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# INSIGHTS

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# EDITORS' NOTE

In this month's edition of *Insights*, our articles address the following:

- **Square Pegs in Round Holes – You Like "To-May-To" And I Like "To-Mah-To."** In a post-COVID19 world, anecdotal evidence suggests that individuals and families are relocating to new jurisdictions of residence. Equally, individuals have evidenced renewed vigor in acquiring and structuring assets across a range of jurisdictions. When the individual is a U.S. citizen and the place to relocate or acquire assets is the U.K., care must be taken to avoid common – and not so common – traps and pitfalls regarding taxation. In their article, Ed Powles, a Partner of Maurice Turnor Gardner, London and Emma-Jane Weider, the Managing Partner of Maurice Turnor Gardner, London, identify areas for which tax planning is crucially important prior to a move. Included are (i) tax residence and domicile rules for individuals, (ii) residence tests for trusts, companies, and charities, (iii) identifying areas for which income tax treaties do not necessarily provide relief against double taxation, and (iv) ways in which gift and estate planning, dissolution of marriages, forced heirship, and structures to own personal use residential real property are affected by the move.

- **Andorra: A Comprehensive Tax And Legal Analysis.** Andorra is a tiny landlocked principality nestled in the Pyrenees mountains between France and Spain. While it offers many quality-of-life benefits, the country's biggest attraction has been its favorable taxation system. In recent years, Andorra has worked diligently to enhance transparency and to promote international cooperation in an attempt to rid itself of a tax haven reputation. Today, Andorra is widely considered to have a modern tax system, making it an approved jurisdiction by the E.U. It is a party to 10 double tax agreements, participates in C.R.S., is not on the O.E.C.D. list of noncooperative tax jurisdictions, and has ongoing discussions of association with the E.U. All the while, Andorra maintains attractive tax rates for individuals and corporations. Albert Folguera Ventura, C.E.O., Partner, and Head of Tax at Addwill Partners, Barcelona, explains the ins-and-outs of the Andorran tax system applicable to corporations and individuals resident in the country.

- **Mauritius – Gateway To Africa.** Rightly called "the Pearl of the Indian Ocean," Mauritius is much more than a popular tourist destination. Recent World Bank statistics identify Mauritius as the country with the second highest per capita G.D.P. in Africa. Mauritius maintains relationships with key African and international bodies, such as the Southern African Development Community ("S.A.D.C."), the Common Market for Eastern and Southern Africa ("C.O.M.E.S.A."), the World Trade Organization, and the Commonwealth of Nations. It has a low income tax rate and offers a range of incentives to boost its competitiveness. Sattar Abdoula, the C.E.O. of Grant Thornton Mauritius, and Mariam Rajabally, a partner in the international financial services and tax at Grant Thornton Mauritius, take a deep dive into the tax, financial, and commercial benefits that are available in Mauritius, and why it remains an important gateway into Africa.

- **Notice 2023-80: U.S. Foreign Tax Guidance for Pillar 2.** On December 11, 2023, the I.R.S. issued Notice 2023-55 (the "Notice"), announcing the intention to issue proposed regulations addressing the interaction between the Pillar 2 GloBE Rules and specific U.S. tax provisions, including the foreign tax credit rules and dual consolidated loss rules. The issuance of this guidance is timely, as the I.I.R.'s of most countries took effect at the start of this year. The U.T.P.R.'s are scheduled to come online in 2025. In his article, Michael Bennett tracks the way Notice 2023-80 addresses GloBE model rules and the foreign tax credit. Topics include the application of the foreign tax credit rules in the U.S. to final Top-Up Tax, the Q.M.D.T.T. in general, how the application of the separate levy rules will apply to a foreign country's I.I.R., U.T.P.R., and Q.D.M.T.T, and the interplay of the GloBE rules of B.E.P.S. 2 and the dual consolidated loss rules of U.S. tax law.

- **Receipt of a Profits Interest in a Partnership by a Service Provider – Not Taxable.** In *E.S. N.P.A. Holding L.L.C. v. Commr.,* the U.S. Tax Court decided that the indirect receipt of a profits interest in a partnership in exchange for services was not a taxable event for the recipient. The decision was largely an application of Revenue Procedure 93-27, in which the I.R.S. provided guidance on the tax treatment of an individual who directly provides services to a partnership in exchange for the receipt of a profits interest. However, it is not a run-of-the-mill fact pattern that involves the grant of a profits interest to an individual in the financial services sector. Rather, it is about how an individual running a business through a taxable C-corporation was able to (i) arrange a sale of 70% of the C-corporation's business to new investors bringing in fresh capital and (ii) by choosing a proper structure open a pathway to receive future profits without channeling income through the C-corporation. Wooyoung Lee, Nina Krauthamer, and Stanley C. Ruchelman explain the applicable I.R.S. regulations defining a "profits interest," an important 8th Cir. Case reversing a decision of the U.S. Tax Court, the Revenue Procedure, and finally *E.S. N.P.A. Holding v. Commr.*

- **Unravelling of the *Matryoshka* Doll – Impact of the C.T.A. on entities having nexus to the U.S.** Aimed at curbing money laundering, terrorism financing, and other nefarious activity, Congress enacted the Corporate Transparency Act ("C.T.A.") on January 1, 2021. However, the C.T.A. became fully effective from January 1, 2024. It now requires certain domestic and foreign entities to disclose to the Financial Crimes Enforcement Network ("FinCEN"), a division of the U.S. Treasury Department, the identity of their beneficial owners and control persons. A failure to do so can attract heavy penalties. The targets of the C.T.A. are much like *Matryoshka* dolls, having many layers between what appears on the surface and what exists at the heart. Neha Rastogi and Stanley C. Ruchelman guide the reader through the in's and out's of what is likely the most invasive legislation enacted by Congress.

- **Will Service Automation Companies Qualify for the Q.S.B.S. Exemption?** Many U.S. investors and business owners are familiar with the tax exemption provided to U.S. individuals recognizing gains from the sale of certain U.S. stock, defined as qualified small business stock ("Q.S.B.S."). The Q.S.B.S. exemption plays an important role in the growth of hi-tech industry, which is dependent on investments by U.S. persons. It typically benefits U.S. individuals who invest in start-up software companies. However, the Q.S.B.S.

exemption is not available for investment gains related to corporations engaged in the provision of nonqualified services, such as health care, brokerage, law, engineering, architecture, and accounting. However, a business that develops software that is used in those may qualify in certain circumstances, but not qualify in others. The key is whether the software is a tool for a person performing the nonqualified business or the software supplants the individual in performing the business. In this article, Stanley C. Ruchelman addresses two I.R.S. rulings illustrating the facts that distinguish a computer program that is a tool for service providers from facts that cause a program to be treated as a robot service provider.

We hope you enjoy this issue.

- The Editors

# SQUARE PEGS IN ROUND HOLES – YOU LIKE "TO-MAY-TO" AND I LIKE "TO-MAH-TO"[1]

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**Tags**
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## INTRODUCTION

In a post COVID19 world, anecdotal evidence suggests that sophisticated cross-border personal estate planning is back in vogue. There is increased incidence of individuals and families relocating to other jurisdictions. Equally, individuals have evidenced renewed vigor in acquiring and structuring assets across a range of jurisdictions. The reasons for this are myriad:

- A genuine desire to roam again following unprecedented travel restrictions.
- In some cases, the need for geographical diversification of assets.
- Geopolitical unrest and uncertainty of the highest degree.

People move. People invest internationally. Where individuals move around the world, or where assets are acquired in different countries, the cross-border tax and legal implications can be great but, in many cases, somewhat invisible at first sight.

This article provides a high-level overview of various issues that can arise, with a focus on cross-border tax. In real life, the analysis is inevitably highly fact-dependent as the technical outcome can vary dramatically between two similar cases with only slightly differentiated facts. But we believe that it is interesting to consider a range of points that should always be addressed in the context of a proposed change of residence, or cross-border asset acquisition, particularly with regard to real estate.

On occasion, there may be genuine opportunities to arbitrage the relevant tax systems, and achieve genuinely clean and clear tax mitigation. More often than not, however, it is more a question of avoiding the bear traps. This is due to significant differences between the tax regime in the new country and expectations based on tax residence in another country. What is common best practice planning in one country may be disastrous in the other, and vice versa.

As U.K. lawyers, we shall focus on particular U.K. issues that arise between the U.S. and the U.K., noting some key U.K. tax and succession concepts in passing. The general principles are, however, global in nature. Sometimes, tax errors can be corrected after the event – but more often than not, mistakes will have enduring consequences for clients.

1 "Let's Call the Whole Thing Off" (1937) George and Ira Gershwin.

## GLOBAL MOBILITY AND CHANGE OF TAX RESIDENCE

An immediate point to note is that apparently familiar terms of art can have different technical meanings in different legal systems.  This in itself can lead to inadvertent misanalysis of a client's position.

For the purposes of this article, we shall use the U.K. terms "tax residence" – a factual test of where an individual resides, based on a statutory multi-factor formula – and "domicile."  Domicile is a notoriously complex and nuanced concept, based on a person's individual family history, as well as intentions for the future. It is a link to a particular jurisdiction, such as an individual state of the U.S., for example New York State and Florida. Within the U.K., England & Wales is a unitary jurisdiction. Scotland and Northern Ireland are separate.

Whether a person is U.K. tax resident is a key "gating" question. People who fail to recognize that they have exceeded the triggering point in a given tax year become resident in the U.K. notwithstanding any soft considerations such as intent. Nonresidents with regard to the U.K. generally are outside the scope of tax on U.K. income and capital gains, with a few limited exceptions.  By contrast, U.K. residents generally are within the scope of U.K. income and capital gains taxes, and will likely need to file a tax return for the U.K. tax year, which runs from April 6th in one calendar year to April 5th in the next.  Assessing a person's tax residence is essential.  Residence impacts U.K. tax exposure in both the current and subsequent years.  The consequences are wide-reaching, and for that reason, identifying the date a person becomes resident is key. It may be before a person is physically present in the U.K.

The starting point is that liability to income and capital gains tax is global.  It can relate to a person's individual income and gains, as well as income and gains in trust and corporate structures to which they are connected. For that reason, global corporate structures need to be very carefully reviewed and understood.  There are two important qualifications to global tax liability.  First, being able to claim a domicile other than the U.K.  Secondly, the potential impact of a double tax treaty.

Having (and, where necessary, formally claiming) nondomicile status is a powerful tool.  When available, it limits the scope of tax to U.K. source income and gains, and any income or gains that are remitted to the U.K. "Remittance," here, is a broad concept that encompasses assets physically brought to the U.K. or otherwise enjoyed in the U.K.  With careful planning, the use of "remittance basis taxation" can dramatically restrict a person's liability to U.K. tax.  But there are points to watch.

Favorable remittance basis of taxation does not apply to certain assets such as cryptocurrencies and other cryptoassets, certain life insurance policies, and carried interest.  It may also not apply to trading or employment income where any element of the trade or employment is carried on in the U.K. The source of income and the situs of assets is key, and in the U.K., the rules sometimes lead to counterintuitive results. For example, crypto assets and certain other assets such as debt instruments may be treated as U.K. situs if the owner is U.K. resident.  This is H.M.R.C.'s current stated practice, but the position is controversial. The rules for debt instruments are different for purposes of capital gains tax and inheritance tax. It is not surprising that confusion can abound.

  

Being nondomiciled is also very significant for inheritance tax, which is the U.K.'s combined gift, estate, and trust wealth tax. A person who is not domiciled in the U.K. is within the scope of inheritance tax only on U.K. situs assets, which can include indirect interests in U.K. situs real estate. By contrast, a person who is domiciled in the U.K. is within the scope of inheritance tax on worldwide assets that are owned, potentially subject to treaty relief, as discussed further below.

Assessing a person's domicile status and monitoring that status on a year-by-year basis are essential. If a person becomes a British citizen, certain representations may conflict with the actual domicile position of the individual. Citizenship has other impacts, too, including the material scope of the U.K.-U.S. income and estate tax treaties.

In addition, a person becomes "deemed domiciled" in the U.K. once resident in 15 out of 20 tax years. This is a complicated area in itself – planning in advance of that date may be useful for some clients. After deemed domicile is established, an individual is fully in scope of all U.K. direct taxes, including worldwide inheritance tax. Even at that point, retaining a non-U.K. domicile as a matter of common law may still be important.

## PARTICULAR TRAPS: TRUSTS, COMPANIES, CHARITIES, AND RELATED STRUCTURES

It is natural to focus on an immigrant's personal tax position. But a change of residence or just spending time in the U.K. can have a dramatic effect on global structures that may be owned directly or by trusts that have been established for the benefit of the immigrant and other persons.

A very clear preliminary point is that it is important for central management and control of foreign corporate (and like) structures be maintained outside the U.K. Failure to do so may result in an assertion of U.K. tax resident status for those companies, which will cause all relevant companies to become subject to U.K. corporation tax when the assertion cannot be rebutted. The risk is significant. Best practice is to carefully limit decision-making that occurs in the U.K. and to maintain substantial evidence of where decisions are made and who makes them.

Several risks arise when individuals are trustees of family trusts. A change of residence by the trustees as a body can cause a change in the residence status of the trust. A move to the U.K. by trustees can result in the establishment of U.K. tax residence. Worse, a subsequent change back to nonresident status of the trustees can result in a deemed sale of all trust assets at fair market value. Given that trusts are common tools in U.S. estate tax planning, any family trusts must be reviewed with care before a trustee move to the U.K.

Difficult questions of characterization may need to be answered.

- Is a foundation treated as a trust or a company?
- Who is properly taxed in connection with a *usufruct* arrangement?

- What is the U.K. tax characterization of (a) the rights of the holder of the bare legal title to the property and (b) the rights of the holder of the *usufruct* interest in the property?
- How might the U.K. residence of individuals affect the tax treatment of an underling group of companies?

What is a common structure in one jurisdiction may well not expressly be catered for in another. As a result, domestic concepts in the U.K. must be applied to foreign structures, which often is an exercise of fitting square pegs in round holes.

When placing those square pegs in round holes, the practice in the U.K. is to pay careful attention to the legal analysis of property rights, contractual arrangements, tax, and procedural questions in relevant foreign jurisdictions. This can be relevant for (i) characterizing corporate receipts as income or something else, (ii) determining whether a foreign entity is opaque or transparent, (iii) determining whether tax errors can be rectified, and (iv) identifying whether property transactions can be recharacterized retroactively, which the authors have seen successfully achieved in one case.

Another very real trap is that the same word may have a meaning that is different in two countries. To illustrate: just because something is a charity in the U.S. does not mean that it will be treated as charitable in the U.K. It may be exempt from taxation in one jurisdiction, but not the other. As a result, dual-registered charities must be structured with great care to ensure that exemptions are triggered in both jurisdictions. As Winston Churchill once said: the U.K. and the U.S. are separated by a common language.

In this context – and to the theme of "to-may-to / "to-mah-to" – estate planning using trusts may result in problems. Common trusts in U.S. tax planning can give rise to difficult U.K. tax and reporting obligations. An example involves the use of a revocable grantor trust. Depending on how the trust instrument is drafted, there may be an immediate tax consequence when the trustees move to the U.K. or subsequent tax consequences if the grantor dies or becomes incapacitated while in the U.K. Careful review and potential restructuring are always essential.

Care also needs to be taken in relation to U.S. L.L.C.'s holding assets that generate profits potentially within the scope of U.K. tax. H.M.R.C.'s starting point is that an L.L.C. is opaque, meaning that income is taxed at the level of the L.L.C. rather than the members. As a result, distributions are taxable as separate income of the members, with potential for double taxation and denial of treaty tax credits. This thorny issue was addressed in *Anson v. Commissioners for Her Majesty's Revenue and Customs*,[2] where the U.K.'s Supreme Court was prepared to accept that based on the particular drafting of the L.L.C. documents in that case, the L.L.C. should be regarded as transparent for U.K. tax purposes. But since H.M.R.C. does not accept this as the general position with respect to all L.L.C.'s, close attention should be paid when setting up such structures where a U.K. nexus is envisaged. It is understood that regulations issued by the I.R.S. may cause U.K. resident members of the L.L.C. to be subject to full 30% withholding tax in the U.S. on their respective shares of dividends, income, and royalties income received by the L.L.C.[3]

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[2] [2015] U.K.SC 44.

[3] Treas. Reg. §1.8945-1(d)(1).

## TREATY RELIEF

A discussion of tax treaties covering (i) income and gains and (ii) estate taxes would require several articles to cover the rules. Sometimes treaties give rise to outcomes that are surprising, helpful, or both. But not always. This is particularly because the same economic item of income or gain may be taxed at different times by each treaty partner jurisdiction. Equally, the same item of income or gain may be assessed on one entity or person in one treaty partner jurisdiction, but on another entity or person in the other treaty partner jurisdiction. That is a particular problem because of the way the U.K. taxes settlors and beneficiaries of trusts, and owners and funders of companies. Relief will not always be available.

Regardless of whether a treaty can and should be invoked in a given case, ensuring correct filing of U.K. and U.S. accounts is essential, not least given that the tax years and filing deadlines are different, which can lead to cashflow challenges. And a change of residence may also affect internal and cross-border reporting regimes, such as F.A.T.C.A. and the common reporting standard. The U.K., itself, has recently expanded reporting in relation to trusts and companies, and is consulting on further new regimes.

***"Structuring the ownership of real estate in a foreign jurisdiction is another arena in which mismatched legal and tax regimes often clash."***

## PLANNING FOR ASSETS

Structuring the ownership of real estate in a foreign jurisdiction is another arena in which mismatched legal and tax regimes often clash.

Classically, foreign owners of U.K. real property have utilized corporate structures, or in the case of U.S. purchasers, L.L.C.'s. Successive changes to the U.K. tax regime have generally made such structures unattractive compared to personal ownership (particularly for property intended for personal use as a second home) because of increased stamp duty land tax ("S.D.L.T.") and the annual tax on property held in corporate structures ("A.T.E.D."). And the U.K.'s recently introduced public register of foreign entities owning U.K. real property means that corporate structures no longer offer the level of confidentiality they once did.

However, for a person domiciled in the U.S., the U.K.-U.S. Estate Tax Treaty may still provide protection from inheritance tax for property held in corporations, which could justify the additional tax costs of S.D.L.T. and A.T.E.D., particularly in light of the relatively minimal tax-exempt amount for inheritance tax compared to the current amount of the Unified Tax Credit in the U.S. For U.S. families, debt structuring may also help to mitigate inheritance tax exposure. This must be assessed on a case-by-case basis.

Where trusts are involved, particular care is required to avoid difficulties arising from a mismatch between the U.K. and U.S. tax treatment of U.S. revocable grantor trusts noted earlier and succession issues that can arise in relation to U.K. real property because the U.K. does not recognize the concept of lifetime testamentary trusts.

## NON-TAX CONSIDERATIONS

Life is rarely about tax, exclusively. Numerous non-tax considerations surround a change of residence and domicile. From the U.K. perspective, the following should be considered, where relevant:

- Change of status may impact where a person can be served with process in civil proceedings. The rules are complex.
- In particular, the threshold for service of divorce papers in England is relatively low.
- If a person becomes domiciled in England & Wales, then succession to worldwide estate becomes subject to English law. For some clients, this may not seriously impact their succession plans. But for others, such as those from civil law jurisdictions with forced heirship, this can be a dramatic difference. The conflict of law rules in succession planning – including renvoi – are notoriously complicated in an area where different domestic systems of law vary massively.

We are not talking about subtle distinctions, necessarily, here. Bluntly, it might be possible to disinherit an heir in one jurisdiction, but not in another. The consequences can plainly be severe.

## CONCLUSION

Even if you like "to-may-to" and I like "to-mah-to," let's not "call the whole thing off." Exploring the very different approaches of legal systems to the same underlying facts is an interesting and important exercise. Not falling into traps is of course important. But every now and then, genuinely worthwhile planning opportunities may be found.

# ANDORRA: A COMPREHENSIVE TAX AND LEGAL ANALYSIS

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Co-Principality

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## INTRODUCTION

Andorra is a tiny landlocked principality nestled in the Pyrenees mountains between France and Spain. It boasts a unique history and political structure originating in feudal times. Andorra is a Co-Principality that is shared by the Catholic Bishop of Urgell in the north of Catalonia and the President of the Republic of France. At the same time, it operates as an independent parliamentary democracy.

Less than a three-hour drive from Barcelona, Andorra is known for its ski resorts, mountains, long streets lined with stores, and low crime rate. Perhaps the country's biggest attraction is taxation. Hundreds of high net worth individuals, such as content creators, cyclists, YouTubers, gamers, Moto GP racers, poker players, big online marketers, traders, and crypto investors have established residence in Andorra. The country is linguistically diverse. Catalan is the official language, and Spanish, French, English, and Portuguese are widely spoken.

This article provides a brief introduction to the rich history of Andorra. It then addresses the legal and tax facets of residence.

## HISTORY

Legend has it that Charlemagne founded Andorra in the year 805, though the first mention of the country appears in the Act of Consecration of the Cathedral of Santa Maria d'Urgell in the middle of the 9th century. In the 13th century, a conflict over Andorra's sovereignty arose between the religious authorities of Urgell and the counts of the region. The conflict was resolved in 1278 by an agreement between the French Count of Foix and the bishop of La Seu d'Urgell, who shared their power over the country (the "Co-Princes"). This agreement gave the small principality its territory and the current form of government, that of a Co-Principality. The Co-Princes are jointly and severally the Heads of State.

On January 14, 1982, Andorra's first government took office, separating the legislative power from the executive for the first time. In the early 1990's, Andorra signed an agreement with the European Economic Community and a new penal code was adopted, while the population continued to grow rapidly. On March 14, 1993, the second written constitution in its history was approved by referendum, dismantling the last feudal remnants of Andorra's government by declaring the Andorran people as the sole sovereign of the state. The power of the Co-Princes was reduced and a modern parliamentary system of government was created. On July 28, 1993, Andorra became a full member of the United Nations.

The Euro is the official currency of Andorra by virtue of the monetary agreement signed with the European Union.

In 2022, Andorra's G.D.P. reached €3.188 billion, with a per capita G.D.P. of €39,068, placing it in a prominent position internationally.

## TAXATION

### Andorra as a Tax-Approved Jurisdiction

Andorra has been included for decades in international lists of tax havens due to its bank secrecy and its refusal to exchange tax information with other jurisdictions. Despite that history, Andorra has worked diligently to enhance transparency and to promote international cooperation.

Currently, most O.E.C.D. members and all E.U. Member States recognize Andorra as a tax-approved jurisdiction for the following reasons:

- Its commitment to transparency and international cooperation
- The existence of bilateral agreements on exchange of tax information upon request
- Its participation in the O.E.C.D.'s automatic exchange of information agreement known as the Common Reporting Standard ("C.R.S.")
- Its removal from the O.E.C.D. list of non-cooperative tax havens May 2009, and its removal from the ECOFIN list in 2018 after its participation in the B.E.P.S. Inclusive Framework
- The ongoing negotiations regarding the execution of an association agreement with the E.U., which will result in a closer relationship with the 27 Member States of the E.U., even though taxation is excluded from the negotiations

In sum, Andorra is widely considered to be a jurisdiction that complies with the requirements of minimum taxation, tax fairness, and tax transparency. It is also a country with a stable and reliable legal and tax system. All of this makes it attractive for foreign investors.

### Transition to Openness

#### *Andorra's Modern Tax System*

Andorra's tax system has evolved in accordance with the activity and economic structure of the country, and the tax base has been broadened in order to distribute the weight of the tax burden in a more optimal manner, moving from reliance mostly on indirect taxes to a modern system of direct taxation.

In 2013, the current General Indirect Tax was adopted, replacing most existing indirect taxes on consumption. This move created a more neutral and efficient framework for businesses and a fairer system for citizens. The general rate of the indirect tax is 4.5% for most items and 1% for goods and services related to health, education, culture, food, and rentals. The rate is much lower than rates in France (20%) and Spain (21%), its neighboring countries.

State direct taxation commenced in 2006, with the implementation of the tax on capital gains in real estate transactions. In 2010, the Company Income Tax law and the

Nonresident Tax Law were passed. Finally, in 2014, Personal Income Tax was introduced, completing the configuration of the Andorran tax framework, and introducing a tax comparable in concept to those in other European and O.E.C.D. countries.

*Double Taxation Agreements*

In 2013 Andorra signed its first bilateral Double Taxation Agreement ("D.T.A.") with France, which entered into force on July 1, 2015. Andorra's D.T.A. with Spain was signed in early 2015 and entered into force on February 26, 2016. Today, D.T.A.'s exist with (i) France, (ii) Spain, (iii) Luxembourg, (iv) Liechtenstein, (v) Portugal, (vi) the United Arab Emirates, (vii) Malta, (viii) Cyprus, (ix) the Republic of Saint Marino, and (x) Hungary. D.T.A.'s with Germany and the Netherlands are currently under negotiation.

## CURRENT TAX SITUATION

No wealth tax, inheritance and gift taxes, or exit tax exist in Andorra. Therefore, the two main direct taxes applicable are Personal Income Tax and Corporate Income Tax.

***"No wealth tax, inheritance and gift taxes, or exit tax exist in Andorra."***

**Personal Income Tax ("P.I.T.")**

*Taxpayers Subject to This Tax Are Individuals with Tax Residency in Andorra*

The income of individuals considered to be tax resident in Andorra is taxed on a worldwide basis.

Individuals are considered to be tax residents in Andorra in either of the following circumstances:

- The individual resides in the Andorran territory for more than 183 days during the calendar year. For this purpose, sporadic absences are disregarded, unless the taxpayer can prove tax residency in another country.
- The individual's center of vital interests or base of activities or economic interests is located directly or indirectly in Andorran territory. If an individual's spouse and minor children are resident in Andorra, the individual is presumed to be tax resident in Andorra unless legally separated from the spouse.

*Transactions Exempt from P.I.T.*

Several exempt or zero-rated transactions make Andorra attractive for resident investors:

- Dividends and other income derived from participation in net assets are exempt, when paid by tax-resident entities in Andorra or by Andorran collective investment undertakings subject to the Andorran Corporate Tax.
- Capital gains[1] resulting from the transfer or redemption of shares or stakes in collective investment organization are exempt.

[1] It follows that if a transaction is of a type for which capital gains are not taxed, capital losses incurred from that type of transaction are not deductible.

- Capital gains resulting from the transfer of shares are exempt when the transferor and certain related parties collectively own less than 25% of the capital during the twelve months preceding the transfer.

- Where the transferor and related parties collectively own more than 25% of the capital of the issuing company, capital gains resulting from the transfer of shares are exempt when those shares have been held for ten years or more.

- Capital gains from the transfer of real estate located outside the Andorran territory when the taxpayer has owned these properties for at least ten years prior to the transfer.

*Main Reductions to P.I.T.*

Taxpayers have the right to apply several reductions, the most relevant ones being the minimum personal reduction, the reduction on contributions made to pension plans, and the €3,000 exemption for financial income realized.

- The minimum personal reduction amounts to €24,000. The reduction is increased to €40,000 where the spouse or life partner living with the taxpayer receives no income.

- The reduction for contributions made to pension plans is based on the actual contributions made. The reduction is capped. It cannot exceed the lower of (i) 30% of the net income from employment and economic activities and (ii) €5,000 per year.

*Tax Rate*

The tax payable is determined by applying a flat 10% tax rate to the tax base of the individual. In computing the tax base, the reductions discussed above are taken into account as well as deductions to eliminate domestic and international double taxation within certain limitations.

The following example illustrates the computation of the tax base. In the facts presented below, an individual with a total income of €270,000 would only end up paying a total of €11,300, which represents an effective average tax rate of 4.18%.

*Example*

**Personal Circumstances**

- Male

- Married (the spouse does not earn any income)

- Two children under 25 years

**Income**

- Salary: €100,000

- Capital gains: €10,000 for the sale of shares of a company (<25% of shares during 2 years)

- Interests from Andorran bank accounts: €10,000

- Dividends from Andorran company: €100,000
- Dividends from non-Andorran company: €50,000

**Sources of Income Analysis**

| Source of Income | Amount (€) | Taxable/Exempt |
|---|---|---|
| Salary | 100,000 | Taxable |
| Capital gains | 10,000 | Exempt |
| Interests from bank accounts | 10,000 | 3,000 exempt |
| Dividends from an Andorran company | 100,000 | Exempt |
| Dividends from a non-Andorran company | 50,000 | Taxable |

**Applicable Reductions**

| Reductions | Amount (€) |
|---|---|
| Other deductible costs (3% salary, max. €2,500) | 2,500 |
| Personal minimum reduction | 24,000 |
| Personal minimum spouse reduction | 16,000 |
| Descendants (2 sons) reduction | 1,500 |
| **Total** | **44,000** |

**Calculations**

| | |
|---|---|
| Total Income | 270,000 |
| *Less* | |
| Exempt Income | 113,000 |
| **Taxable income** | **157,000** |
| *Less* | |
| Applicable Reductions | 44,000 |
| **Tax base** | **113,000** |
| × Tax Rate | 10.00% |
| **Tax payable amount** | **11,300** |
| **Effective tax rate** | **4.18%** |
| **After Tax Net Income** | **258,700** |

## Corporate Income Tax

In principle, corporate income tax is not applied on a territorial basis. Consequently, corporate income tax applies to the income of a resident Andorran legal entity no matter where generated. An entity is considered to be tax resident in Andorra in three fact patterns.

- It is established under Andorran law.
- It has a registered office or maintains co-working space in Andorra.
- Its place of effective management of a business is located in Andorra.

### *General Corporate Tax Regime*

The rate of Corporate Income Tax is 10% of net profits. Collective investment companies enjoy a 0% tax rate under certain circumstances. However, an Andorran company that is part of a multinational group with consolidated revenues of at least €750 million is subject to a 15% tax on profits. This adjustment aligns Andorran tax law with the new global minimum top-up tax under B.E.P.S. 2.0.

### *Reductions in Tax*

The general tax rate is reduced for companies engaged in the international exploitation of intangible property, provided the company maintains a minimum level of economic substance. The bar for meeting the substance requirement is relatively low. It is met if the company has an employee working at least 4 hours per day and an office consisting of twenty square meters.

Dividends or capital gains obtained by Andorran companies from certain local or foreign companies are exempt in order to avoid double taxation when the following three conditions are met:

1. Holds directly or indirectly owns at minimum 5% of the share capital of the foreign company;
2. The shares must be held for more than one year; and
3. If it is a foreign company, has to be subject to income tax imposed at rates analogous to Andorran corporate tax rates. This requirement is considered fulfilled when the invested entity is a nonresident subject, without the possibility of exemption, at a nominal rate equivalent to at least 40%. This condition is considered satisfied when the invested entity is a resident in a country with which Andorra has entered into an agreement to avoid double taxation.

The tax benefit is cut back with effect as of January 1, 2024. A minimum tax of 3% is imposed on the corporate income for all companies generating profits, irrespective of existing deductions and offsets.

### *Withholding Tax on Outbound Dividends and Certain Gains*

No withholding is made on dividends paid to nonresidents.

In comparison, a 10% tax is imposed on capital gains derived by nonresidents from the transfer of shares of an Andorran company. The 10% tax is also imposed on the payment of liquidation distributions to nonresidents at the time an Andorran company is wound-up.

*Special Tax Regime for Holding Companies*

A special tax regime applies to dividends and gains derived by an Andorran holding company. No tax is levied in Andorra on a holding company that receives dividends from, or realizes capital gains related to, a foreign company. The exemption is subject to the following condition: the foreign company must be resident in a country in which corporate tax rate is at least 4% or be resident in a country with which Andorra has signed a D.T.A. (Double Taxation Agreement). An Andorran holding company need not maintain a minimum percentage of the share capital of the foreign corporation in order to benefit from the regime. Similarly, no minimum holding period is required.

***"A special tax regime applies to dividends and gains derived by an Andorran holding company."***

Dividends paid from the holding company to Andorran companies or private individuals who are tax resident in Andorra are also exempt.

**Nonresidents Income Tax ("N.R.I.T.")**

Several exempt or zero-rated transactions make Andorra attractive for foreign investors (individuals or companies):

- Dividends and other income derived from participation in net assets are exempt, when paid by tax-resident entities in Andorra or by Andorran collective investment undertakings subject to the Andorran Corporate Tax.
- Capital gains[2] resulting from the transfer or redemption of shares or stakes in collective investment organization are exempt.
- Capital gains resulting from the transfer of shares are exempt when the transferor and certain related parties collectively own not more than 25% of the capital during the twelve months preceding the transfer.

## TRUSTS IN ANDORRA: A LEGAL OVERVIEW

Trusts play a pivotal role in wealth management and succession planning. Originating from English common law, trusts are recognized in various legal systems, particularly in Anglo-Saxon countries. Notably, Andorra lacks an equivalent instrument to the trust and has not signed The Hague Convention of 1985.

A technical announcement of November 25, 2015, explains the treatment of foreign trusts in Andorra. The trust is not recognized in Andorra. Consequently, the settlor is considered to be the owner of the trust's assets when control has not been transferred to the beneficiary. Therefore, the settlor will be subject to P.I.T. on the income generated by the assets, due to transparency of the trust. However, where the trust is irrevocable, both control and possession are viewed to shift to the beneficiary, resulting in the recognition of a capital gain by the settlor. Given the absence of taxes for the beneficiary on donations and inheritance, the transfer of assets from settlor to beneficiary is not subject inheritance tax or gift tax.

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[2] It follows that if a transaction is of a type for which capital gains are not taxed, capital losses incurred from that type of transaction are not deductible.

In the event that an Andorran company is part of a foreign trust, the ultimate beneficiary must be officially disclosed to the Andorran government through an official declaration. This ensures compliance with regulatory requirements and fosters transparency in financial dealings involving trusts within the jurisdiction.

## LEGAL RESIDENCE IN ANDORRA

Understanding the criteria for legal residence in Andorra is crucial for those considering a relocation. There are various ways to obtain legal residence in Andorra.

- **Employment Visa.** This visa requires an employment contract calling for permanent residence in Andorra. More than 183 days annually must be spent in the country. Police oversight ensures compliance with required days of presence. The renewal of residence hinges on meeting both requirements. An initial deposit of €15,000 must be paid. The deposit is refundable upon permanent departure from the country. Persons who carry on certain professions are exempt from the deposit requirement.

- **Self-Employment Visa.** This visa requires the formation of a company in Andorra. More than 183 days annually must be spent in the country. A deposit of €50,000 must be made with the Andorran Financial Regulator ("A.F.A."). The individuals obtaining the visa must serve as the company administrator and own more than 34% of the shares of the company.

- **Investment Visa.** This visa requires a €600,000 investment in Andorran real estate, shares of an Andorran company, or listed financial products in Andorra. Additionally, a deposit of €47,500 must be made with the A.F.A. for the investor and an extra €9,500 must be made for each dependent. An investment visa requires presence in Andorra for a period of only 90 days. This visa is suitable for individuals already retired, managing assets from Andorra, and benefiting from its tax advantages. It is comparable to "golden visa" programs in other European countries.

- **Scientific, Cultural, and Sports Visa.** This visa is equivalent to an O-1 visa in the U.S. applicable to individuals with extraordinary ability or achievement. It is open to any foreign individual with international recognition for talent in science, culture, or sports. It requires a stay in Andorra of a minimum period of 90 days each year. In addition, it requires the acquisition or lease of personal use residential property in Andorra. At least 85% of the individual's talent related services must be performed outside of Andorra. A deposit of €47,500 must be made to the A.F.A. for the individual and an additional deposit of €9,500 must be made for each dependent individual.

- **Professionals with International Operations.** This visa is available for a professional or sole trader establishing a headquarters for operations. At least 85% of the services of the professional or businessperson must be performed outside of Andorra. The visa holder can employ only one person on a regular basis.

### Rights of Mobility to Spain and France for Andorran Residents

While maintaining its autonomy and not being a part of the European Union or the Schengen area, Andorra provides residents with unique mobility rights in Spain and

France under a Mobility Agreement approved in 2020. The practical implications are that individuals arriving from any European state need not undergo any special procedures. A simple passport or ID card is sufficient for entry or exit from Andorra.

## CONCLUSION

Andorra stands out as an exceptionally attractive European destination for living, seamlessly blending natural beauty, a high quality of life, and distinctive advantages. Its strategic proximity to major European cities positions it as an ideal choice for those seeking a quiet lifestyle while still maintaining accessibility to larger urban centers. It is an alternative to more well-known locations due to its favorable tax system, while providing mobility to the rest of Europe.

# MAURITIUS – GATEWAY TO AFRICA

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**Tags**
Af.C.F.T.A.
C.I.G.A.
Collective Investment Scheme
I.F.C.
Mauritius
V.A.I.T.O.S.
Virtual Assets

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## INTRODUCTION

Rightly called the Pearl of the Indian Ocean, Mauritius is much more than a popular tourist destination. With an area of 2,040 square kilometers and a population of just over 1.3 million, the tiny island is situated off the southeast coast of Africa next to Madagascar. It pulls more than its weight when it comes to financial services. Mauritius positioned itself for cross-border activities in the early 1990's, and since then, it has been recognized as a reputable International Financial Center ("I.F.C.'') and the preferred gateway for investments into (and out of) Africa and Asia (mainly India).

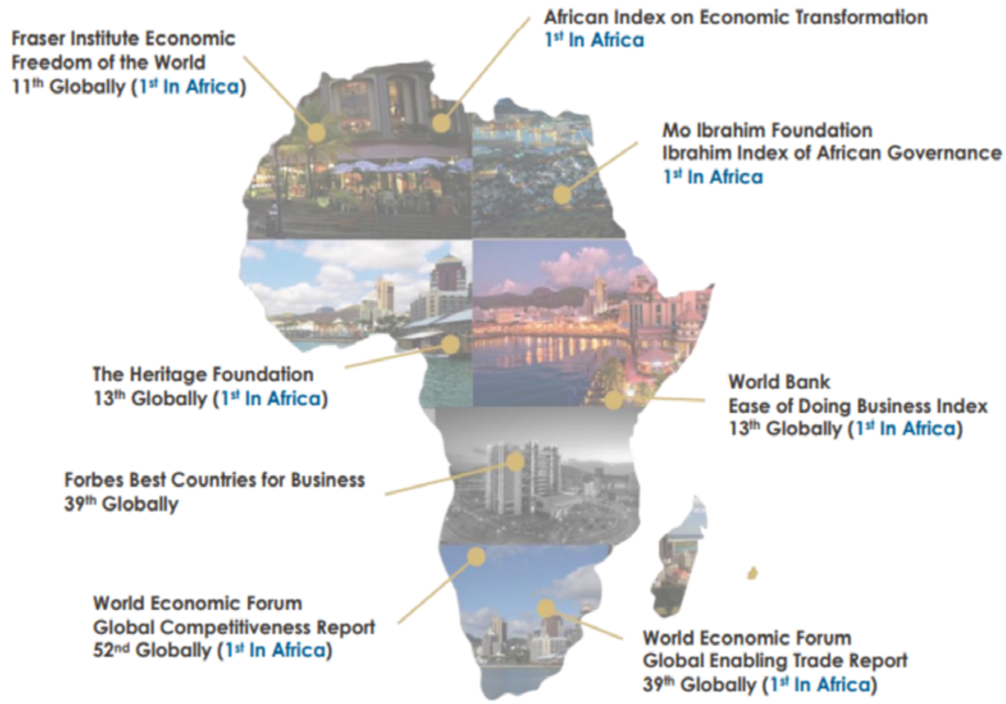
## MAURITIUS AT A GLANCE

The 2022 World Bank statistics placed Mauritius as the country with the second highest per capita G.D.P. in Africa, ahead of its better-known neighbor, South Africa. The country offers a high standard of living in a stable social, political, and economic environment.

Mauritius is a multicultural and multiethnic hotchpot with a diverse population of Indian, African, Chinese, and European origins. The country has long served as a cultural bridge between Asia and Africa. This cultural connectivity can be advantageous for businesses looking to understand and navigate the nuances of different markets. Although the official language is English, French remains widely used, and both languages are used for business purposes.

The country is a multiparty parliamentary democracy with a well-regulated financial services sector and an effective, independent legal system having the Judicial Committee of the Privy Council in the U.K. as its highest court of appeal. One attractive characteristic of the legal system is that it remains a hybrid system with features of both the English Common Law and the French Napoleonic Code Civil.

Over the years, Mauritius has won a number of international accolades reinforcing its reputation as an I.F.C.




## WHY MAURITIUS?

Mauritius offers all the advantages of an established I.F.C.

- Mauritius is one of the most stable and attractive environments for doing business in Africa thanks to its political and economic regime, tax rules, robust legal and judicial framework, and foreign currency availability with free capital flows.
- Mauritius has a highly literate, comparatively low-cost, and multilingual workforce. The country has a skilled workforce of around 15,000 professionals servicing the I.F.C. including accountants, fund administrators, lawyers, and bankers to deal with modern international clients' exigencies. The level of service is high and the culture is hard working, fast, and efficient.
- The island offers excellent infrastructure. Mauritius actively encourages foreign talent, know-how, and investment into the country. The infrastructure in Mauritius is on par with international standards.
- The banking system in Mauritius comprises of 19 banks with over $43 billion of assets on a cumulative basis. The banking industry is at the cutting edge of innovations and international regulatory developments.
- Favorable regulatory environment. Mauritius has developed an internationally compliant regulatory framework that encourages foreign investment.


- Foreign companies enjoy free repatriation of profits, which positions Mauritius as a welcoming and investor-friendly jurisdiction.
- Strategic time zone (G.M.T. +4), which enables trading and business to be conducted with Africa, Europe, Asia, and the U.S. on the same business day.

## THE MAURITIUS I.F.C.

Mauritius, as an I.F.C., offers a range of products and structures which have helped develop a conducive ecosystem for promoting cross-border investment and solutions to high net worth individuals in positioning private wealth.

The Global Business Company ("G.B.C.") is the vehicle of choice for holding foreign assets. About 15,000 G.B.C.'s are in existence as of the date of this article. In addition, over 900 global funds are based in Mauritius. The legal framework for trusts and foundations also makes Mauritius a favored jurisdiction for succession, wealth planning, and philanthropic solutions for individuals and families.

The I.F.C. sector represents more than 13% of G.D.P., arising from

- the export of goods and services;
- cross-border investment and corporate banking;
- recent emphasis on tapping into renewable energy and E.S.G. projects built around U.N. Sustainable Development Goals by African countries;
- private banking and wealth management;
- business and financial rules that promote capital raises and public offerings;

- frameworks for FinTech, Virtual Assets, and Initial Token Offering Services;
- emerging products, such as peer-to-peer lending, crowdfunding, and artificial intelligence-enabled services;
- mediation and arbitration rules for non-judicial settlement of legal disputes; and
- global headquarters administration.

## NEW DEVELOPMENTS

The recent legislation around virtual assets and initial token offerings ("V.A.I.T.O.S.") makes Mauritius one of the first countries in Africa to provide a regulatory framework for Virtual Assets Service Providers ("V.A.S.P."), removing the lack of transparency and certainty around these activities. The regulatory framework also paves the way for V.A.S.P. to access formal banking services enabling growth and expansion for those operators.

The V.A.I.T.O.S. Act provides for several subcategories of licenses:

- Licenses allowing Virtual Asset Broker-Dealers to carry out activities such as exchanges between virtual assets ("V.A.'s") and fiat currencies or exchange between one or more forms of V.A.'s
- Virtual Asset Wallet Services licenses pertain to the transfer of V.A.'s
- Virtual Asset Custodian licensees are responsible for the safekeeping of V.A.'s or instruments enabling control over V.A.'s, administration of V.A.'s or instruments enabling control over V.A.'s
- Virtual Asset Advisory Services licenses covering the participation in, and provision of, financial services related to an issuer's offer or sale of V.A.'s
- Virtual Asset Market Place licenses that allow for the setting up of a Virtual Asset Exchange as a centralized or decentralized virtual platform, whether in Mauritius or in another jurisdiction, thereby facilitating the exchange of V.A.'s for fiat currency or other V.A.'s on behalf of third parties for a fee, a commission, a spread, or other financial benefit

This new legislation coupled with the regulatory sandbox regime available in Mauritius has created a conducive environment for V.A.S.P. and other new technology providers to collaborate and develop innovative solutions. This is proving especially useful for Africa where V.A.S.P. are playing a critical role across all sectors of the continent's economies.

## GATEWAY TO AFRICA

Mauritius is the jurisdiction of choice for firms wanting to expand their business into Africa. Mauritius has long-standing relationships with key African and international bodies, including the Southern African Development Community ("S.A.D.C.") and the Common Market for Eastern and Southern Africa ("C.O.M.E.S.A."), the World Trade Organization, and the Commonwealth of Nations. It has also established a network of agreements, comprising 24 signed Investment Promotion and Protection Agreement ("I.P.P.A.'s") and 21 signed Double Taxation Avoidance Agreements ("D.T.A.A.'s") with African states, which means that global investors, traders, and private equity companies gain preferential access to a number of key African markets and hundreds of millions of customers.

The African Continental Free Trade Agreement ("Af.C.F.T.A."), established in January 2021, covers preferential trade for both goods and services between all 55 African countries. Mauritius is a signatory. With 55 African countries, a market of 1.3 billon people, and an economy of $2.6 trillion, the opportunity for member states is huge. The agreement has the potential to drive inclusive growth in Africa.

***"Over the last few years, Mauritius has undertaken a complete overhaul of its tax system eliminating all laws deemed as harmful tax practices by the O.E.C.D."***

## THE MAURITIUS TAX REGIME

The tax regime of Mauritius remains one of the points of attraction for the country. Mauritius has a low income tax rate. In addition, Mauritius offers a range of incentives that reduces the tax rate in order to boost the competitiveness of the island in terms of facilitating business in the country. For instance, dividends paid by a Mauritius resident company and gains derived from the sale of units, securities, or debt obligations are exempt from income tax in Mauritius. There is no withholding tax on dividends paid by a Mauritian resident company. There are no capital gains tax and no inheritance tax in Mauritius.

Over the last few years, Mauritius has undertaken a complete overhaul of its tax system eliminating all laws deemed as harmful tax practices by the O.E.C.D. Significant changes were implemented to the tax system for the country to shed its image of a tax haven. As a result,, Mauritius has moved away from being a traditional tax haven to a tax-efficient jurisdiction of substance.

In 2019, the headline tax rate was harmonized at 15% for both the domestic and offshore sectors providing a transparent system and level playing field for all businesses. This regime has successfully generated substantive economic activities across all sectors of the Mauritian economy.

Previously, Mauritian tax law provided for a foreign deemed tax credit for companies operating in the global business sector. No matter what taxes were paid abroad, a tax credit of 80% could be claimed on foreign income which essentially meant that such income was effectively taxed at 3%. As a result of international pressures, the deemed foreign tax credit of 80% was abolished in 2019 and replaced by a system whereby a partial exemption of 80% was applied to certain types of income subject to meeting the substance requirements in Mauritius. Under the 80% partial exemption regime, 80% of the relevant income would be treated as exempt from tax in Mauritius.

Income from the following activities are eligible for the partial exemption:

- Foreign dividends derived by the company
- Interest derived by a company other than banks, money changers, insurance companies, and leasing companies
- Income derived from ship or aircraft leasing

- Income attributable to a permanent establishment
- Income from reinsurance and reinsurance brokering activities
- Income from leasing & provision of international fiber capacity
- Income from the sale, financing, arrangement, or asset management related to aircraft, including spare parts and aviation advisory services
- Interest income derived by a person from money lent through a peer-to-peer lending platform

The partial exemption regime is only applicable to companies which have substance in Mauritius, which is defined in the following way:

- The core income generating activities ("C.I.G.A") of the company must be located in Mauritius.
- The company should be managed and controlled from Mauritius.
- The company should be administered by a Management Company.

In order for a company to be managed and controlled from Mauritius, it should meet the following conditions:

- Its principal bank account should be maintained in Mauritius at all times.
- Its accounting records are maintained at its registered office in Mauritius.
- It prepares its statutory financial statements in Mauritius.
- Meetings of directors must include at least two directors from Mauritius.

In addition to the 80% partial exemption regime, Mauritius offers numerous tax incentives to boost competitiveness. To illustrate, all profits from the export of goods are taxed at 3% and profits from a Collective Investment Scheme ("C.I.S."), Closed-End Fund ("C.E.F."), C.I.S. Manager, C.I.S. Administrator. C.I.S. Adviser, or C.I.S. Asset Manager benefit from a 95% tax exemption.

A number of regimes offering tax holidays for a certain period are also available. With a strong finance sector and business environment, Mauritius has become a popular location for global corporations to maintain regional headquarters. The Mauritian legislation is designed to promote the establishment of companies offering Global Headquarters Administration ("G.H.A.") and Global Treasury Activities ("G.T.A.") activities from a base in Mauritius.

An eight-year tax holiday on corporate income is applicable to companies holding a G.H.A. license and a tax holiday of five years is available to companies holding a G.T.A. license.

The G.H.A. licenses are issued to companies which provide any three of the following services to related corporations within a multinational grouping:

- Administration and general management
- Business planning, development, and coordination

- Economic or investment research and analysis
- Services related to international corporate headquarters in Mauritius

Companies holding a G.T.A. License are expected to provide at least three treasury services to related companies from the following list:

- Arrangement for credit facilities, including credit facilities with funds obtained from financial institutions in Mauritius or from surplus of related companies
- Arrangement for derivatives
- Corporate finance advisory
- Credit administration and control
- Factoring and re-invoicing activities
- Guarantees, performance bonds, standby letters of credit, and services relating to remittances
- Management of funds for designated investments

Despite the overhaul of its tax system, Mauritius has retained certain key attractive tax features which make it a tax-efficient jurisdiction while still being approved by international regulators.

Mauritius has proven itself to be a collaborative and responsible international financial center that has taken significant steps to adhere to international best practices. To enhance its transparency and collaboration framework, Mauritius signed the O.E.C.D. Multilateral Convention on Mutual Administrative Assistance in Tax Matters in June 2015. Mauritius is also a member of the Early Adopters Group committed to the early implementation of the Common Reporting Standard ("C.R.S.") on the automatic exchange of financial account information.

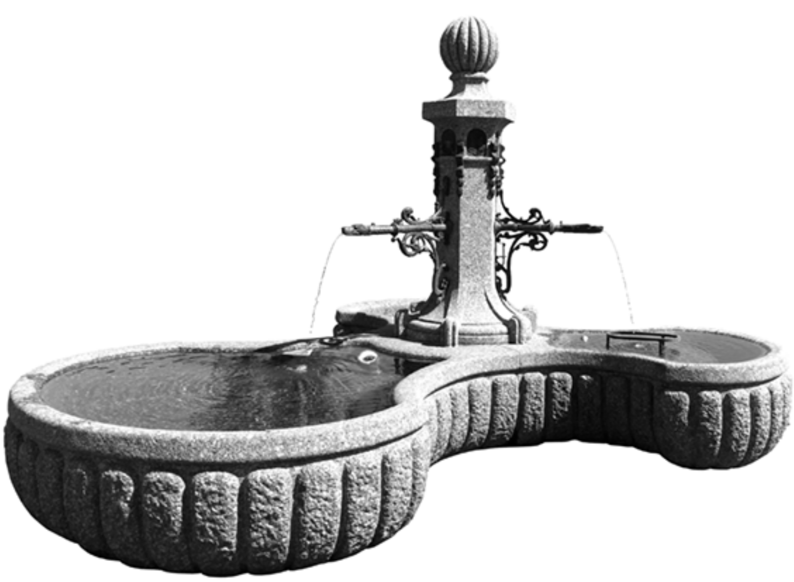
The O.E.C.D. Global Forum has rated Mauritius as a "Largely Compliant" jurisdiction – a rating which equals that obtained by developed economies such as the U.S., the U.K., and Germany. It was the first African country to sign up to an Intergovernmental Agreement with the U.S. for the implementation of the Foreign Accounts Tax Compliance Act ("F.A.T.C.A.") and has joined the O.E.C.D.'s Inclusive Framework to implement the Base Erosion and Profit Shifting ("B.E.P.S.") recommendations and the new initiative on exchange of beneficial ownership information.Why Africa, why now?

Given its youthful, rapidly urbanizing population, it is no surprise that Africa remains at the top of investment agendas for businesses. Africa is currently going through a structural change and recent trends show that investors' interest has shifted from extractive activities to consumer-oriented activities, comprising new sectors such as technology, media and telecommunications, financial services, consumer product, retail & real estate, hospitality, and construction, and next-generation industries such as business services, tech, automotive, and life sciences.

The rewards promise to be substantial. The McKinsey Global Institute projects that by 2025, African household consumption and business-to-business ("B2B") spending could reach $5.6 trillion. That is equivalent to nearly a third of the current U.S.

gross domestic product. To get there, the continent has enormous infrastructure gaps to fill. Those gaps themselves represent enormous opportunities.

Mauritius provides the right launching pad and ecosystem for structuring investments into Africa with appropriate structuring vehicles, an investor-friendly jurisdiction, a dynamic and flexible debt market, and investment protection mechanisms and tools.



# NOTICE 2023-80: U.S. FOREIGN TAX GUIDANCE FOR PILLAR 2

**Author**
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**Tags**
Dual Consolidated Losses
Foreign Tax Credit
Income Inclusion Rule
Notice 2023-80
Pillar 2
Qualified Domestic Minimum
Top-Up Tax
Undertaxed Payments Rule

On December 11, 2023, the I.R.S. and Treasury Department issued Notice 2023-55 (the "Notice"), announcing the intention to issue proposed regulations addressing the interaction between the Pillar 2 GloBE Rules and specific U.S. tax provisions, including the foreign tax credit rules and dual consolidated loss rules. Pillar 2 establishes a top-up tax framework through the GloBE rules, which consists of the Income Inclusion Rule ("I.I.R.") and the Undertaxed Payments Rule ("U.T.P.R."). The issuance of this guidance is timely, as the I.I.R.'s of most countries took effect at the start of this year, while the U.T.P.R.'s are scheduled to come online in 2025. The Notice does not cover the U.T.P.R., as the I.R.S and Treasury Department continue to analyze issues related to the U.T.P.R. Although the U.S. has not yet implemented the GloBE rules, in scope U.S.-based multinational enterprises ("M.N.E.'s") will be required to comply with the rules as enforced by other countries.

## OVERVIEW OF PILLAR 2

Pillar 2 is part of the two-pillar solution put forth by the O.E.C.D. to address the tax challenges emerging from the digitalization of the economy. Pillar 2 is designed to ensure large M.N.E.'s pay a minimum level of tax on the income generated in each jurisdiction where they operate.

Pillar 2 consists of two main rules:

- The Subject to Tax Rule ("S.T.T.R.")
- The Global Anti-Base Erosion (GloBE) Rules

The S.T.T.R. is effectively a treaty-override provision that allows source jurisdictions to tax certain payments up to a globally agreed 9% minimum tax rate.

The primary rules under Pillar 2 are the GloBE rules, which impose a 15% minimum tax rate on in-scope M.N.E.'s with annual global revenues exceeding €750 million. The GloBE rules establish a top-up taxation framework consisting of the I.I.R. and the U.T.P.R. using a jurisdictional blending approach.

The I.I.R. is the primary mechanism to account for the top-up tax. The home jurisdiction of the Ultimate Parent Entity ("U.P.E.") of an M.N.E. group may impose an I.I.R. on the U.P.E. to the extent the effective tax rate ("E.T.R.") on income earned in any foreign jurisdiction falls below 15%. In cases where the home jurisdiction does not impose an I.I.R., the right to tax extends down the group to the next company where there is an I.I.R.

The U.T.P.R. operates as a backstop to the I.I.R. In cases where the entire top-up tax is not allocated under the I.I.R., the responsibility for addressing the outstanding top-up tax falls upon the group entities. The U.T.P.R. requires an adjustment, such as a denial of a deduction, that increases the tax at the level of the group entities. The adjustment is an amount sufficient to ensure that the group entities pay their share of the top-up tax remaining after the I.I.R. Each entity's share of the top-up tax is based on its *pro rata* share of the income, taking into account its relative share of assets and employees. The U.T.P.R. is designed to prevent countries from favoring their resident M.N.E.'s by abstaining from imposing the I.I.R.

The last piece of the puzzle is the Qualified Domestic Minimum Top-Up Tax ("Q.D.M.T.T."). A Q.D.M.T.T. allows the low-tax jurisdiction to apply a top-up tax on the income of a constituent entity of an M.N.E. group in its jurisdiction, as opposed to the tax being collected by other jurisdictions through the I.I.R. or U.T.P.R. Essentially, businesses would generally pay an equivalent level of tax on their profits, whether a Q.D.M.T.T. is in place or not. However, instead of allowing another country to collect that tax through the I.I.R. or U.T.P.R., the Q.D.M.T.T. guarantees the tax is remitted to the domestic government.

In general, Pillar 2 operates as follows. An M.N.E. group first determines whether it is in scope of the GloBE rules. If an M.N.E. group is in scope, it then must calculate its GloBE E.T.R. If the E.T.R. is less than the 15% global minimum rate, the group must calculate the amount of top-up tax, representing the difference between the GloBE E.T.R. and the 15% rate. The amount of top-up tax is reduced by the Q.D.M.T.T. After the reduction for the Q.D.M.T.T., if tax is still payable, the I.I.R. is applied, and then, if necessary, the U.T.P.R.

## NOTICE 2023-80

### GloBE Model Rules and the Foreign Tax Credit

The Notice describes rules addressing the treatment of certain taxes, including the I.I.R., U.T.P.R., and Q.D.M.T.T., under Code §§ 59(l), 78, 275, 704, 901, 903, 951A, 954, and 960. The I.R.S. and the Treasury Department intend to issue proposed regulations consistent with the guidance provided in the Notice.

Code §901 generally allows a credit for foreign income taxes paid or accrued during the taxable year to any foreign country or U.S. territory, and in the case of a domestic corporation, the taxes deemed to have been paid under Code §960. Code §903 adds that foreign income taxes include a tax paid in-lieu-of a generally imposed foreign income tax.

The rules are expected to have adverse implications for U.S. taxpayers, as both the I.I.R. and the U.T.P.R. are likely to be non-creditable for U.S. tax purposes.

### Final Top-Up Tax

A foreign income tax is a "final top-up tax" if the foreign tax law takes into account taxes imposed by other countries on the entity's direct or indirect owners or on the entity itself for income earned in the foreign country.

No credit is allowed under Code §§901 or 59(l) to a person for a final top-up tax if the foreign tax law takes into account any U.S. Federal income tax liability in computing the final top-up tax (without regard to whether the person has any amount of U.S. Federal income tax liability).

The final top-up tax is treated as if it were a creditable tax at the partnership and C.F.C. level, with the disallowance of the credit pursuant to the above applying at the partner or U.S. shareholder level. This treatment is intended to facilitate appropriate results where a final top-up tax is creditable as to one partner or U.S. shareholder, but not as to another. Moreover, a final top-up tax is not taken into account in determining whether the high-tax exception under Subpart F or G.I.L.T.I. applies.

Specifically:

- A final top-up tax is treated as a creditable foreign tax expenditure under Treas. Reg. §1.704-1(b)(4)(viii)(b).
- A final top-up tax is treated as an eligible current year tax under Trea. Reg. §1.960-1(b)(5).
- In computing the effective rate of foreign income tax under Treas. Reg. §1.954-1(d)(2) and §1.951A-2(c)(7)(vi),
    - a final top-up tax is excluded from the amount of foreign income taxes described in Treas. Reg. §§1.954-1(d)(2)(i) and 1.951A-2(c)(7)(vi)(A); and
    - increases the amount of the net item of income described in Treas. Reg. §1.951-1(d)(2)(ii) and the amount of the tentative tested income item described in Treas. Reg. §1.951A-2(c)(7)(vi)(B), as applicable.

***"The final top-up tax is treated as if it were a creditable tax at the partnership and C.F.C. level, with the disallowance of the credit pursuant to the above applying at the partner or U.S. shareholder level."***

If a taxpayer chooses to claim a foreign tax credit, the gross-up rule of Code §78 and the deduction disallowance rule of Code §275(a)(4) apply to any foreign income tax paid or accrued, including a final top-up tax. Code §78 requires a taxpayer to include a final top-up tax in gross income and Code §275(a)(4) denies a deduction for a final top-up tax.

The following examples illustrate the above rules.

*Example 1: I.I.R. that is a Foreign Income Tax*

Facts

- Country X imposes an I.I.R. on certain entities resident in Country X.
- The I.I.R. is considered a foreign income tax within the meaning of Treas. Reg. §1.901-2(a) and (b).
- Under Country X law, the I.I.R. calculation includes the foreign tax liability of direct and indirect owners if, under Country X tax law, they are part of the same M.N.E. Group as the Country X taxpayers.
- U.S.P., a U.S. corporation, owns all the stock of C.F.C.-X., a Country X corporation, which in turn owns all the stock of C.F.C.-Y., a Country Y corporation.
- U.S.P. is considered part of the M.N.E. Group with C.F.C.-X. and C.F.C.-Y. under Country X law. Accordingly, any U.S. tax liability of U.S.P. that relates to the I.I.R. is taken into account in computing the I.I.R.
- In 2024, C.F.C.-X. is liable for $5 of Country X I.I.R.

- U.S.P. is deemed to pay $4 of the Country X I.I.R. under §960(d).
- U.S.P. chooses to credit foreign income taxes for 2024.

Analysis

The Country X I.I.R. is a final top-up tax because it is a foreign tax that takes into account taxes imposed by other countries on the owners of the entity subject to the I.I.R. with respect to income subject to the Country X I.I.R.

U.S.P. cannot claim a Code §901 credit for the $4 of Country X I.I.R. because, according to Country X law, the U.S. Federal income tax liability of U.S.P. may be considered in the Country X I.I.R. calculation.

It does not matter whether U.S.P. has any amount of U.S. Federal income tax liability or whether any of that liability is taken into account in computing the Country X I.I.R.

The amount included in U.S.P.'s income by reason of Code §78 and Treas. Reg. §1.78-1(a) is $5.

*Example 2: Minority U.S. Shareholder*

Facts

Same as Example 1, but with the following variations:

- U.S.P. and U.S.M., a U.S. corporation, own 70% and 30% of HoldCo, a C.F.C. in Country A.
- HoldCo owns all the stock of C.F.C.-X.
- U.S.M. is not part of the same M.N.E. Group as U.S.P., C.F.C.-X., and C.F.C.-Y. under Country X law.
- C.F.C.-X. is liable for $6.50 of Country X I.I.R.
- Under Code §960(d), U.S.P. is deemed to pay $3.64 of the Country X I.I.R. and U.S.M. is deemed to pay $1.56.

Analysis

Similar to Example 1, the Country X I.I.R. is a final top-up tax.

U.S.P. cannot claim a Code §901 credit for the $3.64 of Country X I.I.R. deemed to be paid because U.S.P.'s U.S. Federal income tax liability may be taken into account in computing the Country X I.I.R. under Country X law.

U.S.M., on the other hand, may be eligible for a Code §901 credit for the $1.56 of Country X I.I.R. deemed to be paid. This is because, under Country X law, no part of U.S.M.'s U.S. Federal income tax liability is considered in the I.I.R. calculation as U.S.M. is not part of the same M.N.E. Group as C.F.C.-X.

Under Code §§78 and 1.78-1(a), the amount included in U.S.P.'s income is $4.55 and the amount included in U.S.M.'s income is $1.95.

*Example 3: Q.D.M.T.T. as Foreign Income Tax*

Facts

Similar to Example 1, but with the following variations:

- Country Y imposes a Q.D.M.T.T.
- The Q.D.M.T.T. by Country Y is considered a foreign income tax within the meaning of Treas. Reg. §1.901-2(a) and (b)
- Country Y law does not consider the foreign tax liability of owners in the Q.D.M.T.T. calculation. Accordingly, any U.S. tax liability of U.S.P. is not taken into account in computing the Q.D.M.T.T.
- In 2024, C.F.C.-X. has no liability for Country X I.I.R., and C.F.C.-Y. is liable for $10 of Country Y Q.D.M.T.T.
- U.S.P. is deemed to pay $8 of the Country Y Q.D.M.T.T. under Code §960(d).

Analysis

The Country Y Q.D.M.T.T. is not a final top-up tax because Country Y law does not consider taxes imposed by other countries on the owners in the Q.D.M.T.T. calculation.

U.S.P. may be allowed a credit under Code §901 for the $8 of Country Y Q.D.M.T.T. deemed paid under Code §960(d).

The amount included in U.S.P.'s income under Code §78 and Treas. Reg. §1.78-1(a) is $10.

## Separate Levy Rules

The Notice provides that the I.R.S. and the Treasury Department intend to issue proposed regulations regarding how the separate levy rules of Treas. Reg. §1.901-2(d) apply with respect to an I.I.R., U.T.P.R., and Q.D.M.T.T. This treatment would reflect that the amount of tax imposed under an I.I.R., U.T.P.R., or Q.D.M.T.T. is computed separately from any other levy imposed by a foreign country and would ensure consistent treatment of an I.I.R., U.T.P.R., and Q.D.M.T.T. no matter how a foreign country constructs an I.I.R., U.T.P.R., or Q.D.M.T.T. Consequently, it does not matter whether the foreign country imposes these taxes independently or by adjusting the base of any other levy (such as through an addition to income or denial of deductions).

## Determining the Taxpayer for a Q.D.M.T.T.

The Notice provides that the I.R.S. and the Treasury Department intend to issue proposed regulations establishing rules for determining the company deemed to be the payer of a Q.D.M.T.T. for purposes of Treas. Reg. §1.901-2(f) when a Q.D.M.T.T. is computed by reference to the income of two or more companies.

If a Q.D.M.T.T. is computed by reference to the income of two or more persons, foreign tax law is considered to impose legal liability for the Q.D.M.T.T. on each person in proportion to the person's Q.D.M.T.T. Allocation Key. A person's Q.D.M.T.T. Allocation Key is the product derived by multiplying (i) the excess, if any, of the

Q.D.M.T.T. Rate over the person's Separate Pre-Q.D.M.T.T. E.T.R. against (ii) the person's Separate Q.D.M.T.T. Income.

- Q.D.M.T.T. Rate means the minimum E.T.R. stated in the foreign tax law to which the actual E.T.R. of a person or persons is compared for purposes of computing the Q.D.M.T.T.
- A person's Separate Pre-Q.D.M.T.T. E.T.R. means the person's Separate Pre-Q.D.M.T.T. Taxes (whether positive or negative) divided by the person's Separate Q.D.M.T.T. Income.
- A person's Separate Q.D.M.T.T. Income means the income or loss of the person that is taken into account under the foreign tax law for purposes of computing the Q.D.M.T.T.

If a person's Separate Q.D.M.T.T. Income is zero or negative, the Q.D.M.T.T. Allocation Key will be treated as zero. These rules apply regardless of (i) how the foreign tax law distributes the Q.D.M.T.T. liability among multiple persons, (ii) the person who is responsible for paying the tax, (iii) the person who actually pays it, or (iv) the person that may be pursued by the foreign country for collection of the tax if any part of it remains unpaid.

A person's Separate Q.D.M.T.T. Income and Separate Pre-Q.D.M.T.T. Taxes are determined by looking at the relevant amounts stated in any return, schedule, or required document under the foreign tax law for Q.D.M.T.T. purposes. Negative amounts attributable to other persons are ignored. If a separate filing is not required under foreign tax law, the foregoing amounts are determined by referring to the relevant figures in the books of account regularly maintained and used for computing the Q.D.M.T.T.

The following examples illustrate the above rules.

*Example 4: Q.D.M.T.T. Imposed on Two or More Persons*

Facts

- Country X enacted a Q.D.M.T.T.
- Under Country X tax law, entities that are resident in, or have a taxable presence in, Country X and are in the same M.N.E. Group are jointly and severally liable for the Q.D.M.T.T.
- U.S.P. owns all stock of C.F.C.-1 and C.F.C.-2. Each C.F.C. is a tax resident of Country X and a member of the same M.N.E. Group.
- In Year 1, C.F.C.-1's Separate Q.D.M.T.T. Income is $100, and Separate Pre-Q.D.M.T.T. Tax is $5. C.F.C.-2's Separate Q.D.M.T.T. Income is $50, and Separate Pre-Q.D.M.T.T. Tax is $5.
- The Q.D.M.T.T. Rate in Country X is 15%.
- Country X imposes $12.50 of Q.D.M.T.T. on C.F.C.-1 and C.F.C.-2, collectively.

Analysis

Under Country X tax law, Q.D.M.T.T. is computed based on the income of both C.F.C.-1 and C.F.C.-2.

The $12.50 of Country X Q.D.M.T.T. is allocated between C.F.C.-1 and C.F.C.-2 proportionally to each entity's Q.D.M.T.T. Allocation Key.

C.F.C.-1's Q.D.M.T.T. Allocation Key is $10 ((15% - ($5 / $100)) x $100), and C.F.C.-2's Q.D.M.T.T. Allocation Key is $2.50 ((15% - ($5 / $50)) x $50).

Accordingly, $10 the Country X Q.D.M.T.T. ($12.50 x ($10 / $12.50)) is allocated to C.F.C.-1, and $2.50 ($12.50 x ($2.50 / $12.50)) is allocated to C.F.C.-2.

*Example 5: Effect of S.B.I.E.*

Facts

Same as Example 4, but with the following variations:

- C.F.C.-1 and C.F.C.-2 collectively have $15 of Substance-Based Income Exclusion ("S.B.I.E.").
- According to Country X tax law, S.B.I.E. can reduce an M.N.E. Group's Q.D.M.T.T. liability.
- After taking into account the S.B.I.E., Country X imposes $11.25 of Q.D.M.T.T. on C.F.C.-1 and C.F.C.-2, collectively.

Analysis

The amount of S.B.I.E. and its attribution are not considered in calculating each entity's Q.D.M.T.T. Allocation Key.

The Q.D.M.T.T. Allocation Key for each of C.F.C.-1 ($10) and C.F.C.-2 ($2.50) remains the same as in Example 4, as the Separate Q.D.M.T.T. Income and Separate Pre-Q.D.M.T.T. Tax for each remains unchanged.

As a result, $9 of the Country X Q.D.M.T.T. ($11.25 x ($10 / $12.50)) is allocated to C.F.C.-1, and $2.25 of the Country X Q.D.M.T.T. ($11.25 x ($2.50 / $12.50)) are allocated to C.F.C.-2.

*Example 6: Negative Separate Q.D.M.T.T. Income*

Facts

Same as Example 4, but with the following variations:

- U.S.P. also owns all stock of C.F.C.-3, a C.F.C. tax resident of Country X.
- C.F.C.-3 is in the same M.N.E. Group as C.F.C.-1 and C.F.C.-2 under Country X tax law.
- In Year 1, C.F.C.-3's Separate Q.D.M.T.T. Income is a net loss of $50, and its Separate Pre-Q.D.M.T.T. Taxes are zero.
- Country X imposes $5 of Q.D.M.T.T. collectively on C.F.C.-1, C.F.C.-2, and C.F.C.-3.

Analysis

Country X tax law calculates Q.D.M.T.T. based on the income of C.F.C.-1, C.F.C.-2, and C.F.C.-3.

The $5 of Country X Q.D.M.T.T. is allocated among C.F.C.-1, C.F.C.-2, and C.F.C.-3 proportionally to each entity's Q.D.M.T.T. Allocation Key.

The Q.D.M.T.T. Allocation Key for C.F.C.-1 ($10) and C.F.C.-2 ($2.50) remains the same as in Example 4, given the unchanged Separate Q.D.M.T.T. Income and Separate Pre-Q.D.M.T.T. Taxes for each.

C.F.C.-3's Q.D.M.T.T. Allocation Key is treated as zero since its Separate Q.D.M.T.T. Income is less than zero.

As a result, $4 of the Country X Q.D.M.T.T. ($5 x ($10 / $12.50)) is allocated to C.F.C.-1, $1 of the Country X Q.D.M.T.T. ($5 x ($2.50 / $12.50)) is allocated to C.F.C.-2, and none of the Country X Q.D.M.T.T. ($5 x $0 / $12.50) is allocated to C.F.C.-3.

*Example 7: Negative Separate Pre-Q.D.M.T.T. Taxes*

Facts

Same as Example 4, but with the following variations:

- In Year 1, C.F.C.-1's Separate Pre-Q.D.M.T.T. Taxes is -$5, representing a negative amount of income tax expense (a tax benefit).
- Country X imposes $22.50 of Q.D.M.T.T. collectively on C.F.C.-1 and C.F.C.-2.

Analysis

Country X tax law calculates Q.D.M.T.T. based on the income of both C.F.C.-1 and C.F.C.-2.

The $22.50 of Country X Q.D.M.T.T. is allocated between C.F.C.-1 and C.F.C.-2 proportionally to each entity's Q.D.M.T.T. Allocation Key.

The Allocation Key for C.F.C.-2 ($2.50) remains the same as in Example 4, given its unchanged Separate Q.D.M.T.T. Income and Separate Pre-Q.D.M.T.T. Taxes.

C.F.C.-1's Q.D.M.T.T. Allocation Key is now $20 ((15% - (-$5 / $100)) x $100), reflecting the change in C.F.C.-1's Separate Pre-Q.D.M.T.T. Taxes.

As a result, $20 of the Country X Q.D.M.T.T. ($22.50 x ($20 / $22.50)) is allocated to C.F.C.-1, and $2.50 of the Country X Q.D.M.T.T. ($22.50 x ($2.50 / $22.50)) is allocated to C.F.C.-2.

## The Nonduplication Requirement for In-Lieu-of Taxes

The I.R.S. and the Treasury Department also intend to amend the nonduplication requirement in Treas. Reg. §1.903-1(c)(1)(ii).

In essence, in order to qualify as an in-lieu-of tax, a foreign tax need only be in substitution for a generally-imposed net income tax and not in substitution for all net income taxes imposed by that country. Accordingly, the first sentence of the non-duplication requirement in Treas. Reg. §1.903-1(c)(1)(ii) will be revised as follows:

> The generally-imposed net income tax for which the tested foreign tax is imposed in substitution is not also imposed, in addition to the tested foreign tax, on any persons with respect to any portion of the income to which the amounts (such as sales or units of production) that form the base of the tested foreign tax relate (the 'excluded income').

The modification is a result of a technical issue because the foreign tax credit regulations follow a twofold approach, offering two credit methods based on the presence of either an income tax or a Code §903 in-lieu-of-an-income-tax. Since the Code §903 tax is designed to serve as a substitute, the absence of direct counterparts for I.I.R.'s and Q.D.M.T.T.'s necessitated the incorporation of a specific carveout tailored for the GloBE rules.

The following example illustrates the above rule.

*Example 8: Country X Net Income Tax and Q.D.M.T.T.*

Facts

- Country X imposes a net income tax within the meaning of Treas. Reg. §1.901-2(a)(3) on the income of nonresident companies attributable to activities within Country X ("N.R.C.I.T.").
- The tax constitutes a generally-imposed net income tax.
- The N.R.C.I.T. excludes nonresident corporations engaged in Industry B activities, which are instead subject to the Industry B Tax.
- Country X also enacts a Q.D.M.T.T. that is a net income tax within the meaning of Treas. Reg. §1.901-2(a)(3).
- The Country X Q.D.M.T.T. is imposed on gross income that is also included in the Industry B Tax base.

Analysis

The Industry B Tax fulfills the requirement in Treas. Reg. §1.903-1(c)(1)(i) because Country X has a generally-imposed net income tax, the N.R.C.I.T.

Additionally, the Industry B Tax meets the requirement in Treas. Reg. §1.903-1(c)(1)(ii) (modified as described above) because the N.R.C.I.T., the substituted generally-imposed net income tax, is not imposed on excluded income when the Industry B Tax is applied.

It is not relevant that the Country X Q.D.M.T.T. is also imposed on the excluded income.

## Applicability Date and Reliance

It is anticipated that the proposed regulations consistent with the Notice will apply to taxable years ending after December 11, 2023. Moreover, taxpayers may rely on the guidance described in the Notice for taxable years ending after December 11, 2023, and on or before the date proposed regulations are published.

## GloBE Rules and Dual Consolidated Losses

### *Background*

Code §1503(d) and the regulations issued thereunder (the "D.C.L. rules") aim to prevent "double dipping" of losses where the same economic loss offsets both U.S. taxable income and foreign taxable income. A dual consolidated loss ("D.C.L.") is the combined net operating loss of a dual resident corporation and the net loss of a domestic corporation that is attributable to foreign branches or interests in hybrid entities.

Under the D.C.L. rules, a D.C.L. cannot offset the income of a domestic affiliate, subject to certain exceptions. One exception allows a domestic use of D.C.L. if the taxpayer makes a domestic use election, certifying no foreign use of the D.C.L. Foreign use occurs when any portion of the D.C.L. offsets income under a foreign country's tax laws that, under U.S. tax principles, would be considered income of a foreign corporation or an owner of certain interests in hybrid entities. If foreign use happens during the certification period, the taxpayer must recapture the D.C.L. as ordinary income and pay an interest charge. However, exceptions exist. One such exception involves a fact pattern in which a foreign country allows a foreign use election with regard to the loss, but the election is not made. In essence, the domestic use election under foreign law gives the taxpayer the choice to apply the D.C.L. for domestic or foreign use, but not both.

### *Interaction with the GloBE Rules*

Under the GloBE rules, if an M.N.E. Group's E.T.R. for a jurisdiction is below the 15% minimum rate, it needs to calculate the Jurisdictional Top-up Tax owed for that jurisdiction. This tax is determined based on factors like Adjusted Covered Taxes and the Net GloBE Income of constituent entities within the jurisdiction.

*"Under the GloBE rules, if an M.N.E. Group's E.T.R. for a jurisdiction is below the 15% minimum rate, it needs to calculate the Jurisdictional Top-up Tax owed for that jurisdiction."*

To compute this, the GloBE rules adopt a jurisdictional blending approach, where all income and loss of constituent entities in the same jurisdiction are generally combined. However, this aggregation raises concerns similar to those the D.C.L. rules were designed to address. For instance, if a loss resulting in a D.C.L. is combined with items that, according to U.S. tax principles, belong to a foreign corporation in that jurisdiction, the loss could be used to offset both U.S. tax (if a domestic use election is allowed) and the Jurisdictional Top-up Tax.

These concerns may arise even for a D.C.L. incurred in a taxable year ending before the anticipated effective date of the GloBE rules (*e.g.*, a year ending on December 31, 2023) if timing differences between U.S. tax law and financial accounting standards lead to a portion of the loss contributing to the D.C.L. being recognized as an expense under the GloBE rules in a later year.

Moreover, the GloBE rules have some features that differ from traditional foreign income tax systems. Unlike traditional systems, these rules lack a mechanism for a taxpayer to opt-out of aggregation. Consequently, a taxpayer might be compelled to apply a D.C.L. to a foreign use, eliminating the choice between domestic and foreign use. Furthermore, a loss may not yield any benefit under the Jurisdictional Top-up Tax. This can happen if the E.T.R. in the jurisdiction is at or above the Minimum

  

Rate, irrespective of the loss, and the loss is not carried over to calculate the Jurisdiction Top-Up Tax in a subsequent year.

The I.R.S. and the Treasury Department are examining how the D.C.L. rules should apply to the GloBE rules. This includes looking at whether combining certain items through aggregation should lead to a foreign use of a D.C.L. The I.R.S. and the Treasury Department are also assessing whether the GloBE rules should classify an entity, not otherwise subject to a foreign jurisdiction's income tax, as a dual resident corporation or a hybrid entity under Treas. Reg. §§1.1503(d)-1(b)(2) or (3). Additionally, the I.R.S. and the Treasury Department are considering whether these rules should prevent such an entity from being treated as a transparent entity under Treas. Reg. §1.1503(d)-1(b)(16).

Finally, the I.R.S. and the Treasury Department are exploring similar issues in the context of other provisions, such as how the anti-hybrid rules under Code §§245A(e) and 267A interact with the GloBE rules.

*Treatment of Legacy D.C.L.'s*

To provide clarity while the I.R.S. and Treasury Department work on guidance regarding the interaction of the D.C.L. rules with the GloBE rules, proposed regulations will be issued with respect to D.C.L.'s incurred in taxable years ending on or before December 31, 2023. Proposed regulations also will be issued covering cases where the taxpayer's taxable year aligns with the fiscal year of the M.N.E. Group, but losses in taxable years beginning before January 1, 2024, and ending after December 31, 2023 are taken into account.

Under this proposal, a foreign use would not be considered to occur for a legacy D.C.L. solely because deductions or losses that comprise the D.C.L. are factored into determining the Net GloBE Income for a specific jurisdiction. However, this proposed rule would not apply to any D.C.L. incurred or increased with the intent of reducing the Jurisdictional Top-Up Tax or qualifying for the rule described in the Notice.

Taxpayers may rely on the guidance in the Notice until proposed regulations are published.

# RECEIPT OF A PROFITS INTEREST IN A PARTNERSHIP BY A SERVICE PROVIDER – NOT TAXABLE

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**Tags**
*Campbell v. Commr*.
Contribution of Service
E.S. N.P.A. Holding L.L.C.
Partnership
Profit Interest
Section 707
Section 721(a)

## INTRODUCTION

In *E.S. N.P.A. Holding L.L.C. v. Commr.*,[1] the U.S. Tax Court decided that the indirect receipt of a profits interest in a partnership in exchange for services was not a taxable event for the recipient. The ruling was largely an application of Revenue Procedure 93-27, in which the I.R.S. provided guidance on the tax treatment of an individual who directly provides services to a partnership in exchange for the receipt of a profits interest in the partnership. The court notably held for the taxpayer even though the taxpayer provided services and received a profits interest indirectly, a situation not specifically addressed in the revenue procedure.

This article explains the applicable regulations, an important 8th Cir. Case reversing a decision of the U.S. Tax Court, the Revenue Procedure mentioned above, and finally *E.S. N.P.A. Holding v. Commr.,* a case in which certain applicable tax rules were stretched by the court.

## REGULATIONS

U.S. law generally gives tax-free treatment to contributions of property to an entity in exchange for ownership interests in the entity, provided certain requirements are met.[2] But this favorable treatment is typically unavailable if the item contributed is viewed to be services instead of property.[3] In the partnership context, Treas. Reg. §1.721-1(b)(1) states that the "receipt of a partnership capital interest in exchange for services is taxable to the service provider." In explaining the rule, however, the regulation distinguishes between the receipt of a capital interest – *viz.*, an immediate interest in the assets of the partnership, which can be received on termination of the partnership – from the receipt of a profits interest – meaning an interest in a share of future profit:

> To the extent that any of the partners gives up any part of his right to be repaid his contributions *(as distinguished from a share in partnership profits)* in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61. [Emphasis added.]

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1. T.C. Memo. 2023-55 (2023).
2. See Code §§351, 721.
3. See Code §351(d).

 

## CAMPBELL V. COMMR.

Many commentators interpreted this language to mean that the receipt of a profits interest in return for the provision of services would not result in taxable income and that the result would not differ whether the services were performed before or after the partnership interest was received.[4] However, in *Campbell v. Commr.,*[5] the Tax Court determined, *inter alia*, that the receipt of a partnership interest for past services performed as an employee was a taxable event, stating as follows in pertinent part:

> We reject petitioners [sic] argument that we should no longer follow our decision in the *Diamond* case and reaffirm our holding that section 721(a) and the regulations thereunder are simply inapplicable where, as in the *Diamond* case and the instant case, a partner receives his partnership interest in exchange for services he has rendered to the partnership. In order to invoke the benefits of nonrecognition under section 721(a), the taxpayer must contribute "property" to the partnership in exchange for his partnership interest. *United States v. Stafford* (11th Cir. 1984). The *Stafford* case makes it clear that services are not "property" for purposes of section 721(a).
>
> The considerations which underlie section 721(a) nonrecognition treatment where a taxpayer receives a partnership interest in exchange for property are vastly different from those reasons advanced by petitioners in favor of section 721(a) nonrecognition treatment where a taxpayer receives a partnership interest in exchange for services. In the former situation, there has been no disposition of the contributed property. The partnership interest such partner receives represents a mere change in the form of an asset which the taxpayer already owns. *Archbald v. Commissioner*, 27 B.T.A. 837 (1933), affd. 70 F.2d 720 (2d Cir. 1934). In the latter situation, it represents compensation for services, the value of which has not previously been reported as income.

On appeal, the I.R.S. conceded that no difference in tax treatment exists merely because a partnership interest is issued before or after services are performed. In both fact patterns, Code §721(a) applies and no income is recognized. However, it argued that the taxpayer received the partnership interests in exchange for services he provided to his employer, rather than services he provided to the partnerships. According to the I.R.S., the Tax Court essentially held that Campbell received the interests as compensation from his employer. Thus, he was not a service partner; the principles of partnership taxation did not apply; and the receipt of compensation from his employer was taxable upon receipt. The 8th Circuit disagreed with the I.R.S. and reversed the U.S. Tax Court decision,[6] stating as follows:

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4 A. Willis, Partnership Taxation, p. 125 (2d ed. 1976); Cowan, "Receipt of an Interest in Partnership Profits: The Diamond Case," 27 Tax Law Review 161 (1972)

5 T.C. Memo. 1990-162 (1990), rev'd in pertinent part, 943 F.2d 815 (8th Cir. 1991).

6 943 F.2d 815 (1991).

> Contrary to the Commissioner's belief, the tax court did not hold that Campbell received his partnership interests for services he performed for his employer rather than services performed for the partnerships. In reaffirming *Diamond v. Commissioner*, 492 F.2d 286 (7th Cir.1974), the court held "that section 721(a) and the regulations thereunder are simply inapplicable where, as in the *Diamond* case and *the instant case, a partner receives his partnership interest in exchange for services he has rendered to the partnership*." *Campbell*, 59 T.C.M. at 249. [Emphasis added.] The court also noted the records of the partnerships indicate that Campbell received the partnership interests after rendering services. *Id.* at 249. The Commissioner tenuously relies on the tax court's statements that Campbell received his partnership interests in connection with services provided for his employer. *Id*. at 251-53. These statements were made in the discussion of *when* Campbell received his interests. We believe that the court did not specifically hold that the interests were received as payment for services provided to his employer.

In response to the Tax Court's observation that the statutory language did not distinguish between capital interests and profits interests, the 8th Circuit wrote that separate treatment was warranted because the issuance of a profits interest did not represent a transfer of assets to the partner.

> Section 721 codified the rule that a partner who contributes property to a partnership recognizes no income. * * * And, regulation 1.721-1(b)(1) simply clarified that the nonrecognition principles no longer apply when the right to return of that capital asset is given up by transferring it to another partner. At that time, the property has been disposed of and gain or loss, if realized, must be recognized. As a corollary, section 1.721-1(b)(1) outlines the tax treatment of the partner who receives that capital interest. A substantial distinction, however, exists between a service partner who receives a capital interest and one who receives a profits interest. When one receives a capital interest in exchange for services performed, a shift in capital occurs between the service provider and the individual partners. * * * The same is not true when a service partner receives a profits interest. In the latter situation, prior contributions of capital are not transferred from existing partners' capital accounts to the service provider's capital account. Receipt of a profits interest does not create the same concerns because no transfer of capital assets is involved. That is, the receipt of a profits interest never affects the nonrecognition principles of section 721. Thus, some justification exists for treating service partners who receive profits interests differently than those who receive capital interests. [Citations omitted.]

The appeals court also drew a comparison with Code §707. Under this section, a partner's provision of services to a partnership in a nonpartner capacity generates income that is immediately taxable as compensation. This contrasts with the general rule that money from a partnership to a partner represents a distributive share of partnership income. In the court's view, Code §707 would be redundant if the receipt of a profits interest for services provided as a partner were also immediately taxable as compensation.

> Probably more relevant to our analysis, however, is section 707 of the Internal Revenue Code, which supports Campbell's argument. See I.R.C. §707 (1988). Generally, a partner receives a distributive share of income instead of compensation from his partnership. See Pratt v. Commissioner * * * (salary payments to a partner treated as a distributive share of income); Commissioner v. Moran * * * ("an individual cannot be his own employee nor can a partner be an employee of his own partnership") * * *. Except under certain circumstances, "the general statutory policy for treating partnerships for tax purposes contemplated that the income of a partnership would flow through to the individual partners." * * * Only when the transaction is treated as one between the partnership and a partner acting in a nonpartner capacity is the payment received by the partner not considered a distributive share. See * * * I.R.C. §707(a)(2)(A). Section 707 created an exception to the general rule.
>
> Section 707 provides that when a partner engages in a transaction with a partnership in a nonpartner capacity that transaction will be treated as between the partnership and one who is not a partner. I.R.C. §707(a)(1). When a partner receives payment for services performed for the partnership, that transaction falls under section 707(a)(1) if "the performance of such services ... and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership." Id. section 707(a)(2)(A)(iii). This exception was enacted to prevent partnerships from using direct allocations of income to individuals, disguised as service partners, to avoid the requirement that certain expenses be capitalized. See W. McKee, supra, ¶5.02[1][b], at 5-13. However, it was not intended to apply when a service provider acts within his capacity as a partner. See §707(a)(2)(A)(iii). Arguably, section 707(a) would be unnecessary if compensatory transfers of profits interests were taxable upon receipt because, if so, every such transfer would be taxed without this section. W. McKee, supra, ¶5.02[1][b], at 5-13 to -14. [Citations omitted.]

In addition, the Appeals Court was concerned with the value given to the profits interest by the U.S. Tax Court.

> More troubling, however, is Campbell's argument that the profits interests he received had only speculative, if any, value. We fully agree with this contention and we reverse the tax court. * * * The tax court relied too heavily on the fact that Class A limited partners were willing to pay substantial sums for their interests at the same time Campbell received his interest. Because of the difference in the nature of the investments, we believe that this fact is not relevant. The Class A limited partners had superior rights to cash distributions and return of capital, as well as some rights of participation. * * * Further, the predictions contained in the offering memoranda were just that — predictions. The partnerships had no track record. Any predictions as to the ultimate success of the operations were speculative. Thus, we hold that Campbell's profits interests * * * were without fair

> market value at the time he received them and should not have been included in his income for the years in issue.

## REV. PROC. 93-27

The I.R.S. subsequently issued Revenue Procedure 93-27. It provides the following:

> If a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, the Internal Revenue Service will not treat the receipt of such an interest as a taxable event for the partner or the partnership.

In addition to textual consistency, the general rule helps deal with the tricky question of valuation that the 8th Circuit found decisive. As the name suggests, profits interests are typically only a right to future profits and not a right to a partnership's current assets. Valuation is made more difficult by the fact that profits interests are usually given to service providers and rarely to third parties. This means that there is a lack of comparable prices that might otherwise be helpful in determining the value.

This problem is further compounded by partnership accounting rules. There is no accounting mechanism that increases a partner's capital account for a contribution of services, even if the corresponding profits interest has a determinable, positive value. This could lead to double taxation, as the partner would be taxed both on the receipt of the profits interest (compensation) and the realization of profits. Income would be taxed to the same taxpayer both when it is speculative and when it is concrete.

There are three exceptions to the safe harbor provided by the revenue procedure.[7] These exceptions are aimed at situations where valuation might be easier to determine with relative accuracy.

- It does not apply to a profits interest that relates to predictable streams of income from partnership assets (such as high-quality debt securities).
- It does not apply if the partner disposes of the interest within two years of receipt.[8]
- It does not apply to a profits interest in a publicly traded partnership.[9]

## E.S. N.P.A. V. COMMR.

*E.S. N.P.A.* differs from the usual fact pattern that often involves the grant of a profits interest to an individual in the financial-services sector. Rather, it is about how an individual running a lending business through a taxable C-corporation was able to (i)

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7 Note that being outside of the safe harbor does not necessarily mean that the receipt of the profits interest will be taxed.

8 However, certain dispositions may not establish value. For example, a gratuitous transfer in the context of wealth planning for a family may technically be outside the scope of the revenue procedure but might not lead to adverse results.

9 Under Code §7704, a publicly traded partnership generally is treated as a corporation for U.S. income tax purposes.

arrange a sale of 70% of the C-corporation's business to new investors bringing in fresh capital, and by choosing a proper structure and (ii) by doing so, open a pathway to receive future profits without channeling income through the C-corporation.

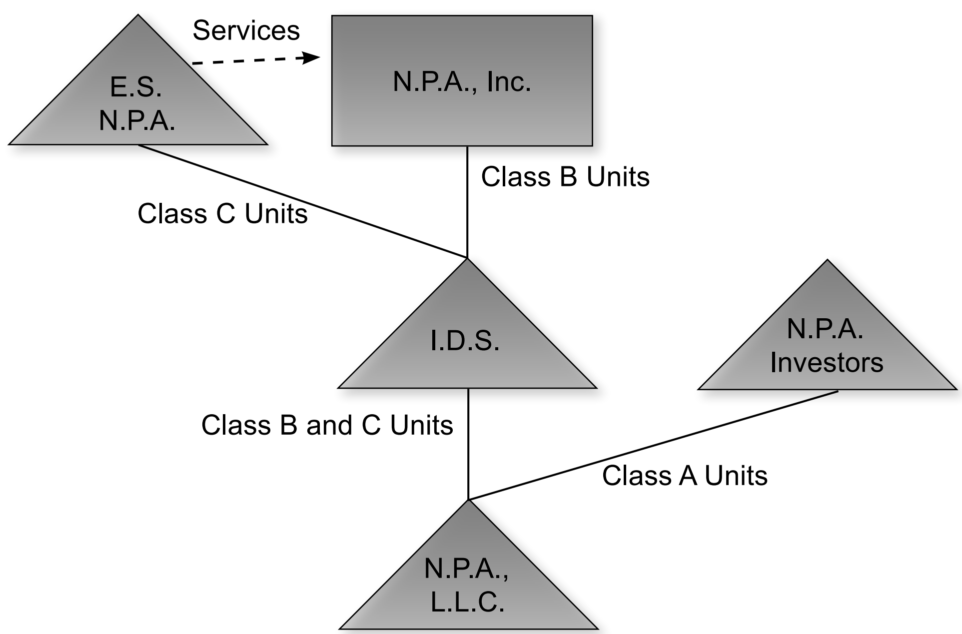
**Facts**

In *E.S. N.P.A.*, an individual proposed selling his consumer loan business, National Processing of America, Inc. ("N.P.A., Inc."). N.P.A. Inc. formed two L.L.C.'s, referred to as I.D.S. and N.P.A., L.L.C. Then, N.P.A., Inc. contributed business assets to N.P.A., L.L.C. and contributed the membership interests in N.P.A., L.L.C. to I.D.S., creating a three-tier structure with N.P.A., Inc. at the top, I.D.S. in the middle, and N.P.A., L.L.C. at the bottom. Both I.D.S. and N.P.A., L.L.C. were flow-through entities for U.S. income tax purposes, leading up to N.P.A. Inc., the C corporation.

I.D.S. had two classes of membership units called Class B and Class C units. N.P.A., L.L.C. had three classes of membership called Class A, Class B, and Class C. I.D.S. Class B and Class C units tracked, respectively, the Class B and Class C units in N.P.A., L.L.C. This meant that the owner of I.D.S. Class B units was entitled to all payments to which the owner of N.P.A., L.L.C. Class B units was entitled.

An entity named N.P.A. Investors, L.P. ("N.P.A. Investors") purchased all of N.P.A., L.L.C.'s class A units from I.D.S. in exchange for $14,502,436. On the same day, E.S. N.P.A. exercised a call option granted by N.P.A., Inc. to acquire all of the I.D.S. Class C units in exchange for E.S. N.P.A.'s payment to N.P.A., Inc. of $100,000 and services provided or to be provided. The services were to consist of "strategic advice for the purpose of enhancing the performance of [N.P.A. Inc.'s] business and to assemble an investor group that would purchase 40 [sic] percent of [N.P.A. Inc.'s] business for approximately $21 million."[10] As a result, the I.D.S. Class C units reflected an indirect interest in the class C units of N.P.A., L.L.C."

The following diagram illustrates the structure of the reorganized business:




[10] The quoted material comes from a call option that gave N.P.A., Inc. the right to acquire the Class C units of I.D.S.

## Tax Return and I.R.S. Assertion

E.S. N.P.A.'s partnership return reflected the view that its indirect receipt of the Class C units in N.P.A., L.L.C. (through the Class C units in I.D.S.) was properly categorized as the receipt of a "profits interest" in N.P.A. L.L.C. For that reason, the value of the profits interest was not taxable under case law, and under Revenue Procedure 93-27, was properly excluded from income.

On examination of the partnership tax return, the I.R.S. determined that Revenue Procedure 93-27 was inapplicable because E.S. N.P.A. did not provide services to I.D.S.[11] The I.R.S. determined that E.S. N.P.A. failed to report income and pay tax on the receipt of the Class C units in I.D.S. The I.R.S. position reflected alternative arguments. First, it asserted that Revenue Procedure 93-27 was inapplicable because no services were performed for the benefit of a partnership. Second, it argued that under the revenue procedure's definition, the taxpayer's interest was a capital interest instead of a profits interest. It determined that the fair market value of E.S. N.P.A.'s class C units in I.D.S. exceeded $12 million and that the total amount of unreported income exceeded $16 million.

***"This question is factual, and the answer came down to valuation . . ."***

## Tax Court Determination

The court held that the partnership interest held by E.S. N.P.A. was a profits interest. Revenue Procedure 93-27 defines a profits interest as any interest in a partnership other than a capital interest. A capital interest is an interest that would give the interest holder a share of the liquidation proceeds if the partnership were to sell its assets at fair market value and distribute the proceeds in liquidation immediately thereafter.

This question is factual, and the answer came down to valuation. The operating agreement of N.P.A., L.L.C. provided that Class C holders would receive distributions only after the Class A and Class B holders received distributions equal to their capital accounts. Thus, if the fair market value of N.P.A., L.L.C.'s assets was sufficient to repay the capital contributions of Class A holders ($21 million) and Class B holders ($9 million) and have enough left over to make distributions to the Class C owner, E.S. N.P.A.'s indirect interest in N.P.A., L.L.C. would be a capital interest. Otherwise, the interest would be a profits interest.

E.S. N.P.A.'s expert testified that the Class A units in N.P.A., L.L.C. (representing 70% of the ownership interests) had been sold to an outside party for $21 million. The taxpayer applied this figure to the partnership proportionately and produced a valuation of $30 million, which would not leave anything to the Class C holders. In comparison, the I.R.S. expert looked to the values of comparable businesses that were sold, justifying a valuation of $52 million. The result was that the Class C interest was worth $12 million in a hypothetical liquidation. In the end, the Court looked to the actual sale of 70% of the business, which was the method used by the taxpayer's expert. The I.R.S. expert had been unaware of the actual sale and conceded that it was the best indicator of value.

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[11] Under Code §6221, any adjustment to a partnership-related item is determined, at the partnership level and tax, penalties and interest are collected at the partnership level.

The more novel question was whether the taxpayer provided services to N.P.A., L.L.C. As the I.R.S. pointed out, the taxpayer provided services to N.P.A., Inc., the upper-tier corporation, and received a direct interest in I.D.S, the middle-tier partnership. The I.R.S. therefore concluded that the taxpayer did not provide services to the lower-tier partnership, N.P.A., L.L.C., and did not hold an ownership interest in the lower-tier partnership. This view is in line with regulations that were proposed in 2005, which limited a profits interest in a partnership to an interest that is received for providing services directly to the partnership.[12]

While the I.R.S. characterized Revenue Procedure 93-27 as a narrow safe harbor, the court believed that it provided broadly applicable guidance and rejected the I.R.S. view, describing it as "unreasonably narrow." Using this logic, the court agreed with the taxpayer that the Revenue Procedure applied to the situation. It cited several reasons for disregarding the intermediate entities between the taxpayer and the lower-tier partnership:

- The material assets were held in the lower-tier partnership.
- The taxpayer's activities were for the benefit of this partnership.
- The middle-tier partnership was a mere conduit. This was because the Class C units in both partnerships were identical.
- The taxpayer took on entrepreneurial risk and received a profits interest in a partner capacity.

## PATH FORWARD

Several related questions remain open.

- It is not clear whether the court would have reached the same conclusion if the two types of Class C units were not identical. The court's generally broad reading suggests that the answer might be yes, as long as the partnership is benefiting from the provision of services in some way (even if indirectly).
- Neither the I.R.S. nor the court took issue with the fact that not all of the taxpayer's services were for the benefit of the lower-tier partnership. The taxpayer was obligated to provide advice on expanding the business, which was clearly related to the lower-tier partnership, as it held the business, and on finding buyers for N.P.A., Inc.'s business, arguably more of a service for the upper-tier partner's benefit than for the lower-tier partnership's benefit. This implicitly suggests that services do not have to be solely for the benefit of the partnership.

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[12] Prop. Reg. §1.721-1(b)(3) ("…an interest in the transferring partnership that is transferred in connection with the performance of services for that partnership…"). These proposed regulations would have changed the rule of Rev. Proc. 93-27 by potentially making the receipt of partnership interests (whether capital or profits) in exchange for services taxable upon receipt. However, the interests would have been valued in the same way as Rev. Proc. 93-27, *i.e.*, by using a hypothetical liquidation. In the near-20 years since these regulations were proposed, there has been little indication that the I.R.S. intends to finalize and adopt them.

- The case expands the boundaries of Revenue Procedure 93-27. Prior to this case, the extent of the Revenue Procedure's application was not clear. Arguably, Revenue Procedure 93-27 can now apply even if (i) services are not provided directly to a partnership, provided the partnership still benefits, (ii) the taxpayer receives the profits interest from another partner instead of the partnership, or (iii) the partnership interest is held indirectly. This affirms that the issuance of indirect interests in more complex structures will be respected. But given the court's emphasis on the provision of services that benefit a partnership, the case suggests that any indirect issuance of a profits interest to a service provider should be accompanied by documentation clearly showing how the partnership will benefit from these services.

# THE UNRAVELLING OF THE *MATRYOSHKA* DOLL – IMPACT OF THE C.T.A. ON ENTITIES HAVING NEXUS TO THE U.S.

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FinCEN
Ownership Interest
Reporting
Reporting Company
Substantial Control

## INTRODUCTION

Because most U.S. States do not require information about the beneficial owners of an entity, and with more than two million entities being formed in the U.S. each year, it was about time for Congress to enact a law that mandates disclosure of the identity of the ultimate beneficial owners and the persons who maintain substantial control of private entities.

Aimed at curbing money laundering, terrorism financing, serious tax fraud, human and drug trafficking, counterfeiting, piracy, securities fraud, financial fraud, and similar activities, Congress enacted the Corporate Transparency Act ("C.T.A.") on January 1, 2021. The D.T.A. became fully effective from January 1, 2024. It requires certain domestic and foreign entities to disclose to the Financial Crimes Enforcement Network ("FinCEN"), a division of the U.S. Treasury Department, the identity of their beneficial owners and control persons. A failure to do so can attract heavy penalties.

The targets of the C.T.A. are much like *Matryoshka* dolls, having many layers between what appears on the surface and what exists at the heart. Congress intended to unravel the identity of the ultimate beneficial owners by peeling one layer at a time, thereby requiring the lowest tier entity to disclose the identity of the individuals that control the company.

This article serves as a primer to the C.T.A., asking questions and providing answers.

## WHO IS REQUIRED TO REPORT UNDER THE C.T.A.?

Briefly, any entity that is either organized in the U.S. or a foreign entity that is registered to conduct business in the U.S. is required to report certain specific information about its (a) individual ultimate beneficial owners and (b) individuals who assisted either in the formation of the entity or obtaining the registration to conduct business in the U.S.

### General Definition

A Reporting Company has been broadly defined to mean the either of the following:[1]

[1] 31 U.S. Code § 5336(a)(11)(A); 31 CFR 1010.380(c)(1).

1. A domestic Reporting Company. This is defined to mean any of the following entities:

    a. A corporation

    b. A limited liability company

    c. An entity that is created by the filing of a document with a secretary of state of one of the states or any similar office under the law of a State or Indian tribe

2. A foreign Reporting Company. This is defined to mean a company that meets the following criteria:

    a. It is a corporation, limited liability company, or other entity.

    b. It is formed under the law of a foreign country.

    c. It is registered to do business in any U.S. State or tribal jurisdiction by the filing of a document with a secretary of state or any similar office under the law of a State or Indian tribe.

**Exemption for Heavily Regulated Entities**

Companies that are subject to substantial reporting requirements under another Federal statute are exempt from the reporting under the C.T.A. Examples include the following:[2]

1. Entities registered with the Securities Exchange Commission. Examples include the following:

    a. Publicly traded companies (registered securities issuers)

    b. Brokers or dealers in securities

    c. Securities exchanges or clearing companies; money services businesses

    d. Other Exchange Act registered entities

    e. Investment companies or investment advisers

    f. Venture capital fund advisers

    g. Commodity Exchange Act registered entities

2. Entities in the Financial and Insurance sector that are regulated businesses. Examples include the following:

    a. Banks

    b. Credit unions

    c. Depository institution holding companies

    d. Insurance companies

[2] 31 U.S. Code § 5336(a)(11)(B).

e. State-licensed insurance producers

f. Pooled investment vehicles

g. Financial market utilities

3. Governmental authorities and political subdivisions

4. Inactive Entities[3]

5. Large Operating Entities[4]

6. Public accounting firms registered under the Sarbanes-Oxley Act

7. A public utility that provides telecommunications services, electrical power, natural gas, or water and sewer services within the U.S.

8. Any entity that is controlled or wholly owned, directly or indirectly, by one or more entities that are otherwise exempt in the above categories.

## WHAT IS A REPORTING COMPANY REQUIRED TO REPORT UNDER THE C.T.A.?

*"An entity meeting the definition of a Reporting Company is required to file a beneficial Ownership Interest report ("B.O.I. Report") to report certain information about itself, its Beneficial Owners, and Company Applicants."*

An entity meeting the definition of a Reporting Company is required to file a beneficial Ownership Interest report ("B.O.I. Report") to report certain information about itself, its Beneficial Owners, and Company Applicants.[5]

**Information About the Reporting Company**

The report must include the following:

1. The Reporting Company's full legal name
2. Any trade names it uses
3. Its business address
4. Its I.R.S. tax identification number

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[3] 31 CFR 1010.380(c)(2)(xxiii). An inactive entity is any entity that (a) was in existence prior to January 1, 2020, (b) is not engaged in an active business, (c) is not owned by a foreign person (directly or indirectly, in whole or in part), (d) has had no changes in ownership during prior 12 months, (e) has not sent or received funds greater than $1,000 in the prior 12 months, and (f) does not hold any assets in the U.S. or otherwise, including any ownership interests in other entities.

[4] 31 CFR 1010.380(c)(2)(xxi). A Large Operating Entity is any entity that (a) has an operating presence at a physical location in the U.S.; (b) employs more than 20 full-time employees; and (c) has filed a federal tax return for the previous year showing more than $5,000,000 of gross receipts.

[5] The terms "Beneficial Owner" and "Company Applicant" have been defined below in detail.

**Information About Each of the Reporting Company's Beneficial Owners and Company Applicants**

The report must include the following:

1. Full name

2. Date of birth

3. Residential address

4. A unique identifying number and the issuing jurisdiction for that number. The number must be derived from the individual's

    a. U.S. passport;

    b. state-issued driver's license;

    c. identification document issued by a state, local government, or tribe; or

    d. foreign passport if none of the above documents are available.

5. An image of the above-mentioned document from which the identifying number is reported. Any change in any of the above information must be reported to FinCEN within 30 calendar days of such change.

## WHO IS A BENEFICIAL OWNER OF THE REPORTING COMPANY?

A "Beneficial Owner," with respect to a Reporting Company, is either of the following individual or individuals:

1. An individual who directly or indirectly exercises substantial control over a Reporting Company

2. An individual who owns or controls at least 25% of the ownership interests in a Reporting Company

An individual might be a beneficial owner through substantial control, ownership interests, or both. A Reporting Company is not required to report the reason that an individual is a beneficial owner.

## WHEN IS AN INDIVIDUAL SAID TO EXERCISE SUBSTANTIAL CONTROL OVER A COMPANY?[6]

An individual is said to exercise substantial control over a Reporting Company in any of the following circumstances:

[6] Small Entity Compliance Guide published 9/18/23.

1. The individual serves as a senior officer[7] of the Reporting Company.

2. The individual has authority over the appointment or removal of any senior officer or a majority of the board of directors (or similar body).

3. The individual directs, determines, or has substantial influence over important decisions made by the Reporting Company. Important decisions include decisions regarding the following items:

   a. The nature, scope, and attributes of the business of the Reporting Company, including the sale, lease, mortgage, or other transfer of any principal assets of the Reporting Company.

   b. The reorganization, dissolution, or merger of the Reporting Company.

   c. Major expenditures or investments, issuances of any equity, incurrence of any significant debt, or approval of the operating budget of the Reporting Company.

   d. The selection or termination of business lines or ventures, or geographic focus, of the Reporting Company.

   e. Compensation schemes and incentive programs for senior officers.

   f. The entry into or termination, or the fulfillment or non-fulfillment, of significant contracts.

   g. Amendments of any substantial governance documents of the Reporting Company, including the articles of incorporation or similar formation documents, bylaws, and significant policies or procedures.

4. The individual has any other form of substantial control over the Reporting Company.

An individual may, directly or indirectly, exercise substantial control over a Reporting Company in any of the following ways:

1. Through board representation

2. Through ownership or control of a majority of the voting rights of the company.

3. Through rights associated with any financing arrangement or interest in a company

4. Through control over one or more intermediary entities that separately or collectively exercise substantial control over a Reporting Company

5. Through financial or business relationships, whether formal or informal, with other individuals or entities acting as nominees

6. Through any other contract, arrangement, understanding, relationship, or otherwise

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[7] "The term "senior officer" means any individual holding the position or exercising the authority of a president, chief financial officer, general counsel, chief executive officer, chief operating officer, or any other officer, regardless of official title, who performs a similar function." 31 CFR § 1010.380(f)(8).

## WHEN IS AN INDIVIDUAL SAID TO OWN OR CONTROL AN OWNERSHIP INTEREST OF A REPORTING COMPANY?[8]

An individual is considered to be a beneficial owner if he or she owns or controls at least 25% of the ownership interest in a Reporting Company. An individual is said to have an ownership interest in a company in any of the following ways:

1. The individual owns equity, stock, or similar instrument.
2. The individual owns capital or profit interest in an entity.
3. The individual owns a convertible instrument (with or without consideration).
4. The individual owns options or other non-binding privileges (including any put, call, straddle) to buy or sell any of the foregoing instruments.

The fact that any of the above instruments is characterized as debt is irrelevant.

Ownership or control of the ownership interest may be held in any of the following ways:

1. It may be held jointly.
2. It may be held directly.
3. It may be held indirectly through any contract, arrangement, understanding, or relationship.
4. It may be held through a nominee, intermediary, custodian, or agent.

In the case of a trust, ownership or control of a Reporting Company may be held by any of the following persons involved with the trust:

1. Ownership or control of a Reporting Company may be owned by a trustee having the authority to dispose of trust assets.
2. Ownership or control of a Reporting Company may be owned by a beneficiary who is the sole permissible recipient of income and principal from a trust.
3. Ownership or control of a Reporting Company may be owned by a beneficiary who has the right to demand a distribution of the assets from the trust.
4. Ownership or control of a Reporting Company may be owned by a grantor or settlor who has the right to revoke the trust or otherwise withdraw the assets of the trust.

[8] Small Entity Compliance Guide published 9/18/23.

## HOW IS THE OWNERSHIP PERCENTAGE OF AN INDIVIDUAL IN A COMPANY CALCULATED WHEN DETERMINING THE 25% THRESHOLD?

In determining whether an individual owns or controls at least 25% of the ownership interests of a Reporting Company, the total ownership interests that an individual owns or controls, directly or indirectly, shall be calculated as a percentage of the total outstanding ownership interests of the Reporting Company as follows:

1. Any options or similar interests of the individual shall be treated as exercised.

2. For Reporting Companies that issue capital or profit interests (including entities treated as partnerships for federal income tax purposes), the individual's ownership interests are the individual's capital and profit interests in the entity, calculated as a percentage of the total outstanding capital and profit interests of the entity.

3. For corporations, entities treated as corporations for U.S. Federal income tax purposes, and other reporting companies that issue shares of stock, the applicable percentage shall be the greater of

    a. the total combined voting power of all classes of ownership interests of the individual as a percentage of total outstanding voting power of all classes of ownership interests entitled to vote, and

    b. the total combined value of the ownership interests of the individual as a percentage of the total outstanding value of all classes of ownership interests.

## DOES THE C.T.A. CARVE OUT ANY EXCEPTIONS FROM THE DEFINITION OF A "BENEFICIAL OWNER?"

Yes, the C.T.A. exempts the following from the definition of a Beneficial Owner:

1. A minor child, as defined under the local law of the State in which a domestic Reporting Company is organized or a foreign Reporting Company is registered.[9]

2. An individual acting as a nominee, intermediary, custodian, or agent on behalf of another individual.

3. An employee of a Reporting Company, acting solely as an employee, whose substantial control over or economic benefits from such entity are derived solely from the employment status of the employee, provided that such person is not a senior officer.

[9] The reporting company is required to report the requisite information of a parent or legal guardian of the minor child.

4. An individual whose only interest in a Reporting Company is a future interest through a right of inheritance.

5. A creditor of a Reporting Company.

> *"A company applicant is an individual who directly files the document that either creates a domestic Reporting Company or first registers a foreign Reporting Company. "*

## WHO IS A COMPANY APPLICANT REQUIRED TO REPORT?

A company applicant is an individual who directly files the document that either creates a domestic Reporting Company or first registers a foreign Reporting Company. If more than one individual is involved in the filing process, a company applicant is the individual who is primarily responsible for directing or controlling such filing. For example, the attorney responsible to the client is the company applicant even though the filing may be done by a paralegal or intern.

Reporting Companies in existence prior to January 1, 2024, are not required to include any information for a Company Applicant.

## DOES THE C.T.A. OFFER RELIEF FOR BENEFICIAL OWNERS AND COMPANY APPLICANTS WHO DO NOT WISH TO DISCLOSE SENSITIVE PERSONAL?

Yes. A beneficial owner or a company applicant may obtain a FinCEN Identifier from FinCEN which may be reported by the Reporting Company in the B.O.I. Report in lieu of the personal information required to be disclosed in the report. A FinCEN identifier is a 12-digit unique identifying number which, in the case of individuals, starts with the numeral 3. For entities, a FinCEN Identifier starts with the numeral 2.[10]

1. A FinCEN Identifier is obtained by providing the required Personal Information (that must be reported in a B.O.I. Report) directly to FinCEN.[11]

2. A FinCEN Identifier is an option made available to individuals who do not wish to disclose their Personal Information to the Reporting Company.

3. Reporting Companies may prefer to receive FinCEN Identifiers from their beneficial owners and company applicants in order to avoid the hassle of implementing security protocols otherwise required to protect the Personal Information from unauthorized disclosure and liability in the event of a breach.

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[10] A Reporting Company may apply for a FinCEN identifier by checking a box on the B.O.I. report at the time of submitting the report. The FinCEN Identifier is issued instantly upon submission.

[11] To request a FinCEN identifier, an individual is required to first obtain a login.gov account. After signing in to login.gov, a FinCEN Identifier can be obtained by completing the FinCEN ID application at here. It requires the same information which an individual who is a beneficial owner or a company applicant is otherwise required to furnish to a Reporting Company to complete a B.O.I. Report.

4. Use of a FinCEN Identifier prevents an individual who may be a beneficial owner of more than one Reportable Company from repetitiously furnishing the same information to multiple filers.

5. The individual is responsible for updating any changes to his or her personal information which dispenses the need for Reporting Companies to file updated BOI Reports each time the personal information of a beneficial owner changes.

## WHAT IS THE DUE DATE FOR FILING A B.O.I. REPORT UNDER THE C.T.A.?

The due date for filing a B.O.I. depends on the date of the formation of the entity.[12]

1. A domestic Reporting Company formed on or after January 1, 2024, and before January 1, 2025, must file a report within 90 calendar days of the earlier of the date of receipt of notice of its creation and the date on which a secretary of state or similar office first provides public notice (such as through a publicly accessible registry) that the domestic Reporting Company has been created.

2. The time period for filing a report is reduced to 30 days for any domestic Reporting Company created on or after January 1, 2025.

3. A domestic Reporting Company created before January 1, 2024, and any entity that became a foreign Reporting Company before January 1, 2024 are required to file a report not later than January 1, 2025.

4. An entity that no longer meets the definition of an exempt company is required to file a report within 30 calendar days after the date that it no longer meets the criteria for any exemption.

5. Any change or inaccuracy in the reported information must be reported or corrected to FinCEN within 30 calendar days of the change or when the inaccuracy comes to the knowledge of the Reporting Company.[13]

6. The C.T.A. does not specify the point in time the substantial control or ownership interest must be measured.

## DOES THE C.T.A. IMPOSE PENALTIES FOR A WILLFUL FAILURE TO COMPLY WITH ITS PROVISIONS?[14]

Yes, a penalty may be imposed for willfully providing false or fraudulent beneficial ownership information, including a false or fraudulent identifying photograph or document, or willfully failing to report a completed or updated B.O.I. Report. A person found liable may be subject to a penalty of up to $500 for each day a violation

[12] 31 CFR 1010.380(a)(1).

[13] 31 CFR 1010.380(a)(2) and (3).

[14] 31 U.S. Code § 5336(h).

continues and has not been remedied, a fine of up to $10,000 and prison time of up to two years, or both.

Also, any person who knowingly disclose or use the beneficial ownership information obtained by him or her for purposes of completing a B.O.I. Report may be subject to a penalty of up to $500 for each day a violation continues and has not been remedied, and a fine of up to $250,000 and prison time of up to five years, or both. No penalty is imposed if the person corrects the inaccurate or incomplete information within 90 days of the original filing. The exception, however, does not apply if the person has actual knowledge of the inaccuracy or incompleteness at the time of original filing.

## CONCLUSION

The C.T.A. is a game-changer in so far as it attempts to unravel the *Matryoshka* dolls to identify the real economic owners hiding behind corporate structures. FinCEN will soon develop a vast C.T.A. repository of information. Only time will tell if it can muster enough resources to dig out meaningful information necessary to combat illicit activities it intended to curb in the first place. The resources of artificial intelligence companies clearly will be required by FinCEN if it wishes to extract information promptly and in meaningful form.

***"The C.T.A. is a game-changer in so far as it attempts to unravel the Matryoshka dolls to identify the real economic owners hiding behind corporate structures."***

# WILL SERVICE AUTOMATION COMPANIES QUALIFY FOR THE Q.S.B.S. EXEMPTION?

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**Tags**
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## INTRODUCTION

Many U.S. investors and business owners are familiar with the tax exemption provided to U.S. individuals recognizing gains from the sale of certain U.S. stock defined as qualified small business stock ("Q.S.B.S.").[1] The Q.S.B.S. exemption plays an important role in the growth of hi-tech industry, which is dependent on investments by U.S. persons. It typically benefits U.S. individuals who invest in start-up software companies.

The Q.S.B.S. exemption is not available for investment gains related to shares of stock of corporations engaged in a business involving the provision of specified nonqualified service. In recent years, many start-up software companies have focused on the development of technological tools to provide automated services. Some of those services are of a type considered to be nonqualified business activity for Q.S.B.S. purposes. This raises several interesting questions:

- Will investment gains in these software companies qualify for the Q.S.B.S. exemption?
- In what circumstances are the software companies considered to be providers of nonqualified services?
- In what circumstances are the software companies only providing software tools that are sold to service providers?

This article addresses those questions.

## THE GENERAL FRAMEWORK OF THE Q.S.B.S. EXEMPTION

Code §1202 provides that gains from the sale of qualified small business stock held for more than five years are not included in the taxable income of a U.S. individual

[1] Section 1202 of the Internal Revenue Code of 1986, as amended (the "Code"). The Q.S.B.S. exemption was enacted to incentivize investment in U.S. corporations as a vehicle for business start-ups. For many years, the exemption was limited to 50% or 60% of the gain. The limitation was removed by the Tax Cuts and Jobs Act of 2017.

shareholder.[2] The exempt amount is the greater of $10 million or 10 times the aggregate basis in the stock held in the Q.S.B.S.[3]

To qualify for the Q.S.B.S. exemption, the following requirements must be met with regard to the issuer of the stock:[4]

- **A U.S. Corporation.** The corporation must be incorporated in the U.S.[5] or under the laws of one of the states of the U.S.[6] The U.S. corporation cannot be a D.I.S.C., former D.I.S.C., R.I.C., R.E.I.T., R.E.M.I.C., or cooperative.[7] In addition, neither an L.L.C. that has not elected to be taxed as a corporation nor an S-corporation that generally is not subject to corporate tax in the U.S. is considered to be a corporation for purposes of the Q.S.B.S. exemption.

- **An Active Business.** The corporation must be engaged in an active qualified business as defined in Code §1202(e) during substantially all of the shareholder's holding period for the stock.[8] This requirement is at the center of this article and is further discussed below.

- **A Small Business.** The aggregate gross assets of the corporation, including money, must not exceed $50 million both before and immediately after the issuance of the stock.[9] The aggregate gross assets amount is measured by the adjusted bases of the assets the corporation.[10] For this purpose, all corporations that are members of the same parent-subsidiary controlled group are treated as one corporation.[11]

- **Originally Issued Stock.** The stock must have been originally issued to the U.S. individual in exchange for money or property other than shares. Stock originally issued as compensation for services also qualifies. Certain exceptions apply. Stock acquired by gift, bequest, or as a distribution from a partnership generally will qualify if the transferor was the holder of the originally issued stock.[12] Stock held through pass-through entities generally are treated as originally issued stock.[13]

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[2] Code §1202(a)(4).

[3] Code §1202(b)(1). However, for stock purchased before 2010, the exemption is limited to 50% of the gain derived on the sale. See, Code §§ 1202(a)(1) & (4).

[4] Code §§1202(c), (d) & (e).

[5] A corporation formed in the District of Columbia is clearly included as a corporation formed in the U.S.

[6] Code §1202(d)(1). A domestic corporation is defined in Code §7701(a)(4).

[7] Code §1202(e)(4).

[8] Code §1202(c)(2)(A).

[9] Code §1202(d)(1).

[10] Code §1202(d)(2)(A).

[11] Code §1202(d)(3). The term "parent-subsidiary controlled group" means any controlled group of corporations as defined in section 1563(a)(1), except that more than 50%-ownership is the measuring stick rather than at least 80%.

[12] Code §1202(h).

[13] Code §1202(g).

## THE "ACTIVE BUSINESS" REQUIREMENT

The Q.S.B.S. exemption may be claimed by an individual investor with regard to shares of a corporation engaged in an active business. For a corporation[14] to be engaged in an "active business" for purposes of the Q.S.B.S. exemption, at least 80% of its assets, measured by value, must be used by the corporation in the active conduct of one or more "qualified trades or businesses."[15]

The term "qualified trade or business" is defined by exclusion. Under Code §1202(e)(3), all trades or businesses qualify, other than the following:

| | | |
|---|---|---|
| Health | Consulting | Financing |
| Law | Athletics | Leasing |
| Engineering | Financial services | Investing |
| Architecture | Brokerage services | Farming |
| Accounting | Hotel | Actuarial science |
| Banking | Restaurant | Performing arts |
| Insurance | Any trade of business in which the principal asset is the skill or reputation of the employees | Producing or extracting natural resources |

Moreover, certain activities specifically qualify even though they may not meet the general understanding of an active trade or business.[16] These activities include the following:

- **Start-Up Activities.** These are activities described in Code §195(c)(1)(A) for which two conditions are met:
  - The activity takes the form of expenditures (i) to investigate the creation or acquisition of an active trade or business, (ii) to create an active trade or business, or (iii) incurred in any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business.
  - The expenditures would be allowable as a deduction for the taxable year in which paid or incurred if paid or incurred in connection with the operation of an existing active trade or business in the same field.

14 Not including a corporation which is a D.I.S.C. or a former D.I.S.C., R.I.C., R.E.I.T., R.E.M.I.C. and a cooperative. See, Code §1202(e)(4).

15 Code §1202(e)(1). The assets and activities of 50% owned corporations are also taken into account. See, Code §1202(e)(5).

16 Code §1202(e)(2)(A).

- **Research and Experimental Expenditures.** These are research or experimental expenditures which may be charged to capital account and amortized ratably over a 5-year period under Code §174, provided they are paid or incurred in connection with the taxpayer's trade or business.
- **In-House Research Expenses.** These are research expenses incurred in-house by a taxpayer if the principal purpose for making such expenditures is to use the results of the research in the active conduct of a future trade or business. In broad terms, a credit is allowed as provided in Code §41.

## WHEN DO AUTOMATED SERVICES CONSTITUTE A QUALIFIED BUSINESS ACTIVITY?

Software companies are generally treated as meeting the active business requirement. As a result, U.S. individual shareholders may qualify for the Q.S.B.S. exemption, assuming all other conditions are met. In fact, the Code specifically mentions that rights to computer software used to produce active business computer software royalties are generally treated as assets used in the active conduct of a trade or business. However, a tax question often asked by investors is whether the development of a software tool loses its status as a qualified activity if the software is developed to assist a provider of a disqualified service to provide services faster, better, cheaper, or more quickly.

***"Software companies are generally treated as meeting the active business requirement."***

An I.R.S. private letter ruling and an I.R.S. Chief Counsel Advice shed light on the answer.[17] The general approach adopted by the I.R.S. is favorable where the development activity merely creates a software tool that is used by another person in the conduct by that other person of a disqualified business activity, such as consulting. On the other hand, if the software is used by the development company to supplant the person conducting the disqualified business activity, the activity of the software company is properly treated as a nonqualified activity. In the former case, the software company receives software royalties. In the latter case, it receives income from a disqualified trade of business.

The favorable result involved the developer of a medical testing device used by health care providers. The unfavorable result involved the developer of "D.I.Y." software that could be used as a listing device by owners of real property held for lease to the public.

### Medical Device Fact Pattern

In a Private Letter Ruling from 2017,[18] a software company developed a technological tool to perform laboratory tests ordered by healthcare providers. The facts presented to the I.R.S. were as follows:

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[17] Under Code §6110(k)(3), neither a Private Letter Ruling issued to a taxpayer nor a Chief Counsel Advice to an I.R.S. field examiner reviewing a taxpayer's tax return may be cited as authority by anyone other than the taxpayer involved in the matter. Nonetheless, each illustrates the thinking of the National Office of the I.R.S. or the Office of Chief Counsel at the time of issuance. In addition, both may be cited as authority for the limited purpose of demonstrating the existence of reasonable cause to prevent the imposition of a penalty.

[18] P.L.R. 201717010.

[Taxpayer] owned stock in Company and filed a joint tax return. [Taxpayer] was a founder of Company and served as its chairman and C.E.O. since its formation. [Taxpayer] purchased stock in Company on Date 1 and Date 2.

Company, a C corporation, was incorporated in Year 1 to develop a tool to provide more complete and timely information to healthcare providers. Specifically, Company uses proprietary [software] and other technologies for the precise detection of [medical condition]. [Taxpayer] represent[s] that Company is the only person that can legally perform X testing and that its expertise is limited to its patented X testing.

Company analyzes the results of X testing and then prepares laboratory reports for healthcare providers. Company's clients are doctors and other healthcare providers. [Taxpayer] represent[s] that the information the Company provides in a typical laboratory report only includes a summary of z detected and z tested for and not detected. Company's laboratory reports do not diagnose or recommend treatment. [Taxpayer] represent[s] that Company does not discuss diagnosis or treatment with any healthcare provider, and is not informed by the healthcare provider as to the healthcare provider's diagnosis or treatment. Company's sole function is to provide healthcare providers with a copy of its laboratory report. Company receives compensation for reporting results of tests to healthcare providers, which is based on each test performed.

Company accepts orders for tests only from health care professionals. Patients cannot order tests from Company. Although Company in rare instances may provide a copy of a test to a patient, it does not explain its laboratory reports to patients. Instead, Company directs patients to contact their healthcare provider if they have any questions. The only other contact Company has with a patient is in billing situations. Company will bill a patient directly if the patient is self-insured, uninsured, or if the insurance company pays the patient directly.

[Taxpayer] represent[s] that the laboratory director is required to be an M.D., D.O. or a Ph. D. * * *. The lab director reviews results for quality control and quality assurance. [Taxpayer] represent[s] that to the best of his knowledge, other than the laboratory director, Company's laboratory personnel are not subject to state licensing requirements or classified as healthcare professionals by any applicable state or federal law or regulatory authority. [Taxpayer] also represent[s] that laboratory director never has direct contact with patients and that none of the Company's personnel diagnose, treat or manage any aspect of any patient's care.

[Taxpayer] represent[s] that Company's employees, who are well educated, receive up to a year of training to perform the X testing. However, [Taxpayer] represent[s] that the skills employees bring with them when Company hires them are almost useless when performing the X tests and that the skills they acquire at Company are not useful to other employers.

> Company maintains a research division to develop additional uses for its proprietary technology. Company has also developed additional uses for its X testing. For example, it tests for z in food and agricultural products.

On those facts, the I.R.S. ruled that the U.S. corporation owned by Taxpayer engaged in a qualified trade or business under the definition that appears in Code §1202(e)(3).

> Company provides laboratory reports to health care professionals. However, Company's laboratory reports do not discuss diagnosis or treatment. Company neither discusses with, nor is informed by, healthcare providers about the diagnosis or treatment of a healthcare provider's patients. Company's sole function is to provide healthcare providers with a copy of its laboratory report.
>
> Company neither takes orders from nor explains laboratory tests to patients. Company's direct contact with patients is billing patients whose insurer does not pay all of the costs of a laboratory test.
>
> In addition, you represent that the skills employees bring to Company are not useful in performing X tests and that skills they develop at Company are not useful to other employers.
>
> Further, none of Company's revenue is earned in connection with patients' medical care. Other than the laboratory director, Company's laboratory technicians are not subject to state licensing requirements or classified as healthcare professionals by any applicable state or federal law or regulatory authority.
>
> Although Company's laboratory reports provide valuable information to healthcare providers, Company does not provide health care professionals with diagnosis or treatment recommendations for treating a healthcare professional's patients nor is Company aware of the healthcare provider's diagnosis or treatment of the healthcare provider's patients. In addition, the skills that Company's employees have are unique to the work they perform for Company and are not useful to other employers.
>
> Thus, based on the facts and representations submitted, we conclude that for purposes of § 1202(e)(3), Company is not in a trade or business (i) involving the performance of services in the field of health or (ii) where the principal asset of the trade or business is the reputation or skill of one or more of its employees.

### **<u>"D.I.Y." Software Supplanting Real Estate Broker Services</u>**

Like healthcare services, the provision of brokerage services is considered a non-qualified businesses for Q.S.B.S. purposes. In a 2022 Chief Counsel Advice,[19] the I.R.S. concluded that a company that developed the software for D.I.Y. real estate

[19] .C.A. 202204007. In comparison to a Private Letter Ruling, Chief Counsel Advice arises when a field agent of the I.R.S. who is examining a taxpayer's income tax return seeks legal advice from the Office of the Chief Counsel.

listings generated revenue from the performance of brokerage activities, a disqualified business activity. The facts were as follows:

> Taxpayer sold stock in Corporation. Corporation operates a website on which potential lessees may use the website to make nonbinding reservations for the use of certain facilities at specified rental rates from facility lessors that are included in the website data base. Corporation has no authority to enter into or sign leases on behalf of the potential lessors or lessees. A legally binding rental agreement for the use of a facility does not arise until the potential lessor and the potential lessee enter into a lease agreement. Corporation's website will show a user that is considering leasing one or more facilities in a particular location the facilities in that area that are included in the website database.
>
> Potential lessees do not pay any fee to Corporation for the use of Corporation's website. In its "Terms of Service" for lessees, Corporation states that it has no control over the facilities to be leased and does not guarantee the accuracy of any listings. Nor does Corporation guarantee that a lessee will actually be able to lease a facility listed in its database.
>
> The lessors are responsible for all payments to Corporation. As a condition of being listed in Corporation's public, searchable database, lessors agree to compensate Corporation. Specifically, Corporation charges lessors a recurring periodic fee for simply being listed in the database, and a contingent fee based on a percentage of rent paid by a lessee actually leasing a facility from a lessor through a search of Corporation's database. Corporation requires lessees to pay the rent for the leased facility through Corporation's website.
>
> The facilities listed for lease on Corporation's website [includes] real property. In Corporation's "Terms of Service," Corporation represents to potential lessees that * * * it is not responsible for, and does not engage in, brokering, selling, purchasing, exchanging, or leasing posted properties. Although it may hold a real estate broker license in one or more states, Corporation asserts that it is not a broker with respect to the leasing of the facilities. Further, a lessee's use of the website constitutes an acknowledgement that Corporation has pre-negotiated rental rates with the lessors included on its website, part of which will be retained by Corporation as compensation for its services.
>
> Corporation may also provide other services to lessors. For example, Corporation may charge a lessor a monthly fee to build and host a website for the lessor to be used in conjunction with the leasing of the lessor's facility. Liability for this monthly fee is not contingent on the lessor successfully leasing its facility to potential lessees.

In the C.C.A., Taxpayer characterized Corporation's activities as merely advertising, which is not a nonqualified business activity. However, the C.C.A. concluded that the activity of Corporation extended beyond passive advertising and constituted the provision of brokerage services.

Recognizing that neither the Code §1202 nor the regulations issued under that section define the term "brokerage services," the I.R.S. looked at how brokerage was defined in other areas of the tax law. In particular, it pointed to Code §6045(a), which requires every person doing business as a broker to file information returns regarding the person's customers in accordance with I.R.S. regulations. Code §6045(b) also requires the person doing business as a broker to provide a statement to the customer. The term broker is broadly defined in the statute without any restriction to a particular type of business. Specifically, Code §6045(c)(1) provides that the term broker includes—(A) a dealer, (B) a barter exchange, and (C) any other person who (for a consideration) regularly acts as a middleman with respect to property or services. Moreover, Code §6045(e) acknowledges that more than one person can serve as a broker for real estate and prescribes an ordering rule as to which of the persons identified as a broker with regard to a particular transaction has a reporting obligation.

***"One example given in the regulations involves a taxpayer in the business of executing transactions for customers involving various types of securities or commodities generally traded through organized exchanges or other similar networks."***

In addition, Code §448 provides that partnerships conducting certain business activity are required to report income to the I.R.S. using the accrual method of accounting. Brokerage partnerships must report income using the accrual method of accounting. The regulations issued by the I.R.S. recognize that a person who provides both brokerage and advisory services is considered to be a broker for purposes of Code §448 if its right to income is based primarily on closing a transaction. One example given in the regulations involves a taxpayer in the business of executing transactions for customers involving various types of securities or commodities generally traded through organized exchanges or other similar networks. The taxpayer provides its clients with economic analyses and forecasts of conditions in various industries and businesses. Based on that data, the taxpayer makes recommendations regarding transactions in securities and commodities. Clients place orders with the taxpayer to trade securities or commodities based on the taxpayer's recommendations. The taxpayer's compensation for its services is typically based on the trade orders it fulfills. Based on the way the taxpayer is compensated, it is not considered to be engaged in the performance of services in the field of consulting. It is properly treated as a broker.

The Chief Counsel advice concludes that the corporation developing the software and maintaining the listing service met the definition of a broker for purposes of Code §1202, leading to a denial of the Q.S.B.S. exemption.

> We conclude that Corporation should be classified as a broker under the common meaning of the term and as it is defined under § 6045, rather than the more narrow a definition that applies for purposes of § 199A.* * * While Corporation states that it does not provide brokerage services but instead provides advertising services, it is our view that the actions and services provided by Corporation support our position that Corporation is a broker for purposes of § 1202(e)(3)(A).
>
> A broker serves as an intermediary between a buyer and a seller, and Corporation does this. Corporation does not just passively publish advertisements on its website that are provided to it from potential lessors desiring to lease property. Unlike a search engine that provides content to users and also sends targeted advertisements to those users based on their search history, Corporation's website is solely devoted to effectuating agreements between potential lessors and potential lessees of certain property.

> Corporation charges a minimum flat fee to lessors irrespective of whether a potential lessor succeeds in entering into lease agreements as a result of the use of Corporation's website. However, Corporation is also compensated on a commission basis based on leasing transactions that are entered into as the result of the use of Corporation's website.
>
> Corporation does not have the authority to enter into leasing agreements on behalf of lessors that use its services. Corporation only provides a vehicle for potential lessees to transmit non-binding reservation requests to potential lessors. Only the potential lessor and lessee have the authority to enter into a binding lease agreement. However, brokerage activity can include simply bringing a potential buyer and seller together to work out the transaction. * * *
>
> The fact that Corporation's services are provided by software created by people rather than directly by people does not change the functional nature of the services. Because Corporation provides brokerage services within the meaning of § 1202(e)(3)(A), taxpayer is not entitled to exclude any of the gain from the sale of stock in Corporation under § 1202. *[Footnotes omitted.]*

## CONCLUSION

For many years, computer software, digital platforms, and other technological tools have been used by service providers in facilitating what they do. To the extent that the customers of the software development company are, themselves, service providers that use the technology as a tool in providing the services they perform, the software development company is not expected to be treated as a service provider. Investors should seek to claim the Q.S.B.S exemption from tax for capital gains, provided all other requirements of Code §1202 are met. However, with the rise of artificial intelligence, more and more software tools will be used to perform analysis, draw conclusions, and even recommend proper business and professional decisions. At present, if the software is merely a data gathering tool for final decisions by a service provider who interfaces with a customer, the software developer corporation should not be viewed to be engaged in a disqualified business. However, once the software reaches the stage of making judgment calls that are communicated directly to a consumer rather than providing data – including conclusions – to an unrelated person that interfaces with a consumer, the software development corporation may find that it has crossed the line from being a compiler of data to become a participant that provides nonqualified business activity to customers. The risk will be greatest if the fee for using software program increases as its decisions are implemented. Here, individuals that invest in the software developer may face an I.R.S. challenge when claiming the benefit of a Q.S.B.S. exemption.

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Ruchelman P.L.L.C. is a boutique law firm based in New York City. It was founded in 1989 by an alumnus of a legacy firm that is now Deloitte's.

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