenue-raising solutions, one approach has recently gained interest: retail delivery fees (RDFs). Sometimes referred to as "doorstep taxes," RDFs can broadly be understood as charges imposed on the delivery by motor vehicles to consumers of products purchased at retail. This item summarizes how RDFs work, highlights some challenges associated with them, and provides thoughts for taxpayers to stay in compliance with state RDF requirements.

How retail delivery fees work

Two states have implemented RDFs — Colorado and Minnesota. Colorado was the first to implement its RDF, effective July 1, 2022 (see Colo. Rev. Stat. §43-4-218(1)(e)), with Minnesota following, effective July 1, 2024 (see Minn. Stat. §168E.03). Often, states will take legislative ideas from each other, as evidenced by the similarities in the Colorado and Minnesota RDF regimes, along with new proposals in a handful of other states. Although the Colorado and Minnesota RDF regimes share similarities, businesses should be aware of some key differences.

The Colorado approach: Colorado imposes a $0.29 RDF on all retail deliveries made by: (1) retailers and marketplace facilitators having $500,000 or more in retail sales of

tangible personal property, commodities, or services to purchasers located in Colorado in the previous calendar year, and (2) retailers and marketplace facilitators that are not required to collect Colorado sales tax because they have no physical location in Colorado and who have more than $100,000 in retail sales of tangible personal property, commodities, or services in Colorado in the previous calendar year. Retail deliveries are defined as retail sales of tangible personal property by a retailer that are delivered to the purchaser at a location in Colorado by a motor vehicle owned or operated by the retailer or any other person, and the sales include at least one item of tangible personal property that is subject to Colorado sales tax. Simply put, if a taxpayer exceeds the revenue thresholds and sells tangible personal property subject to Colorado sales and use tax and then delivers that tangible personal property via motor vehicle to purchasers located in Colorado, the RDF applies.

Businesses subject to the RDF are required to file a separate Form DR 1786, *Retail Delivery Fee Return*. Reporting schedules for the RDF mirror the taxpayer's Colorado sales and use tax reporting schedules (i.e., monthly, quarterly, or annually). A single return should be filed regardless of the number of locations the taxpayer has in Colorado, and the tax is calculated by multiplying the number of retail deliveries by the fee rate. Notably, a single retail delivery is a single transaction, notwithstanding that a single transaction may consist of multiple deliveries to fulfill said single transaction. For example, if it takes three deliveries to fulfill a single transaction, the total amount of retail deliveries subject to the RDF is still one.

The Minnesota approach: Minnesota imposes a $0.50 RDF on each transaction made by: (1) retailers that had $1 million or more in retail sales in Minnesota in the previous calendar year and (2) marketplace facilitators that had $100,000 or more in retail sales through their marketplace in the previous calendar year. The RDF applies to transactions of $100 or more, comprising tangible personal property subject to Minnesota sales tax and clothing (which is exempt from Minnesota sales tax).

Dissimilar to Colorado, Minnesota provides specific exemptions (i.e., products are excluded in determining whether the delivery meets the $100 threshold) from its RDF for the retail sale of certain items, including food and food ingredients or prepared food; drugs and medical devices, accessories and supplies; and certain baby products, even though some baby products exempt from the RDF are subject to Minnesota sales tax. The dichotomy between Minnesota's sales and use tax base and the RDF base arguably creates compliance difficulties because in certain scenarios, sales and use tax applies to deliveries of tangible personal property where the RDF does not and vice versa.

Businesses subject to the Minnesota RDF are required to register for it and report the fee on the RDF line of the Minnesota Sales and Use Tax return. Like Colorado, Minnesota's RDF is imposed once per

PHOTO BY PHOTOSCHMIDT/ADOBE STOCK

transaction, regardless of the number of shipments required to fulfill the transaction.

While there are differences in the Colorado and Minnesota RDFs, they share several common traits:

- RDFs do not apply to wholesale sales or customer pickups;
- Liability for the RDF is borne by the retailer, not the purchaser;
- Retailers have the option of collecting RDFs from customers or absorbing them; and
- If collected from customers, the RDF must be separately stated on the invoice or receipt.

Watch out for bumps in the road

Growing pains are anticipated when implementing new tax or fee regimes, and businesses should be aware of a few bumps in the road that have been identified for RDFs.

Tracking thresholds: The economic nexus thresholds for sales tax purposes are, for Colorado, $100,000 of retail sales and, for Minnesota, $100,000 of retail sales or 200 separate retail transactions. The thresholds governing the RDF, however, differ from those requiring sales tax collection. For Colorado, the RDF thresholds are $500,000 for retailers and $100,000 for marketplace facilitators; in Minnesota, the thresholds are $1 million for retailers and $100,000 for marketplace facilitators. This requires businesses to separately track RDF thresholds from sales tax nexus thresholds, which creates an added process to develop and monitor.

Lack of uniformity: Minnesota's sales and use tax base and those items to which the RDF applies lack uniformity, which can present challenges for some businesses. As previously noted, certain categories of tangible personal property (e.g., certain baby products) are excluded from the RDF but are subject to the Minnesota sales tax. Conversely, the RDF applies to shipments of clothing, which are exempt from the sales tax. These discrepancies complicate taxpayers' internal systems for determining the proper tax or fee on customer invoices. Additionally, explaining why the RDF is being imposed on an otherwise tax-exempt transaction may create a customer service issue. In response to this issue, Minnesota Senate File 41, introduced during the 2025 legislative session, proposes to limit the imposition of the RDF only to items of tangible personal property subject to Minnesota sales tax.

Sometimes referred to as 'doorstep taxes,' RDFs can broadly be understood as charges imposed on the delivery by motor vehicles to consumers of products purchased at retail.

This issue is less important in Colorado because the RDF applies to retail deliveries of tangible personal property unless all items in the delivery are exempt from the sales tax. Businesses should note, however, that Colorado sales tax applies to tangible personal property and specifically enumerated services, and the thresholds for the Colorado RDF are based on sales of tangible personal property, services, and commodities delivered to purchasers, which may lead to some differences.

Collection and reporting: In both states, payment of the RDF is a mandatory obligation borne by the retailer. Also in both states, the seller has the option to either: (1) collect RDF from the purchaser or (2) absorb the RDF themselves. The latter may be an attractive approach to some, offering more control over

the RDF compliance process at a small cost per transaction.

However, complexities may arise when retailers elect to pass on the RDF to customers. In these instances, the RDF must be separately stated and appropriately identified on the customer's invoice or receipt. To the extent that the RDF is not separately stated, it is considered absorbed by the retailer. In Minnesota, a separately stated RDF is not considered part of the purchase price of the item and is not subject to the retail sales tax. A separately stated RDF is not part of the state sales tax base in Colorado, but certain Colorado home rule jurisdictions may include the RDF in their sales tax base.

From a reporting perspective, both states have different requirements. Colorado provides for a separate RDF return, whereas Minnesota includes the RDF on its own line on sales and use tax returns. This nonuniformity may create additional complexity for sellers operating in multiple states.

What is the outlook?

RDFs run into some opposition in state legislatures, mainly involving the equity of imposing a burden on purchasers of delivered items to finance roads and bridges. Nonetheless, state legislatures continue to propose RDF regimes as they search for transportation funding sources.

In the current 2025 legislative session, states such as Hawaii (S.B. 1124) and Mississippi (H.B. 530) have proposed legislation that mirrors the Minnesota approach to RDFs, with several exemptions creating a lack of uniformity with the sales tax base. By contrast, Maryland (S.B. 321 and H.B. 352) and Vermont (S. 75) have proposed RDFs with a tax base that aligns with the sales tax base. Perhaps the most complex proposal from a compliance perspective was put forth by Indiana (H.B. 1461) and provided for a county-level RDF. If the bill including this proposal had been signed by the governor, counties would have been permitted to choose whether to impose an RDF and at what rate (between $0.50 and $1.00 per delivery), creating a municipal compliance mélange. This proposal was removed from the bill.

The undeniable fact is that RDFs raise money. Colorado's RDF generated $93 million in fiscal 2024, and Minnesota's RDF is projected to generate $35 million through June 2025. State legislatures consider these amounts significant and will likely continue to propose new RDF regimes. Taxpayers can prepare themselves in the following ways: first, by continually tracking state legislative updates for RDFs; second, by understanding items on which current and prospective RDF are imposed; and, finally, by having an internal process for tracking thresholds and mapping taxability for RDF purposes. Various tax engines have current RDF content to assist with these issues. Taking these steps will help taxpayers from going off the road with RDF compliance.

From Cory Van Arnum, J.D., LL.M., Jacksonville, Fla., and Jeffrey Cook, J.D., Washington, D.C.

What is a platform? The state and local tax answer

The word "platform" can mean many things. This item discusses its uses as a "computer or hardware device and/or associated operating system, or a virtual environment, on which software can be installed or run" (National Institute of Standards and Technology, *Common Platform Enumeration: Naming Specification Version 2.3*, Interagency Rep't No. 7695 (August 2011)) and "an application or website that serves as a base from which a service is provided" (Merriam-Webster.com

Dictionary). Those definitions seem simple and straightforward. However, the application of state and local sales or other indirect taxes to a platform, or the service provided by that platform, can be as varied as the meaning of the word "platform" itself.

Classifying platform access beyond SaaS

A company typically invests substantial money to develop the software that operates a platform. As such, the first thought is that the sale of access to a company's platform or the service provided by that platform will be classified as software as a service (SaaS) when determining which state or local taxes will apply. While SaaS might be the correct tax classification to use when deciding whether state or local taxes should be collected on revenue from the sale of access to the platform, that conclusion requires performing a more detailed analysis of the platform's use or functionality.

If a customer does not have access to manage or use the software but, rather, the seller oversees and operates the software, SaaS is likely not the correct tax classification. Other state and local tax classifications to consider are data processing or information services, telecommunications services, or digital products. States often look past how the service is provided (i.e., via software), to what the service is or does to conclude whether the service is taxable in the state and, if so, which state or local taxes apply.

Platform service as data processing

The Texas Comptroller of Public Accounts has concluded that SaaS "constitutes a software application delivery model where a vendor develops a web-native software application and hosts and operates (either independently or through a third-party) the application for use by its customers over the internet," and is taxable as a data processing service (State Tax Automated Research (STAR) Document No. 202402014H (Feb. 13, 2024)). Further, "data processing service" includes "word processing, data entry, data retrieval, data search, information compilation, payroll and business accounting data production, and other computerized data and information storage or manipulation" (Tex. Tax Code Ann. §151.0035).

IMAGE BY ISSARONOW/ADOBE STOCK

Texas has issued numerous private letter rulings that analyze whether services provided using a platform are subject to Texas sales tax. The comptroller has concluded that services like those offered through a restaurant mobile ordering and payment platform (STAR Document No. 202109055L (Sept. 17, 2021)) and a platform that assists with educational classroom and curriculum management (STAR Document No. 202206014L (June 10, 2022)) are taxable data processing services unless they are sold to an exempt customer.

Since Texas taxes SaaS as a data processing service, exempting 20% of the revenue from the sale (Tex. Tax Code Ann. §151.351), the platform is ultimately taxed the same whether the service is determined to be remotely accessed software or a data processing service. Texas also taxes 80% of the revenue generated from the sale of certain information services, in the same manner as SaaS and a data processing service. The importance of getting the tax service classification correct carries more risk in a state that taxes SaaS but not information or data processing services or vice versa, because an erroneous taxability determination could result in over- or undertaxing a customer.

Platform services as information service

New Jersey is an example of a state with added complexity surrounding a platform's tax classification. In New Jersey, SaaS is not subject to sales tax, but an information service is taxable (N.J. Division of Taxation Technical Bulletin No. TB-72 (July 3, 2013)). An information service is defined as "the furnishing of information of any kind, which has been collected, compiled, or analyzed by the seller, and provided through any means or method, other than personal or individual information which is not incorporated into reports furnished to other people" (N.J. Rev. Stat. §54:32B-2(yy)).

The application of state and local sales or other indirect taxes to a platform, or the service provided by that platform, can be as varied as the meaning of the word 'platform' itself.

Examination of a platform's taxability in New Jersey could lead to concluding that the service performed by the platform is an information service, and the service might still not be taxable if that information meets the personal or individual information exclusion criteria. Multiple fact-specific decisions affect the fine line between what service a platform is providing and whether that service is taxable or nontaxable.

Platform service as telecommunications

The appropriate tax treatment of platform sales may change over time. Companies often roll out a platform with basic functionality to perform for a specific purpose and then add new features or functions to the platform services offered. The company focus is on increasing sales and customer demand. The company might not consider how subsequent modifications to the platform might affect state or local tax collection responsibilities.

For example, a platform used to schedule customer appointments and share data with the customer can be enhanced to send appointment reminders and other messages and to provide videoconferencing capabilities. Suddenly, the platform is

providing telecommunications services. Will the subscription charge for multiple services/features be treated as a bundle? Will a state analyze the true object or primary purpose of the platform service and find some services are *de minimis* or not part of the bundle? Could the addition of services affect the taxability of the entire platform subscription charge, causing the service to be classified as a telecommunications service that would be taxable in all states, either under the sales tax, a state or local tax in lieu of sales tax, or a tax in addition to sales tax? The conclusion that a platform is primarily providing telecommunications services or providing telecommunications services as part of a bundle can substantially increase a company's state or local tax compliance obligations.

In Florida, a service that is otherwise nontaxable or subject to sales tax could become subject to the communications services tax with the addition of certain features. In New York, a service subject to sales tax could become subject to sales tax and a gross receipts tax. Tax departments need to review the platform and related service offerings when the company first offers the service for sale and with every modification that occurs. The state and local tax application can change as the services offered evolve. The modification to offer additional features might be minimal, but the state and local tax impact could be significant.

Platform service as a digital product

A complete platform service taxability review also requires considering whether the platform could be classified as a digital product in any state. The Streamlined Sales and Use Tax Agreement (SSUTA) definition of "specified digital products" generally includes digital audio-visual works, digital audio works, and digital books (Streamlined Sales and Use Tax Agreement, Article III, Section 332 (Adopted Nov. 12, 2002, and amended through Dec. 20, 2024)). Louisiana, a non-SSUTA state, added the sale or lease of digital products to the sales tax base effective Jan. 1, 2025 (Act 10). Louisiana enacted a "digital products" definition that includes digital applications and games, and digital periodicals and discussion forums, in addition to those digital products set forth in the SSUTA (La. Rev. Stat. Ann. §47:301(31)). Enhanced functionality, especially if available through an app, can move platform services toward being bundled with digital products in states with broad digital product definitions.

Multiple fact-specific decisions affect the fine line between what service a platform is providing and whether that service is taxable or nontaxable.

Improperly determining a platform's taxable or nontaxable status is not the only error that can arise if the platform is classified incorrectly. The bundling and sourcing rules can differ for the platform service, depending on the tax classification. The federal Mobile Telecommunications Sourcing Act, P.L. 106-252, will govern the bundling (or unbundling) and sourcing of wireless telecommunications service, while state laws will generally control the sourcing and bundling rules for other service or product types. For this reason, an inaccurately classified platform service could have the wrong city or state tax laws, rules, and rates applied.

Ensuring proper application of state or local tax

The common state and local taxability answer "it depends" is more applicable than ever

when asked whether a platform, or the service provided by the platform, is subject to state and local tax. One fact can change whether a platform is considered SaaS, a data processing or information service, telecommunications service, a digital product, or something else. Further, that platform might be classified differently from state to state. Ensuring state or local tax is properly applied to a platform requires multiple steps: Check: If a platform does not meet the definition of one taxable service, could the platform be classified as a different taxable service? Double check: If the platform does meet the definition of a taxable service, is there otherwise an exemption or exclusion for the type of data or information provided? And, as platforms are enhanced, check again: Could the addition of platform features create a bundled service or completely change the tax service classification?

From Audra Mitchell, J.D., Kansas City, Mo.

Tax Accounting

Announcement 2024-40: A gift and a curse?

In late 2024, the IRS released Announcement 2024-40, addressing certain federal income tax implications for taxpayers constructing advanced manufacturing facilities funded in part through grant agreements with the government under the CHIPS Act of 2022, Division A of the CHIPS and Science Act, P.L. 117-167 (CHIPS grant agreements).

The announcement states that expenses covered by grant funds may be "qualified investments" for purposes of the advanced manufacturing investment credit under Sec. 48D. This is advantageous for taxpayers seeking the Sec. 48D credit, as more qualified investments generally mean a higher credit.

However, the announcement also clarifies that CHIPS grant agreements do not qualify as long-term contracts under Sec. 460. While Announcement 2024-40 is ostensibly taxpayer-favorable, the conclusions regarding Sec. 460 may cause heartburn for taxpayers undertaking construction activities with government-provided funds.

Income and deductions generally

For federal income tax purposes, under Sec. 61, gross income includes "all income from whatever source derived." Courts have interpreted this to mean that gross income includes "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion" (*Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955)). This means that to exclude the receipt of money or property from income, an explicit provision of the Code or other applicable law must provide for the exclusion.

While Sec. 61 determines whether an item is included in gross income, Sec. 451 generally governs when the item is included in income. Under this section, a cash-method taxpayer recognizes income in the year received, while an accrual-method taxpayer recognizes income in the year the right to the amount becomes fixed and determinable with reasonable accuracy (generally, the earliest of the year received, earned, due, or recognized in certain specified financial statements; see Regs. Secs. 1.451-1 and 1.451-3).

Liabilities, on the other hand, are subject to their own set of rules. Sec. 461 generally takes liabilities into account in the year paid (cash-method taxpayers) or the year incurred (accrual-method taxpayers). A liability is incurred in the year it becomes fixed and determinable and economic performance has occurred (see Sec. 461(h) and Regs. Sec. 1.461-4 for a discussion of the economic-performance rules).

A cost may be taken into account through a current-year deduction or, if another

provision requires it, through capitalization and recovery through depreciation, amortization, cost of goods sold, etc. For example, Sec. 263(a) mandates capitalizing certain costs to acquire or produce property, while Sec. 263A extends this requirement to a larger subset of costs attributable to self-constructed property and property produced or acquired for resale. Costs capitalized under either of these provisions are included in the basis of the underlying property acquired or produced and are generally recovered via depreciation or amortization, upon asset disposition, or through cost of goods sold (see Regs. Sec. 1.263(a)-2(h)).

The following example illustrates how the application of these rules can cause a mismatch whereby income is recognized in a year prior to recovering allocable costs:

> ***Example:*** On June 1, 2024, Taxpayer (a calendar-year, accrual-method taxpayer) and Customer enter into a contract under which Taxpayer agrees to produce an item of machinery (*X*) for Customer in exchange for $1,000. The contract requires Customer to pay Taxpayer the full purchase price by Dec. 1, 2024. Taxpayer estimates that it will cost $900 to produce *X*. During 2024, Taxpayer incurs $450 of production costs and in 2025 incurs the remaining $450 of production costs. On May 1, 2025, Taxpayer completes production and transfers ownership of *X* to Customer.

Applying the general rules discussed above, Taxpayer will recognize $1,000 of taxable income in 2024. Although Taxpayer also incurred $450 of production costs in 2024, Taxpayer must capitalize those costs to *X*'s basis under Sec. 263A. In 2025, when ownership of *X* is transferred to Customer, Taxpayer can recognize the $900 of production costs (note that certain optional rules regarding advance payments and cost offsets in Sec. 451 and related regulations may mitigate this result, but those provisions are beyond the scope of this item).

Another option

An exception to the general rules of Secs. 451 and 461 applies to long-term construction contracts required to be accounted for under the percentage-of-completion method (PCM) of Sec. 460.

Under the PCM, revenue (i.e., the contract price) is recognized over time as the taxpayer incurs allocable contract costs. To ensure that the taxpayer each year recognizes a net amount that approximates the taxpayer's profit or loss on the contract, the PCM generally requires that allocable contract costs be deducted from taxable income as incurred. Accordingly, Secs. 263(a) and 263A exclude from their scope allocable long-term contract costs under Sec. 460.

Applying the PCM to the preceding example, in 2024 when the contract is 50% complete, Taxpayer would recognize $50 of net taxable income related to the contract ($500 of revenue minus $450 of allocable contract costs). In 2025, when the contract is complete, Taxpayer will recognize the remaining

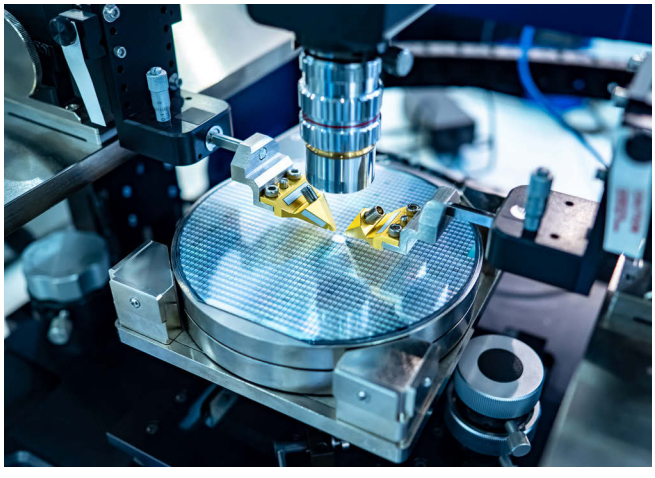


PHOTO BY GRISPB/ADOBE STOCK

contract price ($500) and will deduct the production costs incurred in that year ($450), for net taxable income of $50.

Application to grant proceeds

A taxpayer receiving grant proceeds generally must recognize the proceeds as taxable income. Under the general rule of Sec. 451, the taxpayer will likely be taxed on the income no later than the year the proceeds are received. However, when these proceeds are allocated toward construction activities or the acquisition of fixed assets (which may be required under the terms of the grant agreement), the taxpayer cannot deduct such costs and must instead capitalize them to the produced or acquired assets. For real property construction costs, this typically means recovery through depreciation deductions over a 15-, 20-, or even 39-year period (Sec. 168).

Long-term construction contracts

A long-term construction contract spans more than one tax year and involves building, reconstructing, or improving real property. The primary factor in determining whether a long-term contract is a Sec. 460 long-term construction contract is whether construction activities are essential to fulfilling the taxpayer's obligations under the contract. Crucially, Regs. Sec. 1.460-1(b)(2)(i) provides:

> If a taxpayer has to ... construct an item to fulfill its obligations under the contract, the fact that the taxpayer is not required to deliver that item to the customer is not relevant. Whether the customer has title to, control over, or bears the risk of loss from, the property manufactured or constructed by the taxpayer also is not relevant. Furthermore, how the parties characterize their agreement (e.g., as a contract for the sale of property) is not relevant.

The announcement states that expenses covered by grant funds may be 'qualified investments' for purposes of the advanced manufacturing investment credit under Sec. 48D.

The IRS has previously reflected a broad interpretation of this language, albeit in nonreliance guidance. In Letter Ruling 202318008, the IRS determined that a taxpayer was required to recognize revenue and expenses relating to certain construction activities under the PCM, notwithstanding that the constructed property was intended to, and did, remain in the taxpayer's ownership. The facts indicate that the taxpayer was required, as part of its contract with its customer, to relocate certain of its facilities to remove a customer-owned item. Construction activities included demolishing a portion of the building and adding on to another portion of the same building and a second nearby building. The taxpayer was compensated through a reimbursement of its allocable costs, without any profit markup.

The IRS ruled that the contract was a Sec. 460 long-term contract requiring use of the PCM, noting that it is irrelevant who owns the constructed property, so long as the taxpayer is required to construct the property to fulfill its contractual obligations. Although not explicitly described in the letter ruling, because the contract price effectively equaled the associated costs, the taxpayer presumably

recognized zero net taxable income in each year of the contract under the PCM.

Announcement 2024-40

Despite Letter Ruling 202318008, in Announcement 2024-40, the IRS has arguably narrowed its view of the scope of Sec. 460, implying that there must be an intended (if not an actual) transfer of property or benefits under a contract in order for that contract to be treated as a long-term contract.

Announcement 2024-40 confirms that amounts paid or incurred for the construction, expansion, or modernization of advanced manufacturing facilities pursuant to CHIPS grant agreements are included in the cost basis of the constructed property and therefore may be eligible for the Sec. 48D credit (equal to 25% of the cost basis, or "qualified investment," of credit-eligible property).

As part of this, the IRS concluded that these agreements are not eligible for the PCM, reasoning that Sec. 460 and related Treasury regulations "contemplate an agreement with a customer for the construction of the 'subject matter' of the contract and payment of a 'contract price' as compensation for the 'subject matter' of the contract." According to the IRS, a taxpayer receiving funds under a CHIPS grant agreement "is constructing the facility on its own behalf," and the award typically does not fully compensate the taxpayer for the cost of the project (or provide a return).

Potential timing gap between grant income and recovered costs

While not surprising, the IRS's conclusion in the announcement may be result-driven.

Treasury regulations under Sec. 460 clearly provide that the transfer of property is not relevant in qualifying a contract as a long-term contract. Although grants are often viewed as "free" money, to obtain grant funds under the CHIPS Act and similar legislation, the taxpayer and the applicable agency execute an agreement providing for the payment of funds in exchange for the taxpayer's promise to engage in specified activities. To the extent these include construction activities, the taxpayer must undertake those construction activities to fulfill its contractual obligations.

By covering all or a portion of the taxpayer's costs, the grant effectively compensates the taxpayer for its construction activities to the extent of the grant award. Although the government-grantor is not a "customer" in the sense that it is not purchasing a good or service that will directly benefit it, it is unclear whether this customer standing is required in light of the explicit decision not to require that the contracting party receive ownership of goods under the contract.

The announcement benefits taxpayers claiming the Sec. 48D credit but poses challenges that, if adhered to, could create a timing gap between recognizing grant income and recovering costs. While the announcement's guidance is not mandatory, recipients of construction-related grants should consult their tax adviser to assess the impact and evaluate the risks of taking a taxpayer-favorable position contrary to the IRS's view.

From Kate Abdoo, J.D., LL.M., Washington, D.C. ■

Editor

Mary Van Leuven, J.D., LL.M., is a director, Washington National Tax, at KPMG LLP in Washington, D.C.