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INSIGHTS

ASSISTANCE IN THE COLLECTION OF ANOTHER COUNTRY’S TAXES – RECENT EXPERIENCE IN THE CANADA-U.S. CONTEXT

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EDITORS' NOTE

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

- **Assistance in the Collection of Another Country's Taxes – Recent Experience in the Canada-U.S. Context.** In an age of multilateral agreements to exchange information and other agreements to cooperate in the collection of taxes of another country, many people are unaware of the "revenue rule." This common law doctrine allows courts to decline entertaining suits to collect tax or enforce foreign tax judgments. In their article, Sunita Doobay of Blaney McMurtry L.L.P., Toronto, and Stanley C. Ruchelman explore (i) the general development of the revenue rule, (ii) its extension to North America, (iii) the applicable provisions of the Canada-U.S. Income Tax Treaty allowing for assistance in the collection of tax and exchange of information, (iv) one U.S. wire fraud case involving evasion of foreign import duties, and (v) several recent cases in the U.S. where taxpayers raised creative arguments to attack the validity of treaty provisions, but to no avail.

- **How Soon Is Now? O.E.C.D. Starts Work on a Substitute for Unilateral Digital Economy Fixes.** As of November 2019, the arm's length principle continues to operate among the O.E.C.D. Member States. In a little more than a year, this may be different. The O.E.C.D.'s workplan for urgent policy development will investigate a new nexus standard that departs from the arm's length principle that has been applied for decades. In his article, Michael Peggs explains the current debate between tax administrations concerning the attribution of profit to digital or non-physical P.E.'s and the three popular approaches that have been proposed. The mood in the O.E.C.D. is that markets matter most under each of the suggested approaches. Brainpower and manufacturing prowess are less important.

- **Domestic Partnerships Treated as Entities and Aggregates: New Approach for G.I.L.T.I. and Subpart F.** The effects of the 2017 U.S. tax reform continue to be encountered in unexpected ways. Two prime examples are the final and proposed G.I.L.T.I. regulations issued by the I.R.S. earlier this year. These 2019 regulations attempt to bring order out of the chaos created by proposed G.I.L.T.I. regulations released in September 2018. In their article, Neha Rastogi and Stanley C. Ruchelman look at how the rules treat a domestic partnership and its partners when determining who is – and who is not – a U.S. shareholder of a controlled foreign corporation. The answer affects the application of the G.I.L.T.I., Subpart F, and P.F.I.C. rules. For those who follow the debate over whether a partnership is an aggregate of the partners or an entity that is separate from the partners, chalk up a victory for the proponents of the aggregate approach.

- **Nonprofits: Creeping Commercialization and the Specter of Unrelated Business Income Tax.** In 2018, charitable giving in the U.S. totaled over $427 billion. Yet, charitable contributions are not the only source of revenue for nonprofit organizations. Commercial activities are an ever-growing source of revue in the sector – and one that is causing its own set of issues. Non-profits face unrelated business income tax ("U.B.I.T.") on business income derived from commercial activities not related to tax-exempt status, and in more extreme cases, they may even face the loss of tax-exempt status if not operated exclusively for tax-exempt purposes. Nina Krauthamer and Hannah Daniels, an extern at Ruchelman P.L.L.C. and student at New York Law School, explain.

- **Saving Clementine: Improving the Code §163(j) Deduction.** While the proposed regulations amending Code §163(j) are helpful in many instances, they do not help certain taxpayers. Those that borrow funds to make investments in real estate through partnerships will find themselves on the wrong side of the tax reform provision that limits a taxpayer's deduction for business interest to 30% of its adjusted taxable income arising from the business. Exempt from the cap are (i) taxpayers having gross receipts that do not exceed $25 million and (ii) taxpayers engaged in, *inter alia*, a qualifying real property trade or business, or "R.P.T.O.B." The election for exemption is irrevocable for as long as a taxpayer conducts the R.P.T.O.B. In their article, Andreas A. Apostolides, Nina Krauthamer, and Stanley C. Ruchelman identify the fact patterns that are problematic, explain why they are not covered, and suggest that the I.R.S. may wish to revisit this matter.

- **I.R.S. Releases Relief Procedures for Certain Expats While Warning Bells Ring for Others.** The I.R.S. recently announced new procedures that will enable certain individuals who have or will relinquish their citizenship after March 18, 2010, to come into compliance with related U.S. tax and filing obligations. As a first step, U.S. citizenship must be relinquished. Once that is completed, specified identification documents, a complete dual-status tax return for the year of expatriation, and tax returns for the five tax years preceding the expatriation must be submitted. Comparable provisions will apply for long-term residents who relinquish that status. Galia Antebi and Hannah Daniels explain.

- **S.A.L.T. Cap Repeal Case Dismissed.** Several high-tax states – whose taxpayers are negatively affected by the T.C.J.A.'s $10,000 cap on the Federal deduction for state and local taxes – have instituted a legal challenge that is working its way through the courts. On the last day of September, the U.S. District Court for the Southern District of New York ruled against the states under long standing authority that the Congress has broad power to eliminate tax benefits previously granted. However, this may not be the end of dispute. Nina Krauthamer and Lisa Singh, an extern at Ruchelman P.L.L.C. and a student at New York Law School, recap the ongoing saga and the latest results.

- **I.R.S. Placing Watchdog Agents in International Financial Centers.** In 2015, approximately 21 million people globally owned virtual currencies, but the I.R.S. estimates less than 900 people reported holding virtual currencies in U.S. tax returns. Now, the I.R.S. has adopted measures to ferret out crypto tax cheats. Whether modifying tax forms, cooperating with tax authorities through the J-5, or most recently stationing agents in international financial centers, the I.R.S. is serious in its attempts to track and tax cryptocurrency transactions. In their article, Stanley C. Ruchelman and Lisa Singh look at recent global efforts.

We hope you enjoy this issue.

- The Editors

COLLECTING ANOTHER COUNTRY'S TAXES – RECENT EXPERIENCE IN THE CANADA-U.S. CONTEXT

Authors
Sunita Doobay
Stanley C. Ruchelman

Tags
Canada
U.S.
Revenue Rule

INTRODUCTION

When asking a U.S. tax adviser to describe the "revenue rule," it would not be surprising for the adviser to say that it refers to formal guidance issued by the I.R.S. that can be relied on by other taxpayers as authority for a position taken in a tax return.

However, the term has a much different meaning in a cross-border context. As explained by one author:

> The revenue rule, a common law doctrine with origins in the eighteenth century, is a battleground in the twenty-first century . . . . In its modern form the revenue rule generally allows courts to decline entertaining suits or enforcing foreign tax judgments or foreign revenue laws . . . .[1]

In a U.S. Supreme Court case of this century, the revenue rule is described in the following language:

> Since the late 19th and early 20th century, courts have treated the common-law revenue rule as a corollary of the rule that, as Chief Justice Marshall put it, '[t]he Courts of no country execute the penal laws of another.' . . . The rule against the enforcement of foreign penal statutes, in turn, tracked the common-law principle that crimes could only be prosecuted in the country in which they were committed. . . . The basis for inferring the revenue rule from the rule against foreign penal enforcement was an analogy between foreign revenue laws and penal laws [citations omitted].[2]

The revenue rule can be overridden by treaty, and where it has, the U.S. and Canadian tax authorities have, in recent years, collected the taxes due in the other country.

This article will explore (i) the general development of the revenue rule, (ii) the applicable provisions of the Canada-U.S. Income Tax Treaty (the "Treaty") allowing for assistance in collection and exchanges of information, (iii) one U.S. wire fraud case, and (iv) several recent cases in the U.S. where taxpayers raised creative arguments to attack the validity of the Treaty provisions but to no avail.

Sunita Doobay is a Partner at Blaney McMurtry LLP in Toronto, Canada. Equipped with over a quarter century of tax experience as an international tax lawyer, Sunita is a trusted tax advisor to a broad range of clients.

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1. Mallinak, "The Revenue Rule: A Common Law Doctrine for the Twenty-First Century," 16 Duke J. Comp. & Int'l L. 79 (2006)).
2. *Pasquantino v. U.S.*, 544 U.S. 349, 360 *et. seq,* (2005).

DEVELOPMENT OF THE COMMON LAW RULE

English Common Law

Under common law, a court will not enforce the revenue laws of other countries. In the English case *King of the Hellenes v. Brostron*,[3] Rowlatt J. emphasized this revenue rule, stating:

> It is perfectly elementary that a foreign government cannot come here – nor will the courts of other countries allow our Government to go there – and sue a person found in that jurisdiction for taxes levied and which he is declared to be liable in the country to which he belongs.

The Dutch government was also precluded from collecting Dutch succession duties levied on a Dutch estate with an English-resident beneficiary. Tomlin J. in *re Visser, The Queen of Holland v. Drukker*[4] stated:

> My own opinion is that there is a well-recognized rule, which has been enforced for at least 200 years or thereabouts, under which these courts will not collect the taxes of foreign States for the benefit of the sovereigns of those foreign States; and this is one of those actions which these courts will not entertain.

The reasons for not enforcing a foreign state's revenue laws was explained by the House of Lords in *Government of India, Ministry of Finance (Revenue Division) v. Taylor*:[5]

> If one State could collect its taxes through the courts of another, it would have arisen through what is described, vaguely perhaps, as comity or the general practice of nations inter se. . . . Tax gathering is an administrative act, though in settling the quantum as well as in the final act of collection judicial process may be involved. Our courts will apply foreign law if it is the proper law of a contract, the subject of a suit. Tax gathering is not a matter of contract but of authority and administration between the State and those within its jurisdiction. If one considers the initial stages of the process, which may, as the records of your Lordships' House show, be intricate and prolonged, it would be remarkable comity if State B allowed the time of its court to be expended in assisting in this regard the tax gatherers of State A.

Adoption in Canadian Courts

Canadian common law followed the revenue rule as set out in the above English case law. The revenue rule was applied by the British Columbia Court of Appeal in

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3 (1923) 16 LI. L.Rep. 190, 193.

4 [1928] Ch. 877, 884; 44 T.L.R. 692.

5 [1955] A.C. 491. The factual background in this case is as follows. The government of India sought to enforce and collect capital gains tax from the sale of an English company that carried on business in India. The English company filed for voluntary liquidation and the Indian government brought its claim in the English bankruptcy proceeding. The House of Lords decision was unanimous.

United States v. Harden[6] when it refused to enforce a U.S. judgment obtained against Mrs. Harden, who was a Canadian resident at the time the case was brought. In earlier years, she was a resident of the U.S. In an attempt to sidestep the revenue rule, the U.S. government obtained a judgment against Mrs. Harden in the U.S. District Court for the Southern District of California, Central Division. The judgment was for outstanding tax plus interest in the amount of $200,037.28 for the 1945 U.S. taxation year and $439,462.87 for the 1946 U.S. taxation year.

In Canada, the U.S. conceded the application of the principle that no action will be pursued in Canadian courts by or on behalf of a foreign state to recover taxes payable under foreign revenue laws. However, the U.S. contended that the revenue rule does not apply once the foreign state has recovered judgment in its domestic courts and sues to enforce the judgment in Canada.[7] In essence, the U.S. argued that the once the matter was adjudicated in the U.S. court, the judgment stood on its own merits without the need of any reference to the underlying claim. However, the British Columbia Court of Appeal refused to enforce the California judgment because it remained a claim on behalf of a foreign state to recover taxation due under its law. The underlying claim tainted the enforceability of the judgment.[8]

"The introduction of Article XXVIA meant that a U.S. citizen would no longer be permitted to move to Canada in order to avoid his or her U.S. tax liabilities."

The Supreme Court of Canada unanimously upheld the decision of the British Columbia Court of Appeal.[9] At page 371 of its decision, the Supreme Court cited to the Irish decision *Peter Buchanan Ltd. & Macharg v. McVey*,[10] where Lord Sommervell of Harrow stated at page 515 that a foreign state could not circumvent the direct or indirect application of the revenue rule. The Supreme Court of Canada stated:

> A foreign State cannot escape the application of this rule, which is one of public policy, by taking a judgment in its own courts and bringing suit here on that judgment. The claim asserted remains a claim for taxes. It has not, in our courts, merged in the judgment; enforcement of the judgment would be enforcement of the tax claim.[11]

THIRD PROTOCOL TO THE TREATY ADOPTS ASSISTANCE IN COLLECTION

Article XXVIA (Assistance in Collection) was adopted by Article 15 of the Third Protocol to the Treaty, which was signed on March 17, 1995. That protocol replaced an earlier proposed protocol that was signed on August 31, 1994, but never went into force and was later withdrawn. The text of Article XXVIA appears in **Appendix I**.

The introduction of Article XXVIA meant that a U.S. citizen would no longer be permitted to move to Canada in order to avoid his or her U.S. tax liabilities as in *Harden*.[12] To that end, the Technical Explanation prepared by the Treasury Department

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6 (1962), 40 W.W.R. 428, 36 D.L.R. (2d) 602.

7 *United States v. Harden*, 36 D.L.R. (2d) 602 at p. 606.

8 *Id.* at p. 607.

9 [1963] S.C.R. 366.

10 [1955] A.C. 516.

11 *Supra* note 7 at p. 371.

12 Dianne Bennett, "Third Protocol to the Canada – U.S. Tax Treaty, " in *Report of Proceedings of the Forty-Seventh Tax Conference*, 1995 Conference Report

at the time the Third Protocol was submitted to the U.S. Senate as part of the approval process described the purpose and workings of the provision in the following language:

> Article 15 of the Protocol adds to the Convention a new Article XXVI A (Assistance in Collection). Collection assistance provisions are included in several other U.S. income tax treaties, including the recent treaty with the Netherlands, and in many U.S. estate treaties. U.S. negotiators initially raised with Canada the possibility of including collection assistance provisions in the Protocol, because the Internal Revenue Service has claims pending against persons in Canada that would be subject to collection under these provisions. However, the ultimate decision of the U.S. and Canadian negotiators to add the collection assistance article was attributable to the confluence of several unusual factors.
>
> Of critical importance was the similarity between the laws of the United States and Canada. The Internal Revenue Service, the Justice Department, and other U.S. negotiators were reassured by the close similarity of the legal and procedural protections afforded by the Contracting States to their citizens and residents and by the fact that these protections apply to the tax collection procedures used by each State. In addition, the U.S. negotiators were confident, given their extensive experience in working with their Canadian counterparts, that the agreed procedures could be administered appropriately, effectively, and efficiently. Finally, given the close cooperation already developed between the United States and Canada in the exchange of tax information, the U.S. and Canadian negotiators concluded that the potential benefits to both countries of obtaining such assistance would be immediate and substantial and would far outweigh any cost involved.

However, the two countries were hesitant to allow the application of collection procedures to their respective citizens doing business in the other country. To that end, Paragraph 8 of the Article XXVIA provides:

> No assistance shall be provided under this Article for a revenue claim in respect of a taxpayer to the extent that the taxpayer can demonstrate that . . . the revenue claim relates to a taxable period in which the taxpayer was a citizen of the requested state.

EXCHANGE OF INFORMATION

Article XXVII addresses exchanges of information between the tax authorities in the U.S. and Canada. Originally adopted in 1984, the provision was modified by the Fifth Protocol to the Treaty signed on September 21, 2007. The text of Article XXVII appears in **Appendix II**.

(Toronto: Canadian Tax Foundation, 1996), 44:1-25, at 44:10. *Harden* was cited favorably by the Federal Court in 2015 F.C. 1082 at Paragraph 52 where the Federal Court stated that it was well settled that in no circumstances will a court directly or indirectly enforce the revenue laws of another country, unless expressly allowed to so in the home country of the person in question.

As currently in effect, Article XXVII authorizes the competent authorities to exchange information as may be relevant for carrying out the provisions of the Treaty or domestic tax law, insofar as the taxation under domestic law is not contrary to the Treaty. The Technical Explanation of the Fifth Protocol prepared by the U.S. Treasury Department as party of the approval process in the U.S. explains that the phrase “may be relevant” expresses the intention to allow the I.R.S. to obtain items of potential relevance to an ongoing investigation, without reference to its admissibility. The phrase is not intended to support a request in which a Contracting State simply asks for information regarding all bank accounts in one state maintained by residents of the requesting state.

The authority to exchange information is not restricted to residents of one or both states. Information may be exchanged for use in all phases of the taxation process including assessment, collection, enforcement, or the determination of appeals. Any information received by a state is to be treated as secret in the same manner as information obtained under the tax laws of that state. Disclosure of the information is limited to authorities, including courts and administrative bodies, involved in

- the assessment or collection of tax,
- the administration and enforcement of tax, or
- the determination of appeals in relation to tax.

Information received in any of the three categories may be disclosed in public court proceedings or in judicial decisions.

If one state requests information, the other state is required to use its information gathering measures to obtain the requested information. The requested state is not permitted to decline to obtain and supply information simply because it has no domestic tax interest in such information. This provision is in Article XXVII. It is intended to preclude the taxpayer argument that the requested state is not authorized to obtain information from a bank or fiduciary that is not needed for its own tax purposes.

Article XXVII does not impose an obligation on the requested state to

- carry out administrative measures at variance with the laws and administrative practice of either state,
- supply information that is not obtainable under the laws or in the normal course of the administration of either state,
- supply information that would disclose any trade, business, industrial, commercial, or professional secret or trade process, or
- supply information the disclosure of which would be contrary to public policy.

Nonetheless, Article XXVII does not prevent a requested state from voluntarily complying with a request on a discretionary basis, provided its internal laws are not violated.

A requested state may not decline to provide information because that information is held by a financial institution, nominee, or person acting in an agency or fiduciary capacity. Thus, domestic bank secrecy laws (or similar legislation relating to disclosure of financial information by financial institutions or intermediaries) are overridden by the state's obligation to provide information under Article XXVII.

Finally, in a general note that accompanied the signing of the Fifth Protocol, Canada and the U.S. expressly agree that the standards and practices described for the exchange of information are to be in no respect less effective than those described in the *Model Agreement on Exchange of Information on Tax Matters* developed by the O.E.C.D. Global Forum Working Group on Effective Exchange of Information.

MULTILATERAL CONVENTION ON MUTUAL ADMINISTRATIVE ASSISTANCE IN TAX MATTERS

In negotiating income tax treaties, Canada has abstained from adopting provisions that enforce collection of a treaty partner's tax from its citizens. Along with the U.S., it refused to adopt the assistance in tax recovery provisions of the *Multilateral Convention on Mutual Administrative Assistance in Tax Matters* (the "Convention"). The Convention was designed to cover:

> All possible forms of administrative co-operation between States in the assessment and collection of taxes . . . through exchange of information . . . to the recovery of taxes.[13]

The Convention was developed jointly by the O.E.C.D. and the Council of Europe. It was open for signature in 1988 and came into force on April 1, 1995. The Convention was amended by the 2010 Protocol. Although, Canada signed the Convention on April 28, 2004, it did not ratify the Convention until November 21, 2013. The Convention entered into force in Canada in 2014. The U.S. has not ratified the Protocol.[14] Article 6 of the Convention forms the foundation for what is known as the Common Reporting Standard ("C.R.S."). Although only 26 countries signed the 1988 version of the Convention, 130 jurisdictions are signatories at this time.

C.R.S. is an automatic annual financial information exchange for tax authorities and allows a tax authority to inform another tax authority of the financial accounts held by tax residents of other signatory jurisdictions. Beginning July 1, 2017, Canada Revenue Agency ("C.R.A.") shares information with members of the C.R.S. Multilateral Agreement with which C.R.A. has formalized a C.R.S. partnership, including details of bank accounts held by their residents in Canada. In return, C.R.A. receives information on financial accounts held by Canadian residents outside of Canada from its C.R.S. partners. The information exchanged by C.R.A. comes from filings made to C.R.A. by Canadian financial institutions. Exchanged information includes the nonresident account holder's (i) name, (ii) address, (iii) date of birth, (iv) account balance or value at year end, and (v) certain amounts credited or paid into the account during the year. In comparison to F.A.T.C.A. reporting, C.R.S. has no *de minimis* amount for reporting purposes. The U.S. is not a signatory to C.R.S., as F.A.T.C.A. has been successful in uncovering accounts held outside the U.S.

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13 See O.E.C.D., "Convention on Mutual Administrative Assistance in Tax Matters," last updated October 2019.

14 See O.E.C.D. and Council Europe (2011), The Multilateral Convention on Mutual Administrative Assistance in Tax Matters: Amended by the 2010 Protocol, O.E.C.D. Publishing.

by U.S. persons. Nonetheless, the U.S. has automatic bank deposit exchange of information programs with more than 85 countries.[15]

CANADIAN EXPERIENCE WITH INFORMATION EXCHANGE OBLIGATIONS

The automatic exchange of information is permitted by Section 2 of the Canada-U.S. Enhanced Tax Information Exchange Agreement Implementation Act (the "Implementation Act"). It states that Article XXVII of the Treaty authorizes the exchange of information for tax purposes. It is this provision of the Treaty that authorizes the intergovernmental agreement ("I.G.A.") for purposes of exchange of information to enforce F.A.T.C.A.[16]

Hillis v. Canada

Article XXVIA prevents C.R.A. from collecting penalties imposed on its citizens by reason of F.A.T.C.A. or its global counterpart, C.R.S. In *Hillis v. Canada*,[17] a motion for summary judgment was brought by two "accidental Americans" against C.R.A. seeking an injunction to prevent the supply of Canadian financial information to the I.R.S. Accidental American is a popular term in Canada for an individual who was born in the U.S. to Canadian citizens, moved to Canada as a child, and has never worked nor lived in the U.S. as an adult. It is the "accident" of birth in the U.S. that makes the individual a U.S. citizen.

In the *Hillis* case, the appellants argued that the Implementation Act was contrary to the provisions of Article XXVIA. The arguments of the appellants were similar to those who opposed the I.G.A. at the time of enactment. In broad terms, the arguments may be summarized as follows.

The provisions of the Implementation Act

- unduly harm the privacy rights and interests of all Canadians,
- unduly raise compliance costs to all Canadian financial institutions and Canadian taxpayers,
- impede Canada's efforts to enforce its own tax laws, and
- violate the spirit and potentially the letter of a number of Canadian laws and international treaties.

In sum, the appellants argued that by exchanging information under the Implementation Act, C.R.A. was effectively lending assistance to the I.R.S. in collecting tax from Canadian citizens, which is prohibited by Article XXVIA.

The Federal Court disagreed with the plaintiffs' assertions. The authority to exchange information obtained by Canada pursuant to the terms of the Implementation

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15 See Rev. Proc. 2019-23.

16 *The Agreement Between the Government of Canada and the Government of the United States of America to Improve International Tax Compliance Through Enhanced Exchange of Information under the Convention Between Canada and the United States of America with Respect on Income and on Capital.*

17 2015 F.C. 1082 (September 16, 2015).

Act is derived from Article XXVII of the Treaty. As indicated above, the exchange of information provisions of the Treaty do not expressly prohibit disclosure. The words used in the Implementation Act are explicit and the intention of the two governments was found by the Federal Court to be clear. The intent was that each country agreed to would obtain and exchange, annually and on an automatic basis, all relevant information with respect to reportable accounts, subject to the confidentiality and other provisions of the Treaty.

In reaching its decision, the Federal Court relied on the assurances of C.R.A. that:

> The IRS cannot use such information to administer non-tax laws (such as the US Bank Secrecy Act) or in its dealings with federal entities (such as the Financial Crimes Enforcement Network of the US Treasury Department) who are involved in money laundering repression. Indeed, the CRA will not assist the US in collecting non-tax related penalties such as penalties for failing to file the FBAR [Report of Foreign Bank and Financial Accounts]. Moreover, while the Canada-US treaty says that Canada may assist the US in collecting certain taxes, it also says that the Canadian authorities will not assist the US authorities in collecting a US tax liability if the person was a Canadian citizen when the liability arose. The Federal Court went on to state that, although the Treaty does not prevent the collection and the automatic disclosure of taxpayer information mentioned in Article 2 of the IGA with respect to US reportable accounts, the IRS cannot use such information to administer non-tax laws such as the Bank Secrecy Act in the US or in its operations directed to the suppression of money laundering, such as FinCEN. Consequently, CRA will not assist the U.S. in collecting penalties for failing to file FBAR forms.

“Each country agreed to would obtain and exchange, annually and on an automatic basis, all relevant information with respect to reportable accounts, subject to the confidentiality and other provisions of the Treaty.”

As to the argument that the provision lends assistance in the collection of tax in a way this prohibited by Article XXVIA, the Federal Court disagreed, stating:

> Article XXVI A applies only to cases in which tax liability has been determined and is enforceable, and does not apply to the assessment of tax payable, the verification of taxpayer compliance, or related exchanges of information. Accordingly, I find that the automatic exchange of information allowed by the IGA does not amount at the present time to providing assistance in collection, and is thus not captured under this Article. The plaintiffs have conflated the assessment of taxes, verification of compliance, and collection of penalties possibly due by US persons for non-reporting. The arguments made in this respect are not relevant and are premature in any event.

At Paragraph 76 of its decision, the Federal Court concluded that the I.G.A. was not contrary to the Treaty or the Income Tax Act and it was not up to the court to amend the law. The court stated:

> True, a great number of Canadian taxpayers holding US reportable accounts are likely to be affected by a reporting system that in many quarters is considered unjust, costly and ineffective, considering that at the end of the day they are not likely to owe taxes to the US. In the absence of legislative provisions requiring all Canadian financial institutions (provincially and federally regulated) to automatically notify

> their account holders about reporting to the CRA under the IGA and Part XVIII of the ITA, these taxpayers may also be taken by surprise by any consequences that flow from such disclosure. The plaintiffs may find this deplorable, but apart from a constitutional invalidation of the impugned provisions or a change of heart by Parliament or Congress, or the governments of Canada or the US, there is nothing that this Court can judicially do today to change the situation. The impugned provisions have not been held to be ultra vires or inoperative. Judicial courage requires that judges uphold the Rule of Law.

Deegan v. Canada

A similar conclusion was reached in *Deegan v. Canada*.[18] The provisions of the Implementation Act and Sections 263 to 269 of the Income Tax Act, R.S.C. 1985 (5th Supp.), were challenged by individuals who were accidental Americans.

The plaintiffs alleged that those provisions cause Canada to act as an intermediary between Canadian financial institutions and the I.R.S. Those institutions are required to provide C.R.A. with certain information concerning financial accounts belonging to customers whose account information suggests that they may be U.S. persons. C.R.A. then provides that information to the I.R.S. As a result, the plaintiffs alleged that the provisions of the Implementation Act violate the Canadian Constitution,[19] asserting that they constitute an unreasonable seizure of financial information belonging to U.S. persons in Canada. The plaintiffs also alleged that the information exchange under the Implementation Act violated other provisions of the Canadian Constitution because they singled out individuals based on citizenship or national or ethnic origin.[20] Finally, the plaintiffs alleged that the violations do not constitute reasonable limitations on the privacy and equality rights of affected individuals.[21]

The Federal Court disagreed with the allegations and held that the disputed provisions of the Implementation Act are not unreasonable and do not violate the Canadian Constitution.

The information that is obtained by C.R.A. from Canadian financial institutions is not an unreasonable search and seizure. Departing from the approach taken under the revenue rule, the Federal Court determined that an expectation of privacy is appropriate principally when a Canadian statute is criminal or quasi-criminal in nature. Reporting of tax information by Canadian financial institutions to C.R.A., and ultimately to the I.R.S., does not fit into that protected framework. Tax is essentially a regulatory statute, and the information relates to the manner in which income tax is calculated and collected. Hence, a lesser expectation of privacy exists.

The Federal Court also disagreed with the plaintiff's assertion that the information is not of a kind that is regularly obtained under the Income Tax Act and therefore should not be delivered to C.R.A. Following the holding in *Hillis v. Canada*, the banking

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18 2019 F.C. 960 (July 7, 2019).

19 Section 8 of the Canadian Charter of Rights and Freedoms (the "Charter"), Part I of the Constitution Act, 1982, being Schedule B to the Canada Act 1982 (U.K.), 1982, c. 11.

20 Section 15 of the Charter.

21 Section 1 of the Charter.

information is foreseeably relevant to U.S. tax compliance and can be obtained by C.R.A. pursuant to a request from the I.R.S. under Article XXVII of the Treaty.

To the extent that the disputed provisions draw a distinction based on national origin and citizenship, they are not discriminatory. In reaching its decisions, the Federal Court took into account the detailed negotiations that were carried on by the Canadian government, attempting to negotiate a carve-out for Canada. When the Canadian government realized that a carve-out was not possible, it realized that entering into an I.G.A. was the only way to avoid a potentially devastating effect on the Canadian financial sector.

The plaintiffs alleged that the purpose of the Implementation Act was to assist the U.S. government in implementing F.A.T.C.A. and finding U.S. tax evaders and cheats, a purpose that cannot be described as pressing and substantial for the Canadian government or Canadian residents. However, at the same time that Canada was negotiating its I.G.A. with the U.S. government, the O.E.C.D. was involved in developing and implementing a common standard for the automatic multilateral exchange of financial account information along the lines of the I.G.A. Hence, the Implementation Act could not be said to be out of line with global expectations of financial privacy.

Finally, the argument that the Implementation Agreement resulted in discrimination based on citizenship and national origin were misplaced. The Federal Court held that a classification based on national origin is a form of discrimination only where it perpetuates ongoing disadvantages or prejudice. That is not the case where compliance with laws of a country of citizenship are in issue.

> The Charter does not require Canada to assist persons resident in this country in avoiding their obligations under duly-enacted laws of another democratic state, nor does it require this country to shelter those living in Canada from the reach of foreign laws. Indeed, as was noted earlier, insulating persons resident in this country from their obligations under duly-enacted laws of another democratic state is not a value that section 15 of the Charter was designed to foster.

Overall, the arguments raised by the plaintiffs paled in comparison to benefits that are derived by the banking industry in Canada. The I.G.A. was necessary for Canadian financial institutions to be deemed compliant with the requirements of F.A.T.C.A. and simplified the related data gathering obligations. In sum, the Implementation Act allowed Canadian financial institutions to avoid 30% withholding taxes on the receipt of capital payments on loans to U.S. residents and simplified the information gathering that would otherwise have been required under F.A.T.C.A.

CANADIAN ACTIVITY IN EXCHANGING INFORMATION

Canada has separate tax collection arrangements with Norway,[22] the Netherlands,[23] and Germany[24] that are similar to Article XXVIA. Each treaty has a minimum balance

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22 Article 28 of the Canada-Norway Income Tax Treaty.

23 Article XXVIA of the Canada-Netherlands Income Tax Treaty.

24 Article 27 of the Canada-Germany Income Tax Treaty.

that is required for a referral. The publicly released documentation by C.R.A. blacks out this information. Debts that can be referred arise under the Income Tax Act, the Excise Tax Act, any income or sales taxes collected by Canada on behalf of a province or territory, and all other categories of taxes collected by or on behalf of Canada.

The C.R.A. administrative position on exchanges of information can be found in the *National Collections Manual* (2015). Any referral that is sent to a treaty partner must detail the citizenship of the taxpayer and provide as much information as possible to help the treaty partner. Before it is sent on to a treaty partner, a referral must clear C.R.A.'s Tax Treaty Collection Program. The Tax Treaty Collections Program, upon clearing the request, will forward it to the treaty partner and will be the one that liaises with the treaty partner. Information on this program is not readily available. According to David Sherman, a tax lawyer and author, C.R.A. is reluctant to release any information pursuant to a request made under the Access to Information Act, and only through "tortuous litigation" was he able to obtain the following information[25] – some general statistics, albeit somewhat dated:

- From 1995 to 1999, 177 referrals were made by C.R.A. to the I.R.S. covering $47 million in tax-related debts (amount collected not disclosed) and 87 referrals were made from the I.R.S. to C.R.A. (amount at stake and amount collected not disclosed).
- From 1999 through 2005, 422 referrals were made by C.R.A. to the I.R.S. C.R.A. sent 94 referrals in 2003 and 90 referrals in 2004, covering a total of $96 million. The amounts collected were not disclosed. C.R.A. refused to disclose the number of requests that were received from the I.R.S.
- From 2008 to 2012, annual referrals made by C.R.A. to the I.R.S. ranged between 65 and 115 in number. Collections ranged between $13 million and $69 million. Although all requests were accepted by the I.R.S., no information on the amounts collected was released. During this period, no information was released about collection requests made by the I.R.S. to C.R.A.

PASQUANTINO CASE – FOREIGN CUSTOMS DUTY IS A PROPERTY RIGHT

Pasquantino v. U.S.[26] is a Supreme Court case in the U.S. involving a criminal scheme to defraud Canada of its rightful customs tax revenue. It does not involve a claim by Canada to enforce a customs fraud recovery in the U.S. The defendants attempted to expand the scope of the revenue rule to cover U.S. criminal prosecutions in the U.S. based on smuggling activity into Canada. At first, the defendants succeeded. Ultimately, they lost in the Supreme Court.

Facts and Prior History

Canada imposes substantial sin taxes on alcohol and cigarettes. As a result, a black market exists for those items. Capitalizing on the situation, petitioners David

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[25] David Sherman, "David Sherman's Notes – Canada – United States Income Tax Convention, 1980, Article XXVI-A," TaxnetPro (October 2019).

[26] 544 U.S. 349 (2005).

and Carl Pasquantino, both residents of Niagara Falls, New York, began smuggling cheap liquor into Canada.

Their business began in 1996 and continued through May 2000. Their general procedure was to arrange by telephone to purchase liquor from a discount liquor shop in Maryland. They would drive from Niagara Falls, New York, to Hagerstown, Maryland, to purchase the liquor that would be transported to New York and ultimately smuggled into Canada in hidden compartments in the trunks of cars.

The petitioners were indicted and convicted of wire fraud, in violation of 18 U.S.C. §1343, which provided:

> **§ 1343. Fraud by wire, radio, or television**
>
> Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, transmits or causes to be transmitted by means of wire, radio, or television communication in interstate or foreign commerce, any writings, signs, signals, pictures, or sounds for the purpose of executing such scheme or artifice, shall be fined under this title or imprisoned not more than 20 years, or both. If the violation affects a financial institution, such person shall be fined not more than $ 1,000,000 or imprisoned not more than 30 years, or both.

Upon appeal, the U.S. Court of Appeals for the Fourth Circuit[27] reversed the convictions because a scheme to defraud a foreign government of tax revenues was not recognizable under the wire fraud statute due to the application of the revenue rule. The Fourth Circuit acknowledged that Canada's right to collect taxes was a property right for wire fraud purposes but then concluded that the determination of whether Canada was entitled to the tax revenues involved an inquiry into the validity and operation of a foreign revenue law – an inquiry barred by the principles underlying the revenue rule. In so ruling, the Fourth Circuit joined the First Circuit in holding that a scheme to defraud a foreign nation of tax revenues did not violate the wire fraud statute.[28] The Second Circuit previously upheld wire fraud convictions for schemes to defraud a foreign government of tax revenues.[29] Upon motion of the government, the Court of Appeals granted rehearing *en banc* in *Pasquantino*, vacated its prior decision, and affirmed the petitioners' convictions.[30]

U.S. Supreme Court Ruling

The U.S. Supreme Court affirmed the petitioners' convictions for violating the wire fraud statute.

Wire Fraud Statute

The Supreme Court ruled that the two elements of the wire fraud – (i) a scheme or artifice to defraud and (ii) the object of the fraud being money or property in the victim's hands – were present in this case.

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27 *U.S. v. Pasquantino*, 305 F.3d 291 (4th Cir. 2002).

28 *U.S. v. Boots*, 80 F.3d 580 (1st Cir. 1996).

29 *U.S. v. Trapilo*,130 F.3d 547 (2d Cir. 1997).

30 *Supra* note 27.

“Odd as it may seem for the Federal government to prosecute a U.S. citizen for smuggling cheap liquor into Canada, the broad language of the wire fraud statute authorized such prosecution.”

The petitioners’ plot was a “scheme or artifice to defraud” Canada of its valuable entitlement to tax revenue. The evidence showed that the petitioners routinely concealed imported liquor from Canadian officials and failed to declare those goods on customs forms.

In addition, Canada’s right to uncollected excise taxes on the liquor imported into Canada was “property” in its hands, given the economic equivalence between money in hand and money legally due. The fact that the victim of the fraud happened to be the government, rather than a private party, did not lesson the injury.

Revenue Rule

Having found that wire fraud requirement existed, the Supreme Court next moved to determine whether Congress intended to exempt the prosecution from the wire fraud statute under the common law revenue rule, which clearly barred a prosecution for violating a foreign tax law. The Supreme Court found that no common-law revenue rule cases decided as of the enactment of the wire fraud statute in 1952 barred the U.S. from prosecuting a fraudulent scheme to evade foreign taxes. Odd as it may seem for the Federal government to prosecute a U.S. citizen for smuggling cheap liquor into Canada, the broad language of the wire fraud statute authorized such prosecution, and no canon of statutory construction permitted the Supreme Court to read the statute more narrowly. The Supreme Court affirmed the judgment of the Court of Appeals.

The Supreme Court differentiated this case from the classic example of actions traditionally barred by the revenue rule – this case was not a suit to recover a foreign tax liability. Instead, this was a criminal prosecution brought by the U.S. in its sovereign capacity to punish domestic criminal conduct. A prohibition on the enforcement of foreign penal law did not plainly prevent the U.S. government from enforcing U.S. domestic criminal law.

The petitioners argued that the matter inherently involved a collection of tax because a conviction automatically provided restitution rights to the victim – the government of Canada – under the Mandatory Victims Restitution Act of 1996. The Supreme Court, however, adopted a different view. Under this view, restitution and tax enforcement are one and the same. However, the Supreme Court found that the purpose of the Mandatory Victims Restitution Act is merely to award restitution, not to collect a foreign tax. Restitution metes out appropriate punishment for the criminal conduct. If awarding restitution to foreign sovereigns were to be contrary to the revenue rule, the proper resolution would be to construe the act in a way that would not allow such awards, rather than to implicitly repeal the wire fraud statute when the defrauded party is a foreign sovereign.

The Supreme Court acknowledged that the criminal prosecution enforced Canadian revenue law in an attenuated sense but stated that the line the revenue rule drew between impermissible and permissible enforcement of foreign revenue law had always been unclear and no cases yielded a rule sufficiently well established to narrow the wire fraud statute in the context of the criminal prosecution of the petitioners.

The purposes of the revenue rule did not bar its application here:

- The prosecution posed little risk of causing international friction through judicial evaluation of the policies of foreign sovereigns.

- The prosecution embodied the policy choice of the two political branches of our government – Congress and the executive – to free the interstate wires from fraudulent use, irrespective of the object of the fraud. Such a reading of the wire fraud statute gave effect to the policy choice and posed no risk of advancing the policies of Canada illegitimately.
- The Supreme Court's interpretation of the wire fraud statute did not give it extraterritorial effect – the petitioners' offense was complete the moment they executed the scheme inside the U.S. The wire fraud statute punished frauds executed in interstate or foreign commerce and it was not a statute in which Congress had only domestic concerns in mind.

Dissenting Opinion

Justice Ginsburg wrote a dissenting opinion.

The dissent contended that the decision failed to take account of Canada's primary interest in the matter. U.S. citizens who have committed criminal violations of Canadian tax law can be extradited to stand trial in Canada, and Canadian courts are best positioned to decide whether and to what extent the defendants have defrauded the governments of Canada and Ontario out of tax revenues owed pursuant to their own, sovereign excise laws.

The defendants' convictions of wire fraud could not have been obtained without proof of their intent to violate Canadian revenue laws. The fact that the bulk of the defendants' sentences were related, not to the American crime of wire fraud, but to the Canadian crime of tax evasion showed that this case was primarily about enforcing Canadian law. The wire fraud statute contains no reference to foreign law as an element of the domestic crime of wire fraud. By construing the wire fraud statute to encompass violations of foreign revenue laws, the Supreme Court ignored the absence of anything signaling Congress' intent to give the statute such an extraordinary extraterritorial effect.

The opinion disregarded the recognized principal that "Congress legislates against the backdrop of the presumption against extraterritoriality." Notably, when Congress explicitly addresses international smuggling under 18 U.S.C. §546, it provides for criminal enforcement of the customs laws of a foreign nation only when that nation has a reciprocal law criminalizing smuggling into the U.S. At the time of the case, Canada had no such reciprocal law.

The tax treaty between the U.S. and Canada handles the request for assistance for collection of taxes, and the treaty required certification by the requesting nation that the taxes owed had been finally determined. However, the assistance-in-collection provisions did not apply here because such provisions did not apply to a revenue claim relating to a taxable period in which the individual taxpayer is a citizen of the requested state.

The defendants' conduct arguably fell within the scope of the wire fraud statute only because of their purpose to evade Canadian customs and tax laws; short of that purpose, no other aspect of their conduct was criminal in the U.S. The application of the Mandatory Victims Restitution Act of 1996 to wire fraud offenses is corroborative. The fact that the government effectively invited the district court to overlook the mandatory restitution statute out of concern for the revenue rule was revealing and demonstrated that the government's expansive reading of the wire fraud statute warranted the Supreme Court's disapprobation. Congress has expressed with notable clarity a policy of mandatory restitution in all wire fraud prosecutions while in contrast, is quite ambiguous concerning the wire fraud statute's coverage of schemes to evade foreign taxes. Justice Scalia and Justice Souter join this portion of the dissent.

Finally, the rule of lenity would counsel against adopting the Supreme Court's interpretation of the wire fraud statute as the Supreme Court has long held that, when confronted with two rational readings of a criminal statute, one harsher than the other, the harsher one is to be chosen only when Congress has spoken in clear and definite language. (Justice Scalia and Justice Souter join this portion of the dissent.)

RECENT CASES REGARDING ASSISTANCE IN COLLECTION

As previously discussed, the Treaty contains an article calling for the assistance in collection of taxes of the treaty partner jurisdiction. Two cases in the U.S. illustrate that Canada and the U.S. have similar approaches to the application of Article XXVIA.

Dewees v. U.S.[31]

This case involves a U.S. citizen residing in Canada who, to his chagrin, decided to come into compliance with his U.S. tax obligations only to find that he was denied a refund of Canadian tax.

Facts

Mr. Dewees moved from the U.S. to Canada in 1971 and has continued to reside in Canada through the years in issue. He is the owner of a consulting business that was incorporated in Canada. He paid his Canadian taxes annually, but he did not file his U.S. Federal income tax returns in the U.S.

Mr. Dewees was concerned that the I.R.S. was actively investigating U.S. persons living abroad who did not pay taxes and did not report financial interests in foreign financial accounts. These are persons who did not file F.B.A.R.'s with FinCEN. The penalties for not filing an F.B.A.R. were severe. In 2009, the I.R.S. announced the 2009 Offshore Voluntary Disclosure Program ("O.V.D.P."). It offered taxpayers an opportunity to avoid criminal prosecution and a settlement of a variety of civil and criminal penalties in the form of single miscellaneous offshore penalty. It was based on existing voluntary disclosure practices used by I.R.S. Criminal Investigation. Generally, the miscellaneous offshore penalty for the 2009 program was 20% of the highest aggregate value of the unreported offshore accounts in the period beginning 2003 and ending in 2008. Participants were also required to file amended or late returns and F.B.A.R.'s for those years.

Mr. Dewees applied to participate in O.V.D.P. and was preliminarily accepted into the program. Ultimately, the I.R.S. asserted a miscellaneous offshore penalty in the amount of $185,862. Viewing the penalties to be excessive, Mr. Dewees withdrew from O.V.D.P. This led to an I.R.S. examination in which $120,000 in penalties were assessed. These penalties were related to the failure to file Form 5471, *Information*

31 767 F. App'x. 4 (D.C. Cir., April 9, 2019).

Return of U.S. Persons with Respect to Certain Foreign Corporations, with regard to multiple years.

Mr. Dewees administratively challenged the assessment of penalties through the I.R.S. Taxpayer Advocate's Office, and then through the I.R.S. Appeals Office. Neither succeeded. Dissatisfied, Mr. Dewees refused to pay the penalty.

In 2014, the I.R.S. introduced another program to encourage taxpayers to voluntarily disclose offshore assets – the Streamlined Filing Compliance Procedures (the "Streamlined Procedures"). The Streamlined Procedures differ from the O.V.D.P. in several respects. The Streamlined Procedures involve less paperwork and impose lower penalties than the O.V.D.P.. or no penalties, and only cover three years of noncompliance. In addition, the Streamlined Procedures do not offer immunity from criminal prosecution. Transferring between the two programs is generally disfavored, but taxpayers who are otherwise eligible for the Streamlined Procedures and made their O.V.D.P. submissions before July 1, 2014, were offered the opportunity of remaining in O.V.D.P. while requesting the more favorable terms available under the Streamlined Procedures.

In 2015, the I.R.S. sought assistance from C.R.A., and in 2015, the 2014 Canadian tax refund requested by Mr. Dewees was held back until the I.R.S. penalty was paid in full. This international collection assistance is permitted by Article XXVIA.

<u>Contentions in Litigation</u>

Mr. Dewees promptly sent C.R.A. a check in the amount of $134,116.34, representing the $120,000 penalty plus interest. In September 2015, he filed a claim with the I.R.S. seeking a refund of that amount. The claim was rejected in May 2016. Shortly thereafter, he brought a claim in the District Court for the District of Columbia ("D.C. District Court"),[32] asserting the Treaty provision was unconstitutional under the Excessive Fines Clause of Eighth Amendment, the Due Process Clause of the Fifth Amendment, and the Equal Protection Clause of the Fifth Amendment. The D.C. District Court granted the government's motion to dismiss the case failure to state a claim upon which relief can be granted.

The D.C. District Court granted the motion to dismiss, reaching the following holdings as to the three claims made by Mr. Dewees:

- The Excessive Fines Clause of the Fifth Amendment was not applicable because a tax penalty is considered to be remedial. The clause applies to penalties intended to punish an individual.
- The Due Process Clause of the Fifth Amendment was not violated merely because Mr. Dewees could not appeal the penalty to the Tax Court. The availability of a refund action in U.S. Federal district court afforded him with an adequate opportunity to be heard at a meaningful time and in a meaningful manner.[33]
- The Equal Protection Clause of the Fifth Amendment could not be addressed by the D.C. District Court because Mr. Dewees never applied for the Streamlined Procedures.

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[32] 272 F. Supp. 3d 96 (D.D.C. 2017).

[33] *Mathews v. Eldridge*, 424 U.S. 319, 333 (1976).

Decision

On appeal, two issues were presented. Mr. Dewees claimed the D.C. District Court erred when it ruled that he was not denied rights under the Due Process and Equal Protection Clauses of the Fifth Amendment.

As to the Due Process claim, Mr. Dewees argued that he was denied the opportunity of challenging the penalties prior to payment. The court disagree, pointing out that Mr. Dewees had two opportunities to appeal the penalty asserted in the I.R.S. examination and was unsuccessful. The denial of an opportunity of a third appeal prior to payment does not amount to a constitutional flaw in the process.

As to the Equal Protection claim, Mr. Dewees argued that he was denied the opportunity of lower or no penalties that were subsequently allowed to participants in the Streamlined program. The appellate court agreed that, at a surface level, others were afforded more favorable treatment than he received regarding the penalties for failing to file Form 5471. Thus, he had standing to challenge the denial of entry. However, as a matter of substantive constitutional law, differences in government classification are allowed in there is a rational relationship between the disparity of treatment and a legitimate governmental purpose. In the case, a rational basis existed for different treatment. The Streamlined Procedures were designed to encourage taxpayers that were unknown to the I.R.S. as of June 18, 2014, to come forward. Mr. Dewees came forward previously. Moreover, he was not treated any differently than others with similar facts.

Retfalvi v. Commr.[34]

Retfalvi involves a claim for assistance in collection of Canadian tax made by C.R.A. to the I.R.S. The issue that was framed by Mr. Retfalvi was that Article XXVIA of the Treaty is an unconstitutional provision because it amounts to the adoption of a tax provision that did not originate in the House of Representatives.

Facts

Dr. Retfalvi, is a medical doctor who was born in Hungary. He moved to Canada in 1988 under a restricted work permit, and he became a Canadian citizen in 1993. That same year, Dr. Retfalvi came to the U.S. on a J-1 visa to participate in a medical residency program. After Dr. Retfalvi completed his residency in 1997, he returned to Canada.

The following year, Dr. Retfalvi returned to the U.S. under an H1-B visa. To ensure that he would have a place to live if his H1-B visa was not renewed, Dr. Retfalvi purchased a small condominium in Vancouver and signed a pre-construction contract to purchase a larger one.

In 2005, Dr. Ratfalvi was granted permanent resident status in the U.S. As Dr. Retfalvi was no longer planning to reside in Canada, he sold both condominiums in Canada. Dr. Retfalvi reported the sales on a U.S. Federal income tax return.

In 2008, the C.R.A. sent Dr. Retfalvi a summary of the audit adjustments, finding that he had improperly reported the sale of the condominiums. In 2009, the C.R.A.

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[34] F. 3rd. (4th Cir. Docket No. 18-2158, July 16, 2019) reported unofficially at 124 AFTR 2d 2019-5160.

sent him a Notice of Assessment. Dr. Retfalvi filed an untimely objection in February 2010. In March 2010, he filed a timely administrative appeal. C.R.A. denied his appeal and provided him 90 days to file a petition for review by the Canadian Tax Court. However, Dr. Retfalvi did not challenge the proposed deficiency by the deadline of October 3, 2011. As a result, the Canadian tax liability became final on that date.

Notably, on June 23, 2010, Dr. Retfalvi had become a U.S. citizen.

On October 27, 2015, C.R.A. referred the assessment to the U.S. for collection, pursuant to Article XXVIA. On November 16, 2015, the I.R.S. issued a Final Notice – Notice of Intent to Levy and of Your Right to a Hearing (the "Notice"), instructing Dr. Retfalvi to pay $124,286.83 in U.S. currency to satisfy the Canadian revenue claim. In the Notice, the I.R.S. advised that it intended to use its collection procedures if Dr. Retfalvi did not pay the assessment within the allotted period. The Notice indicated that Dr. Retfalvi had 30 days to seek a hearing before the I.R.S. Office of Appeals regarding the proposed levy. In addition, the Notice stated that the I.R.S. had no authority to adjust the underlying Canadian tax liability.

Dr. Retfalvi objected to the Notice on January 13, 2016, and requested a hearing. On February 23, 2016, he sought a hearing before the I.R.S. Office of Appeals under the Collection Due Process Program, pursuant to Code §6330. In response, Dr. Retfalvi was informed that he was not entitled to a hearing under that program, but he was entitled to a limited hearing under the Collection Appeals Program. Dr. Retfalvi then filed for that hearing. On March 24, 2016, the I.R.S. denied Dr. Retfalvi's Collection Appeal Request because it did not have the authority to adjust a foreign tax liability.

Contentions in Litigation

Dr. Retfalvi filed suit for a declaratory judgment and injunctive relief, but the court dismissed the suit for lack of jurisdiction pursuant to the Anti-Injunction Act.[35] Shortly thereafter, he paid the tax assessment and filed a refund claim with the I.R.S. When the claim was denied, Dr. Retfalvi filed a complaint in Federal district court. Several counts in support of recovery were asserted. Among them are the following:

- Article XXVIA violates the Constitution's Origination Clause, as a revenue raising measure that did not originate in the House of Representatives. The Origination Clause provides that all bills for raising revenue must originate in the House of Representatives. Dr. Retfalvi asserted that Article XXVIA is a bill that raises revenue.

- Article XXVIA does not have the force of law because it is not a self-executing treaty provision. Only Congress has the power to lay and collect taxes. Giving Article XXVIA legal effect absent implementing legislation unconstitutionally encroaches on congressional authority.

- The I.R.S. is not authorized to collect taxes because Article XXVIA has no legal force. The I.R.S. lacked statutory authority to use its domestic enforcement powers to collect a foreign assessment on behalf of Canada.

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35 *Retfalvi v. Commr.*, 216 F. Supp. 3d 648 (E.D.N.C. 2016).

Decision

The district court rejected Dr. Retfalvi's contentions and dismissed the case. On appeal, the Fourth Circuit Court of Appeals affirmed the decision of the district court.

In broad terms, the court reached the following conclusions:

- The Canadian tax collected by the I.R.S. from Dr. Rafalvi was not a tax within the meaning of the Origination Clause. A law does not fall within the Origination Clause if it raises revenue for a specific purpose instead of the obligations of government, generally.
- While the taxing power is granted to Congress, that grant of power is not exclusive. The mere fact that a congressional power exists does not mean that the power is exclusive so as to preclude the making of a self-executing treaty within the area of that power.[36]
- In broad terms, a self-executing treaty provision is equivalent to an act of the legislature.[37] This rule does not apply to a treaty when (i) its text manifests an intention that implementing language is necessary; (ii) the Senate, in giving consent, or Congress, by resolution, requires implementing legislation; or (iii) implementing legislation is constitutionally required. Here, Article XXVIA relies on each country's existing tax laws and procedures for assessment and collection, and requires no additional legislation to operate effectively.
- Article XXVIA authorizes the I.R.S. to employ the procedures created under Code §§6201 and 6301 to pursue and collect Canadian revenue claims. It specifically provides that a revenue claim shall be collected by the requested state as though such revenue claim were the requested state's own revenue claim that has been finally determined in accordance with the laws applicable to the collection of the requested state's own taxes. Consequently, if the U.S. accepts a request from Canada to collect a revenue claim, the U.S. must collect the revenue claim as if it were its own revenue claim.

CONCLUSION

While the revenue rule is not dead within the common law, the world has changed since the time it was first enunciated. Today, treaties, multilateral agreements, and domestic criminal law have reduced the effectiveness of the doctrine. Whether the concept is F.A.T.C.A., C.R.S., the Convention, or criminal enforcement, tax authorities around the world speak with each other, provide information to each other, and provide assistance in collection of taxes. Governments realize that failure to pay tax that has properly been assessed is an activity that should not be supported. In particular, the U.S. and Canada have adopted a working relationship that benefits administrators in both countries. Tax cheats can no longer look with confidence to the revenue rule.

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[36] *Edwards v. Carter*, 580 F.2d 1055 (D.C. Cir. 1978).

[37] *Medellin v. Texas*, 552 U.S. 491 (2008).

APPENDIX I

Today, Article XXVIA provides as follows:

1. The Contracting States undertake to lend assistance to each other in the collection of taxes referred to in paragraph 9, together with interest, costs, additions to such taxes and civil penalties, referred to in this Article as a 'revenue claim'.

2. An application for assistance in the collection of a revenue claim shall include a certification by the competent authority of the applicant State that, under the laws of that State, the revenue claim has been finally determined. For the purposes of this Article, a revenue claim is finally determined when the applicant State has the right under its internal law to collect the revenue claim and all administrative and judicial rights of the taxpayer to restrain collection in the applicant State have lapsed or been exhausted.

3. A revenue claim of the applicant State that has been finally determined may be accepted for collection by the competent authority of the requested State and, subject to the provisions of paragraph 7, if accepted shall be collected by the requested State as though such revenue claim were the requested State's own revenue claim finally determined in accordance with the laws applicable to the collection of the requested State's own taxes.

4. Where an application for collection of a revenue claim in respect of a taxpayer is accepted

    a. By the United States, the revenue claim shall be treated by the United States as an assessment under United States laws against the taxpayer as of the time the application is received; and

    b. By Canada, the revenue claim shall be treated by Canada as an amount payable under the Income Tax Act, the collection of which is not subject to any restriction.

5. Nothing in this Article shall be construed as creating or providing any rights of administrative or judicial review of the applicant State's finally determined revenue claim by the requested State, based on any such rights that may be available under the laws of either Contracting State. If, at any time pending execution of a request for assistance under this Article, the applicant State loses the right under its internal law to collect the revenue claim, the competent authority of the applicant State shall promptly withdraw the request for assistance in collection.

6. Subject to this paragraph, amounts collected by the requested State pursuant to this Article shall be forwarded to the competent authority of the applicant State. Unless the competent authorities of the Contracting States otherwise agree, the ordinary costs incurred in providing collection assistance shall be borne by the requested State and any extraordinary costs so incurred shall be borne by the applicant State.

7. A revenue claim of an applicant State accepted for collection shall not have in the requested State any priority accorded to the revenue claims of the requested State.

8. No assistance shall be provided under this Article for a revenue claim in respect of a taxpayer to the extent that the taxpayer can demonstrate that

   a. Where the taxpayer is an individual, the revenue claim relates either to a taxable period in which the taxpayer was a citizen of the requested State or, if the taxpayer became a citizen of the requested State at any time before November 9, 1995 and is such a citizen at the time the applicant State applies for collection of the claim, to a taxable period that ended before November 9, 1995; and

   b. Where the taxpayer is an entity that is a company, estate or trust, the revenue claim relates to a taxable period in which the taxpayer derived its status as such an entity from the laws in force in the requested State.

9. Notwithstanding the provisions of Article II (Taxes Covered), the provisions of this Article shall apply to all categories of taxes collected, and to contributions to social security and employment insurance premiums levied, by or on behalf of the Government of a Contracting State.

10. Nothing in this Article shall be construed as:

   a. Limiting the assistance provided for in paragraph 4 of Article XXVI (Mutual Agreement Procedure); or

   b. Imposing on either Contracting State the obligation to carry out administrative measures of a different nature from those used in the collection of its own taxes or that would be contrary to its public policy (ordre public).

11. The competent authorities of the Contracting States shall agree upon the mode of application of this Article, including agreement to ensure comparable levels of assistance to each of the Contracting States.

APPENDIX II

Today, Article XXVII provides as follows:

1. The competent authorities of the Contracting States shall exchange such information as may be relevant for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes to which this Convention applies insofar as the taxation thereunder is not contrary to this Convention. The exchange of information is not restricted by Article I (Personal Scope). Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the taxation laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment or collection of, the administration and enforcement in respect of, or the determination of appeals in relation to the taxes to which this Convention applies or, notwithstanding paragraph 4 , in relation to taxes imposed by a political subdivision or local authority of a Contracting State that are substantially similar to the taxes covered by this Convention under Article II (Taxes Covered). Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions. The competent authorities may release to an arbitration board established pursuant to paragraph 6 of Article XXVI (Mutual Agreement Procedure) such information as is necessary for carrying out the arbitration procedure; the members of the arbitration board shall be subject to the limitations on disclosure described in this Article.

2. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall use its information gathering measures to obtain the requested information, even though that other State may not need such information for its own tax purposes. The obligation contained in the preceding sentence is subject to the limitations of paragraph 3 but in no case shall such limitations be construed to permit a Contracting State to decline to supply information because it has no domestic interest in such information.

3. In no case shall the provisions of paragraph 1 and 2 be construed so as to impose on a Contracting State the obligation:

   a. To carry out administrative measures at variance with the laws and administrative practice of that State or of the other Contracting State;

   b. To supply information which is not obtainable under the laws or in the normal course of the administration of that State or of the other Contracting State; or

   c. To supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy (ordre public).

4. For the purposes of this Article, this Convention shall apply, notwithstanding the provisions of Article II (Taxes Covered):

a. To all taxes imposed by a Contracting State; and

b. To other taxes to which any other provision of this Convention applies, but only to the extent that the information may be relevant for the purposes of the application of that provision.

5. In no case shall the provisions of paragraph 3 be construed to permit a Contracting State to decline to supply information because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person.

6. If specifically requested by the competent authority of a Contracting State, the competent authority of the other Contracting State shall provide information under this Article in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings).

7. The requested State shall allow representatives of the requesting State to enter the requested State to interview individuals and examine books and records with the consent of the persons subject to examination.

HOW SOON IS NOW? O.E.C.D. STARTS WORK ON A SUBSTITUTE FOR UNILATERAL DIGITAL ECONOMY FIXES

Author
Michael Peggs

Tags
Arm's Length Standard
Digital Economy
Nexus
P.E.
Transfer Pricing

When you say it's gonna happen 'now'
When exactly do you mean?
See I've already waited too long
And all my hope is gone

– The Smiths, "How Soon Is Now?"

This month finds the arm's length principle continuing to operate among O.E.C.D. Member States and the broader inclusive framework working toward international tax reform of the digitized economy. In a little more than a year, this may be different. The O.E.C.D.'s work plan[1] for urgent policy development will investigate a new nexus standard and departures from the arm's length principle in certain circumstances where the approach underlying decades of global entente may no longer be suited. The O.E.C.D. aims to release final guidance late in 2020.[2]

Meanwhile, the stakes in transfer pricing controversy and G-20 public finance policy are high. O.E.C.D. Member States and the broader "inclusive framework" nations have not reached international consensus but, nonetheless, demand urgent delivery of a policy solution from the O.E.C.D. At the same time as the O.E.C.D. is doing its work, its members and other inclusive framework nations are proposing and enacting new income taxes on digital services and advertising revenue.

In its role as a consensus-building organization, the O.E.C.D. has synthesized three competing proposals concerning permanent establishment ("P.E.") and attribution of profit to P.E.'s for digital economy companies. This synthesis is called the "Unified Approach." The current debate between tax administrations concerning the attribution of profit to digital or non-physical P.E.'s features three popular approaches:

- A modified residual profit split method that introduces a new simplified convention for dividing non-routine profit deemed to be subject to tax within a newly defined digital P.E.
- A fractional apportionment method that departs from the residual profit split approach in favor of developing a formula used to allocate total group profit to identified market jurisdictions
- A series of distribution-based approaches that modify existing marketing and distribution pricing mechanisms to identify baseline profit attributable to

[1] O.E.C.D. (2019), Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy, O.E.C.D./G-20 Inclusive Framework on B.E.P.S., O.E.C.D. Publishing, Paris.

[2] O.E.C.D. Centre for Tax Policy and Administration, Public Consultation Document: Secretariat Proposal for a "Unified Approach" Under Pillar One, October 9–November 12, 2019.

marketing, distribution, and user-related activities and then identify and allocate non-routine profits to certain market jurisdictions[3]

For the proposed unified profit attribution approach to apply, (i) a company's activity in a foreign market jurisdiction must meet the new nexus standard, (ii) the company must exceed a consolidated global sales threshold, and (iii) the business sector of a company must fall outside proposed industry carveouts for the financial, extractive, and commodities sectors. The €750 million country-by-country reporting threshold has been suggested as a reference point. This threshold has become widely popular in proposals attempting to regulate global businesses without adversely affecting larger local businesses.

Notable in the public consultation document is an indication of the intent of the working group to examine an expanded application of the new digital nexus and profit-attribution rules to all companies that are "consumer-facing businesses." The term "consumer" is defined in such a way as to refer to individuals who acquire or use goods and services for personal purposes and is synonymous with the term "user" in the public consultation document. Almost certainly, these terms will have broad implications, which may prove difficult to foresee, for companies with multi-sided business models.

The proposed operation of the new nexus rule would depend on a specified revenue threshold in a particular market, with some consideration made for the size of a country's market. The sources of revenue that contribute toward the threshold amount include online advertising services directed at nonpaying users, remote sales to customers located in the market jurisdiction, and sales made to related or unrelated distributors located in the market jurisdiction. In designing the nexus standard, the O.E.C.D. has been careful to note that the objective is business model neutrality and the ability for the nexus standard to be used in allocating taxing rights under new, yet-to-be-developed business models.

A possible effect of the proposed rules is a move toward local incorporation of customer-facing businesses and a greater reliance by multinationals on intercompany licensing and other business-to-business transactions that are judged under more traditional arm's length transfer pricing rules.

THE ABC'S OF TAXING THE DIGITAL ECONOMY

At the heart of the profit allocation method proposed under the Unified Approach is a three-tiered mechanism.

The following example of a global streaming services company with both physical and digital presence in a market jurisdiction illustrates the approach to calculating the three amounts or sources of market jurisdiction profit:

- Amount A is a percentage of global residual profit. Under this alternative, a resident company that has a non-physical or digital nexus that meets the revenue threshold is deemed to earn W%, the residual profit of the global group or business line. Group or business line consolidated global profit is Z%. Routine profit of the same global business line is X%. The proportion

[3] *Programme of Work, op. cit.*, Chapter II.

W% of the residual Z% - X% is taxable in the jurisdiction. W% is to be either fixed by formula or fixed by formula with some variation by industry and will itself be a residual after consideration of profit attributable to other factors such as trade intangibles.

- Amount B is a fixed baseline or routine marketing and distribution return for activities taking place in the market jurisdiction. The baseline will be determined as a function of either a single fixed percentage, a percentage that varies by industry or region, or some other agreed method.

- Amount C is an arm's length return for marketing and distribution activities in excess of the functionality reflected in the fixed return under the baseline approach in Amount B but not overlapping the result of the residual profit approach in Amount A.

"A particular area of oversimplification and concern is the blurring of the comparable profit split method (the transactional profit split in O.E.C.D. terms) with global formulary apportionment."

The public consultation document indicates that most dispute resolution will be required under a Mutual Agreement Procedure ("M.A.P.") and mandatory binding arbitration articles of applicable income tax treaties in respect of the arm's length return in Amount C. Other multilateral policy changes would be implemented across Articles 7 and 9 of applicable income tax treaties in a manner broadly consistent with the Multilateral Instrument used to implement the various B.E.P.S. recommendations. Public commentary has been requested on definition, measurement, administration, and dispute resolution aspects of the proposed Unified Approach.

In the U.S., the arm's length standard looks at its O.E.C.D. cousin with no immediate plans for a new hairstyle, exploration of a different musical genre, or additions to its spring wardrobe. In general, the I.R.S. position has been that a better understanding and quantification of the profit effects of marketing intangible development and use can mitigate double taxation and that other analytical tools are preferable to resorting to the blunt instrument of profit apportionment. The time to choose will come again for the I.R.S. and Treasury.

In the meantime, there are double tax cases to be resolved with tax authorities that find some transactional and traditional transfer pricing methods too cumbersome to apply. These tax authorities appreciate the apparent simplicity of the profit split method and the brilliance (and magnitude) of the result. See our article "A New Way to Do the Splits" for a discussion of technical developments that contribute to the O.E.C.D. digitalization work plan. Like it or not, the profit split method is now in fashion.

HOW SOON IS NOW FOR A NEW APPROACH?

A particular area of oversimplification and concern is the blurring of the comparable profit split method (the transactional profit split in O.E.C.D. terms) with global formulary apportionment. Eager for simplification and perhaps foreseeing some fraying of the consensus around the arm's length principle, certain tax authorities in North America – meaning C.R.A. in Canada – and further afield are seeking to pass off global formulary apportionment results for transactional profit split method outcomes.

Despite the rejection of formulary apportionment by the O.E.C.D. Member States in 2017, this tax administration practice is being employed with respect to tax years that predate 2017 multilateral guidance from the O.E.C.D. and in rule regimes where relevant guidance from case law is nonexistent. This should not come as a surprise, as many O.E.C.D. Member States apply retroactive effect to income tax treaties when and as the O.E.C.D. model is revised.

In a sense, treaties should be viewed as a dynamic agreement that changes with the time and philosophy of the O.E.C.D. Member States and other tax administrations participating in the inclusive framework.

Ongoing controversies may find their way in two or three years' time to the Competent Authorities of O.E.C.D. Member States that reference the forthcoming 2020 O.E.C.D. guidance when resolving a double tax issue through a M.A.P. Then again, not all treaty partners may apply the forthcoming guidance in the same way. Companies involved in certain types of transfer pricing controversy, whether with the I.R.S. or with foreign tax administrations, should tread carefully during this period of policy transition.

The most recent definition of global formulary apportionment is found in the 2017 O.E.C.D. Guidelines[4] and can be defined by the three steps taken to obtain its result:

- Determining the unit to be taxed, *i.e.* which of the subsidiaries and branches of an MNE group should comprise the global taxable entity;
- accurately determining the global profits; and
- establishing the formula to be used to allocate the global profits of the unit. The formula would most likely be based on some combination of costs, assets, payroll, and sales.

Global formulary apportionment is also defined by what it is not; that is an application of the profit split method under the arm's length principle:

> Global formulary apportionment should not be confused with the transactional profit methods discussed in Part III of Chapter II. Global formulary apportionment would use a formula that is predetermined for all taxpayers to allocate profits whereas t**ransactional profit methods compare, on a case-by-case basis, the profits of one or more associated enterprises with the profit experience that comparable independent enterprises would have sought to achieve in comparable circumstances** [emphasis added].

Global formulary apportionment is the transactional profit split method without the comparability analysis or demonstration by some other means of the division of profit that would result from a transaction or other dealings between independent enterprises.

While it is not necessarily the case that any analysis that does not reference comparable circumstances is an application of formulary apportionment, it remains true that such an analysis is not consistent with an O.E.C.D. transfer pricing method or the arm's length principle. Rather, it is consistent with unitary taxation in California, absent a water's edge election.

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[4] O.E.C.D. (2017), O.E.C.D. Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017, O.E.C.D. Publishing, Paris.

This approach is distinct from the digitalizing economy profit attribution proposal under the Unified Approach that seeks to build consensus and retain a principled approach to minimize future double tax disputes in an environment of significant political pressure.

CONCLUSION

No matter how packaged, the mood in the O.E.C.D. when it comes to tax jurisdiction is that market matters and global taxing rights should be allocated based on market activity and attributes. Brainpower and manufacturing prowess are less important in this approach.

DOMESTIC PARTNERSHIPS TREATED AS ENTITIES AND AGGREGATES: NEW APPROACH FOR G.I.L.T.I. AND SUBPART F

Authors
Neha Rastogi
Stanley C. Ruchelman

Tags
Aggregate Approach
Entity Approach
G.I.L.T.I.
Partnership
Subpart F

The effect of the T.C.J.A. continues to be encountered in unexpected ways during the second year after its enactment. Examples are the final and proposed G.I.L.T.I. regulations (the "2019 Final G.I.L.T.I. Regulations" and the "2019 Proposed G.I.L.T.I. Regulations") issued by the I.R.S. earlier this year in an attempt to bring order out of the chaos created by proposed G.I.L.T.I. regulations released in September 2018 (the "2018 Proposed G.I.L.T.I. Regulations").

This article discusses the approaches to be followed when determining those U.S. Persons that are considered to be U.S. Shareholders for G.I.L.T.I. and Subpart F purposes when a domestic partnership is a shareholder in a controlled foreign corporation. For those who follow the debate of whether a partnership is an aggregate of the partners or an entity that is separate from the partners, chalk up a victory to the proponents of the aggregate approach.

PARTNERSHIPS: AGGREGATE OR ENTITY FOR SUBPART F INCLUSION PRIOR TO THE T.C.J.A.

Depending on the operative Code section, a partnership can treated either as an entity that is distinct and separate from its partners ("entity approach") or as an aggregate of all partners, meaning that each partner takes into account a *pro rata* share of each tax item on the tax return filed by that partner ("aggregate approach").

Prior to the newly proposed G.I.L.T.I. regulations, the approach to identify a U.S. Shareholder of a controlled foreign corporation ("C.F.C.") in the context of an investor partnership depended on whether the investor partnership was domestic or foreign. For Subpart F purposes, a domestic partnership was treated as an entity separate and distinct from its partners, and the partnership – not the partners – was treated as the owner of partnership assets including the stock in a foreign corporation. As a result, each partner of the partnership included a distributive share of the partnership's Subpart F inclusion, even if the partner held less than a 10% indirect interest in the C.F.C. Each U.S. member of the domestic partnership would pay tax on the amount included in that member's distributive share of the Subpart F Income. Each foreign member of the partnership would be taxed only in the rare event that the Subpart F Income constituted effectively connected income.[1]

Entity treatment was consistent with several provisions of U.S. tax law that are the foundations of the C.F.C. rules. These include (i) the characterization of a domestic

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1 Subpart F Income of a C.F.C. owned by a partnership is foreign-source income. As such, most items of Subpart F Income would not be taxed in the U.S. for a partner that is not a U.S. Person, such as an individual who is neither a U.S. citizen nor a U.S. resident for income tax purposes.

partnership as a "U.S. Person" in Code §§7701(a)(30) and (ii) the definition of the term "U.S. Shareholder" for purposes of Subpart F under Code §957(c). It is also consistent with the legislative history of Code §951, which included domestic partnerships within the definitions of the terms "U.S. Person" and "U.S. Shareholder."

Under this view, if a domestic partnership were to own more than 50% of the stock of a foreign corporation, the foreign corporation would be considered a C.F.C. even if the holders of a majority of the capital and income interests in the domestic partnership are not U.S. Persons.

In comparison, a foreign partnership has been treated historically as an aggregate of its partners for purposes of ascertaining the C.F.C. status of a foreign corporation principally owned by the foreign partnership. Therefore, the partners of the foreign partnership are treated as owning the partnership's assets.

In this fact pattern, Code §958(a)(2) looks through a foreign partnership to determine:

- Whether a U.S. partner is a U.S. Shareholder of the foreign corporation under Code §951(b) because, through the foreign partnership, the U.S. partner owns 10% or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation, or 10% or more of the total value of shares of all classes of stock of such foreign corporation, and
- whether one or more U.S. partners that are U.S. Shareholders own, in the aggregate, shares representing more than 50% voting power or value of the foreign corporation.

If both conditions are satisfied, each U.S. Person that is a U.S. Shareholder of the C.F.C. through a foreign partnership must include in gross income the *pro rata* share of Subpart F Income generated through that partnership.

THE ENACTMENT OF THE G.I.L.T.I. PROVISIONS

The T.C.J.A. 2017 introduced a global minimum tax for U.S. Shareholders of C.F.C.'s. Under Code §951A, tax is levied in the current period on G.I.L.T.I. that is allocated to a U.S. Shareholder. In broad terms, G.I.L.T.I. income includes all income of a C.F.C. in excess of a certain base amount[2] that is otherwise not taxed in the U.S. either as effectively connected income at the level of the C.F.C. or as Subpart F Income at the level of a U.S. Shareholder, unless otherwise specifically exempted under the G.I.L.T.I. provisions of U.S. tax law.[3]

Typically, anti-tax deferral regimes prevent unlimited deferral of tax on income that may arise from an abusive plan or tax structure or are relatively passive and

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[2] The base amount is determined by multiplying the C.F.C.'s investment in tangible depreciable property by 10% and reducing the product by interest expense that is not allocable to income characterized as tested income for G.I.L.T.I. purposes. By structuring the base amount in this way, a taxpayer cannot obtain a double G.I.L.T.I. benefit, once from interest expense arising from loans incurred to acquire assets and then from using the assets to compute the base amount.

[3] Among the items that are specifically excluded are (i) income that would be foreign base company income but for the high tax exclusion, (ii) dividend income received from a related person, and (iii) foreign oil and gas extraction income.

notoriously placed in no-tax jurisdictions. However, tax planning among major U.S. based multinationals that mostly operated in the cloud became so sophisticated that the term "stateless income" applied to the income from global operations. By introducing U.S. tax on G.I.L.T.I. of C.F.C.'s, Congress adopted a rule to impose a minimum tax on operations outside the U.S., especially where operations that do not require major investment in depreciable tangible property.

It took the Treasury Department and the I.R.S. almost one full year to determine how the general G.I.L.T.I. rules would be applied in the context of a domestic partnership owning shares of a C.F.C. The balance of this article explains the approach adopted in the Proposed G.I.L.T.I. Regulations.

COMPUTATION OF THE G.I.L.T.I. INCLUSION

Computation Under the 2018 Proposed G.I.L.T.I. Regulations

A U.S. Shareholder of a C.F.C. is required to include its G.I.L.T.I. in gross income for a taxable year in a manner generally similar to the computation of an inclusion of Subpart F Income.[4] Code §951A itself does not contain specific rules regarding the treatment of domestic partnerships and their partners for purposes of G.I.L.T.I. The I.R.S. released the 2018 Proposed G.I.L.T.I. Regulations, which adopted a hybrid approach to the G.I.L.T.I. inclusions received through domestic partnerships.

Under the hybrid approach, a domestic partnership was treated as an aggregate of the partners for those partners who were U.S. Shareholders with regard to a particular C.F.C. and as an entity for those partners who were not U.S. Shareholders as to the same C.F.C.[5] Partners who were U.S. Shareholders when looking through the domestic partnership computed their G.I.L.T.I. inclusion in a manner that was similar to ownership through a foreign partnership, by being allocated a distributive share of the C.F.C.'s tested items.[6] Conversely, partners of a domestic partnership who were not U.S. Shareholders would have been allocated a net G.I.L.T.I. inclusion in a two-step process. First the domestic partnership, as an entity, would compute its G.I.L.T.I. inclusion from the C.F.C. That amount would be allocated through distributive shares to partners who were not U.S. Shareholders.

This hybrid approach was intended to balance the policies underlying G.I.L.T.I. with the relevant statutory provisions. As mentioned above, a domestic partnership is a U.S. Person and a U.S. Shareholder. On the other hand, if a domestic partnership were treated strictly as an entity, a domestic partnership with a G.I.L.T.I. inclusion amount would be ineligible for foreign tax credits under Code §960(d) or a deduction under Code §250 with respect to its G.I.L.T.I. inclusion amount.

Comments to 2018 Proposed G.I.L.T.I. Regulations

During the comment period for the 2018 Proposed G.I.L.T.I. Regulations, two comments received from the private sector raised concerns with the hybrid approach that was adopted.

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4 Code §951A(f)(1)(a).

5 Prop. Treas. Reg. §1.951A–5(b)(1).

6 Prop. Treas. Reg. §1.951A–5(c).

First, domestic partnerships would be required to identify those partners that are U.S. Shareholders of a C.F.C. and those that are not. The determination would be easier for those partners that do not own shares of the C.F.C. directly and more difficult if shares are owned directly by a partner. Without that determination, a partnership is not able to properly calculate a partnership-level G.I.L.T.I. inclusion for its partners. In addition, the proposed hybrid approach raised administrability concerns under the centralized partnership audit regime. Finally, the disparate treatment of partners who are U.S. Shareholders and those that are not affects various provisions regarding basis step-ups for inclusion of G.I.L.T.I. under Code §961 and the interplay of inclusions of income and previously taxed income rules of Code §959. It also affects the computation of capital accounts.

Computation Under the 2019 Final G.I.L.T.I. Regulations

Consequently, the 2019 Final G.I.L.T.I. Regulations adopt a new simplified hybrid approach. Hybrid treatment based on the status of the partner is eliminated and hybrid treatment based on the provision of U.S. tax law being applied is adopted.

Entity Approach to Determine U.S. Shareholders

The 2019 Final G.I.L.T.I. Regulations adopt the entity approach for domestic partnerships for purposes of determining whether a U.S. Person is a U.S. Shareholder or whether a foreign corporation is a C.F.C.[7] Hence, the regulations are consistent with the definitions of a U.S. Person and U.S. Shareholder and are consistent with the entity treatment of domestic partnership under Subpart F.

Aggregate Approach to Compute the Amount of the G.I.L.T.I. Inclusion

The 2019 Final G.I.L.T.I. Regulations provide that in order to determine the amount of the G.I.L.T.I. inclusion, a domestic partnership is not treated as owning stock of a foreign corporation within the meaning of Code §958(a).[8] Rather, the partners of a domestic partnership are treated as owning proportionately the stock of the C.F.C. owned by the partnership in the same manner as if the partnership were a foreign partnership under Code §958(a)(2).

Thus, the aggregate approach applies for purposes of Code §951A (inclusion in income), its regulations, and any other provision that applies by reference to Code §951A or its regulations. It also applies to Code §§959 (previously taxed income), 960 (indirect foreign tax credit), and 961 (adjustments to basis for inclusions of income under G.I.L.T.I.). Applying an aggregate approach to the foregoing provisions was determined to be necessary to ensure that a single G.I.L.T.I. inclusion amount is determined for each taxpayer based on its economic interests in all of its C.F.C.'s.

Change to Treatment of Subpart F Inclusions

To ensure consistent treatment across the G.I.L.T.I. and Subpart F regimes, the 2019 Proposed G.I.L.T.I. Regulations extend the aggregate approach to Code §951, noting that Congress intended for the Subpart F and G.I.L.T.I. regimes to work in tandem. Accordingly, for purposes of determining the Subpart F inclusions of partners of a domestic partnership that is a U.S. Shareholder of a C.F.C., an aggregate

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[7] Treas. Reg. §1.951A-1(e)(2).

[8] Treas. Reg. §1.951A-1(e)(1).

approach will apply such that the partners will be treated as proportionately owning the C.F.C. stock that is held by the domestic partnership. As in the G.I.L.T.I. context, this rule does not apply for purposes of determining U.S. Shareholder or C.F.C. status, or whether the U.S. Shareholder is a controlling domestic shareholder.[9]

> ***"Taxpayers initially must determine whether a corporation is a C.F.C. and then must determine which partners will be taxable under Code §§951 and 951A when a domestic partnership is a U.S. Shareholder."***

One effect of this change in the treatment of domestic partnerships is that, for U.S. Persons owning capital and profits interest of less than 10% in a domestic partnership, the overlap rule between P.F.I.C.'s and C.F.C.'s that treated a U.S. partnership as a U.S. Shareholder no longer will be applicable when a foreign corporation is a C.F.C. and a P.F.I.C.[10] Because these partners will no longer have an inclusion in income under Code §951, the overlap is inapplicable. The P.F.I.C. rules will apply. On the other hand, for purposes of reporting on Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*, the reporting obligation for these partners will be reduced.

Effective Date

These rules are effective for tax years of foreign corporations beginning on or after the finalization date.[11] However, taxpayers may apply and rely on the 2019 Proposed G.I.L.T.I. Regulations for tax years beginning after December 31, 2017, provided they do so consistently.

ILLUSTRATIONS

The examples in the 2019 Proposed G.I.L.T.I. Regulations[12] explain how the stock ownership rules for domestic partnerships apply to determine C.F.C. and U.S. Shareholder status and calculate partner inclusions under Code §§951 and 951A.

In a two-step process, taxpayers initially must determine whether a corporation is a C.F.C. and then must determine which partners will be taxable under Code §§951 and 951A when a domestic partnership is a U.S. Shareholder.

Example 1

Facts

A U.S. parent corporation ("U.S.P.") and Individual A, an unrelated U.S. citizen, respectively own 95% and 5% of a domestic partnership ("P.R.S."). P.R.S. wholly owns a foreign corporation ("F.C.")

Analysis

Determination of U.S. Shareholders: Entity Approach

- Under Prop. Treas. Reg. §1.958-1(d)(2), determining whether P.R.S., U.S.P., and A (all U.S. Persons) are U.S. Shareholders and whether F.C. is a C.F.C. is accomplished without regard to the general rule in Treas. Reg.

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9 Prop. Treas. Reg. §1.958-1(d)(2).

10 Code §1297(d).

11 Treas. Reg. §1.958-1(d)(4).

12 Prop. Treas. Reg. §1.958-1(d)(3).

§1.958-1(d)(1) that a domestic partnership is treated in the same manner as a foreign partnership, *i.e.*, as an aggregate. Therefore, the entity treatment applies.

- P.R.S. owns 100% of the voting power and value of F.C. under Code §958(a), so P.R.S. is a U.S. Shareholder under Code §951(b) and F.C. is a C.F.C. under Code §957(a).

- U.S.P. is a U.S. Shareholder of F.C. because it owns 95% of F.C.'s vote and value under Code §958(b) applying Code §318(a)(2)(A).

- A is not a U.S. Shareholder because A owns only 5% of F.C.'s vote and value. A does not meet the 10% ownership requirement under Code §951(b).

Computation of the G.I.L.T.I. Inclusion Amount: Aggregate Approach

- The general rule in Prop. Treas. Reg. §1.958-1(d)(1) applies. P.R.S. is treated as an aggregate of its partners.

- P.R.S. is not treated as an entity owning the F.C. stock for the purpose of determining the Subpart F and G.I.L.T.I. inclusion amount. Instead, P.R.S. is treated in the same manner as a foreign partnership within the meaning of Code §958(a)(2).

- Consequently, when determining income inclusions, U.S.P. is treated as owning 95% of the F.C. stock under Code §958(a), and A is treated as owning 5% of the F.C. stock under Code §958(a).

- U.S.P. is a U.S. Shareholder of F.C. and determines its income inclusions under Subpart F and G.I.L.T.I. based on its ownership (95%). A is not a U.S. Shareholder. A does not have income inclusions under Code §§951 and 951A.

Example 2

Facts

U.S.P., a domestic corporation, and Individual A, a U.S. citizen, own 90% and 10%, respectively, of P.R.S. 1, a domestic partnership. P.R.S. 1 and Individual B, a nonresident alien individual, own 90% and 10%, respectively, of P.R.S. 2, a domestic partnership. P.R.S. 2 owns 100% of the single class of stock of F.C., a foreign corporation. U.S.P., Individual A, and Individual B are unrelated to each other.

Analysis

Determination of U.S. Shareholders: Entity Approach

- Under Prop. Treas. Reg. 1.958-1(d)(2), the determination of whether P.R.S. 1, P.R.S. 2, U.S.P., and Individual A (each a U.S. Person) are U.S. Shareholders of F.C. and whether F.C. is a C.F.C. is made under the entity approach.

- P.R.S. 2 owns 100% of the total combined voting power or value of the F.C. stock within the meaning of Code §958(a). Accordingly, P.R.S. 2 is a U.S. Shareholder under Code §951(b), and F.C. is a C.F.C. under Code §957(a).

- Under Code §§958(b) and 318(a)(2)(A), P.R.S. 1 is treated as owning 90% of the F.C. stock owned by P.R.S. 2. Accordingly, P.R.S. 1 is a U.S. Shareholder under Code §951(b).
- For purposes of determining whether the F.C. stock is treated as owned by U.S.P. and Individual A under Code §318(a)(2)(A), P.R.S. 1 is treated as owning 100% of the F.C. stock by reason of Code §958(b)(2). Therefore, U.S.P. is treated as owning 90% of the F.C. stock under Code §958(b) (100% x 100% x 90%), and Individual A is treated as owning 10% of the F.C. stock under Code §958(b) (100% x 100% x 10%). Accordingly, both U.S.P. and Individual A are U.S. Shareholders of F.C. under Code §951(b).

Computation of the G.I.L.T.I. Inclusion Amount: Aggregate Approach

- Under Prop. Treas. Reg. §1958-1(d)(1), P.R.S. 1 and P.R.S. 2 are not treated as owning (within the meaning of Code §958(a)) the F.C. stock; instead, P.R.S. 1 and P.R.S. 2 are treated in the same manner as foreign partnerships for purposes of determining the F.C. stock owned by U.S.P. and Individual A under Code §§958(a)(2) and (b) of this section.
- Therefore, for purposes of determining the amount included in gross income under Code §§951 and 951A, U.S.P. is treated as owning 81% (100% x 90% x 90%) of the F.C. stock under Code §958(a), and Individual A is treated as owning 9% (100% x 90% x 10%) of the F.C. stock under Code §958(a). Because U.S.P. and Individual A are both U.S. Shareholders of F.C., U.S.P., and Individual A determine their respective inclusions under Code §§951 and 951A based on their ownership of F.C. stock under Code §958(a).

CONCLUSION

The 2019 Final G.I.L.T.I. Regulations have modified the hybrid treatment afforded partnerships for purposes of Code §951A. No longer are certain partners treated one way and other partners another based on indirect ownership interests in a foreign corporation that is a C.F.C. Rather, a U.S. domestic partnership is treated as an aggregate for purposes of computing an income inclusion, but as an entity for other purposes, such as reporting annual information on the C.F.C.

Because a domestic partnership is not treated as owning Code §958(a) stock for purposes of Code §951A, a domestic partnership does not have a G.I.L.T.I. inclusion amount and thus no partner of the partnership has a distributive share of a G.I.L.T.I inclusion amount. Instead, the tax obligations are determined at the partner level. Consequently, a partner that is not a U.S. Shareholder of a C.F.C. owned by the partnership does not have a *pro rata* share of any tested item of the C.F.C.

Nonetheless, a domestic partnership is treated as a U.S. Person and a U.S. Shareholder for all obligations that are not related to the inclusion of income. Hence, the information gathering obligation under U.S. tax law will be imposed on the U.S. partnership, which is in position to obtain and disseminate information to its partners.

NONPROFITS: CREEPING COMMERCIALIZATION AND THE SPECTER OF UNRELATED BUSINESS INCOME TAX

Authors
Nina Krauthamer
Hannah Daniels

Tags
Charitable Organizations
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OVERVIEW

In 2018, charitable giving in the U.S. totaled over $427 billion. Of that amount, 68% of that giving came from individuals, 18% from foundations, 9% from bequests, and 5% from corporations, according to Giving USA. Yet, while much attention goes to donations, charitable giving is not the only source of revenue for nonprofit organizations – and, importantly, in some cases that revenue may be subject to tax.

Listed under Code §501(c) are the purposes for which a charitable organization can be organized and operated, and thereby qualify for Federal tax exemption. The most common organizations are formed under Code §501(c)(3). Notably, there are boundaries for these organizations and crossing them can mean being subjected to adverse provisions, such as the unrelated business income tax ("U.B.I.T.") or even loss of tax-exempt status. The punitive effect of latter is clear. But what is the U.B.I.T.? And what boundaries was it meant to prevent charitable organizations from crossing?

INTRODUCTION TO CODE §501(C)(3) AND U.B.I.T.

Organizations that fall under Code §501(c)(3) are commonly known as charitable organizations or nonprofits, or simply as 501(c)(3)'s. Under the Code, a 501(c)(3) is "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals."[1] With the exception of organizations testing for public safety, 501(c)(3)'s can receive tax-deductible contributions from donors.[2] The charities themselves are also exempt from tax on these donations as well as on income, other than income falling within the scope of the U.B.I.T. (detailed below).

Whether drawn by the appeal of tax exemption or public trend toward social responsibility, more and more commercial activities have begun creeping into the nonprofit sector – raising questions about whether an organization has, in fact, been "organized and operated exclusively" for its tax-exempt purpose.

Just recently, the I.R.S. (in a private letter ruling) denied tax-exempt status to a community coffeehouse on the grounds that it was not operated exclusively for tax-exempt purposes. The coffeehouse planned to act as a fundraising operation for nonprofits serving the local community and as a venue, with its profits going to other

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1 Code §501(c)(3).

2 "Exemption Requirements - 501(c)(3) Organizations," I.R.S., last reviewed or updated August 7, 2019.

charities selected by its customers and community members. Besides operating the coffeehouse, the organization was to conduct community-building programs such as forums with leaders from multiple religious groups, dialogue and bridge-building conversations, celebrations of holidays recognized by the many cultures living in the community, conversations about shared community values, and a neighborhood talent show where all proceeds would go to the winner's charity of choice.

Nonetheless, the I.R.S. maintained that no matter the number of exempt activities the coffeehouse planned to put on, the substantial purpose of the enterprise was commercial, not charitable.

Once an organization has been granted Federal tax-exempt status, in order to maintain it, the nonprofit will be subject to certain constraints.

First is the "non-distribution constraint." Although a charitable organization is allowed to make a profit and pay reasonable compensation to those who provide capital or services, no part of the net earnings can inure to the "benefit of any private shareholder or individual." Second, no substantial part of the organization's activities can consist of carrying on propaganda or otherwise attempting to influence legislation. And lastly, the organization also cannot participate in, or intervene in, any political campaign on behalf of or in opposition to any candidate for public office.

For those organizations that qualify as nonprofits, the penalty for unrelated commercial activities is primarily the U.B.I.T. The U.B.I.T. provisions permit charitable organizations to maintain their tax-exempt status while making some profit in the open market. Under these provisions, charitable organizations and most other exempt organizations will pay tax on any net income derived from an unrelated trade or business at the Federal corporate tax rates.[3]

WHAT LEAD TO THE U.B.I.T.?

The U.B.I.T. was not enacted until 1950, and like the ruling above, evolved in response to perceived abuses of tax-exempt status.

In part, its history can be traced back to a 1924 case in which the Supreme Court articulated the "destination of income" test. This ruling held that it was the destination of income, not the source, that was the ultimate criterion for tax exemption.[4] Following this standard, nonprofits could conduct business unrelated to their tax-exempt purpose – even as their sole activity – and still qualify for tax-exempt status as long as their net income was used to support an exempt purpose or paid over to a qualified charity.

In a notable example, the Mueller Macaroni Company, one of the nation's largest distributors of macaroni, did not pay income taxes for nearly 40 years because it was wholly owned by New York University and its profits were used to support the law school.[5]

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3 Code §511.

4 *Trinidad v. Sagrada Orden*, 263 U.S. 578, 581 (1924).

5 Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VALR 605 (1989).

Situations like this raised fears that universities would monopolize entire industries, creating unfair competition for for-profit businesses and denying the U.S. Treasury of much-needed tax revenue.[6]

Besides the concerns surrounding nonprofits running businesses to fund their exempt purposes, there was concern over "feeder corporations," entities that operated a "business as their sole activity and [were] legally obligated to pay over their profits to an affiliated 501(c)(3) organization."[7]

Nonprofits claimed that their "income-producing activities [were] vital to support their missions and reduce [their] dependence on government and private philanthropy."[8] They further justified their position, claiming that they provide services to citizens that the government would otherwise be required to provide.[9] However, for-profits countered that their own existence in a given market was evidence that the government would not be required to provide that service.[10]

In the end, out of the chaos of competing voices arose the U.B.I.T. And clearly, the cries from the for-profit sector won out because, as both the Treasury Regulations and a House report reveal, a major function of the tax was the regulation of competition between the nonprofit and for-profit sectors.[11]

WHAT IS THE U.B.I.T.?

The U.B.I.T. was enacted in the Tax Reform Act of 1950 and then amended in the Tax Reform Act of 1969. As previously mentioned, it requires charitable organizations and most other exempt organizations to pay tax on any net income derived from an unrelated trade or business at the Federal corporate tax rates.[12]

Unrelated business income, as defined in Code §512, is "gross income derived by an organization from any unrelated trade or business regularly carried on by it, less the deductions allowed . . . which are directly connected with the carrying on of such trade or business." An unrelated trade or business is "any trade or business the conduct of which is not substantially related to the exercise or performance by such organization of its . . . purpose or function constituting the basis for its exemption."[13] In addition, Code §502(a) operates to deny tax-exemption to feeder corporations, providing that "an organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt from taxation under section 501 on the ground that all of its profits are payable to one or more organizations exempt from taxation under section 501."

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6 James J. Fishman, Stephen Schwarz, & Lloyd Hitoshi Mayer, *Nonprofit Organizations* (5th ed. 2015), p. 527.

7 Fishman, *Nonprofit Organizations*, p. 530.

8 *Id.* at p. 527.

9 *Id.* at p. 556.

10 *Id.*

11 Treas. Reg. §1.513-1(b); H.R. Rep. No. 2319, 81st Cong., 2d Sess. 36-37 (1950).

12 Code §511; Fishman, *Nonprofit Organizations*, pp. 530, 551.

13 Code §513.

As a result, since the introduction of the Revenue Act of 1950, feeder corporations are no longer allowed exempt status, while the U.B.I.T. applies to exempt organizations with income derived from (i) a trade or business that is (ii) regularly carried on and (iii) not substantially related to the organization's exempt purpose(s).

A Trade or Business

Clearly, income can be derived from many different sources; however, the U.B.I.T. is only concerned with income derived from a trade or business. A trade or business is defined as the selling of goods or the performance of services for the production of income with the intent to make a profit.[14] A trade or business will maintain its identity even if it is "conducted within a larger group of similar activities that may or may not be related to the exempt purpose."[15]

To illustrate, the I.R.S. provides the example of a hospital pharmacy that not only provides supplies to the hospital and its patients in line with its exempt purpose but also sells pharmaceutical supplies to the general public. In this situation, the pharmacy is considered a trade or business.

Regularly Carried On

Seemingly, the most debated element of the provision is whether a trade or business is being regularly carried on.

For an activity to be considered regularly carried on, it must be done frequently and continuously and be "pursued in a manner similar to comparable commercial activities of nonexempt organizations."[16]

The I.R.S. gives some examples that help to understand what is regularly carried on and what is not:

- A hospital running a sandwich stand for two weeks every year at a state fair would not be considered as a trade or business regularly carried on.
- However, if that hospital were to operate a commercial parking lot one day per week, year-round, that would constitute a trade or business being regularly carried on.

The reasoning is that the parking lot would compete with similar for-profit facilities that operate year-round but the sandwich stand would not.

Not Substantially Related

The use of the profits derived from an activity will not automatically make that activity substantially related to the organizations exempt purpose. In a 1986 Supreme Court decision, a unanimous court set the standard for what is "substantially related," focusing on the "manner in which the tax-exempt organization operates it business."[17]

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[14] *Tax on Unrelated Business Income of Exempt Organizations*, I.R.S. Pub. No. 598, Cat. No. 46598X (Rev. Feb. 2019).

[15] *Id.*

[16] *Id.*

[17] *U.S. v. Am. College of Physicians*, 475 U.S. 834, 849 (1986).

Competition in an industry, or the lack thereof, plays no part in whether an activity is substantially related to a charitable organization's exempt purpose(s).[18] This is interesting considering the fact that, as previously mentioned, regulating competition was Congress's asserted purpose for enacting the U.B.I.T.

What is significant is the size, scope, and extent of the activities being carried on when compared to the organization's exempt purpose.[19] If an activity is being carried out on a much larger scale than what is necessary for the organization's exempt purposes, the "excess may be treated as unrelated."[20] This is very fact specific, with particular focus on the size and extent of the activity. It essentially boils down to whether the activity "contributes importantly" to accomplishing the organization's exempt purpose.

WHAT DOES AND DOES NOT CONSTITUTE AN UNRELATED TRADE OR BUSINESS?

In an I.R.S. revenue ruling,[21] the tax-exempt organization in question was organized and operated to conduct and support medical and scientific research. The organization operated a medical illustration department that furnished "various photographic, illustrative, and similar services to medical and educational institutions" and ran a clinic for several hospitals. The I.R.S. concluded that these activities were conducted in a manner "similar to a commercial undertaking" and that the income from these activities was disproportionate to the actual "size and extent" of their exempt activities. Therefore, these activities were considered an unrelated trade or business and subjected to the U.B.I.T.

In contrast, the following is an example of an activity that is not an unrelated trade or business. An exempt art museum runs a dining room, cafeteria, and a snack bar. All are available for use by visitors and museum employees. The facilities allow visitors to stay in the museum and view more exhibits while also providing employees with a place to eat on-site. The operation of the dining room, cafeteria, and snack bar "contributed importantly" to the accomplishment of the organizations exempt purpose and therefore would not be considered an unrelated trade or business.[22]

Now take an exempt youth welfare organization. It operates a miniature golf course that is open to the public, managed by salaried employees, and substantially similar to commercial courses, including the charging of comparable fees.[23] Because this miniature golf course is run in a commercial manner, it does not "contribute importantly" to the accomplishment of the youth welfare organizations exempt purpose.[24] It is therefore considered an unrelated trade or business.

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18 *Taxation of Exempt Organizations*, Thomas Reuters Tax and Accounting, TEO WGL ¶ 22.05 (Mar. 2019).

19 *Id.*

20 *Id.*

21 Rev. Rul. 57-313.

22 I.R.S. Pub. No. 598.

23 *Id.*

24 *Id.*

Similarly, an organization is organized and operated under Code §501(c)(3) for the prevention of animal cruelty. If it provides animal boarding and grooming services to the general public, these services do not "contribute importantly" to the accomplishment of preventing animal cruelty and would therefore be an unrelated trade or business.[25]

Generally, when the business is run for the convenience of those the organization is formed to serve or those it employs, there's a better chance that the business will not be considered unrelated. This is especially true when looking at the proportion of services provided to those the nonprofit was organized to serve versus those provided to the general public.

"We must remember the vital role that nonprofits play in our economy."

CONCLUSION

As stated in the Treasury Regulations, "the primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete."[26] However, fairness is in the eye of the beholder. We must remember the vital role that nonprofits play in our economy. In addition to the direct benefits of their exempt purposes, the nonprofit sector is actually put at a disadvantage because they hire, train, and supervise individuals that would not otherwise be employable in the mainstream labor market. And there is potential for damage to our social fabric as well as our economy if the nonprofit sector cannot be sustained.

One thing is clear, while the U.B.I.T. may have many fans and an equal number of critics, as one looks out onto the horizon, the U.B.I.T. lives on.

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[25] *Id.*

[26] Treas. Reg. §1.513-1(b).

SAVING CLEMENTINE: IMPROVING THE CODE §163(J) DEDUCTION

Authors
Andreas A. Apostolides
Nina Krauthamer
Stanley Ruchelman

Tags
B.E.P.S. Action 4
Code §163(j)
Deduction
Real Property
T.C.J.A.
Trade or Business

> Oh my darling, oh my darling, oh my darling, Clementine,
> You are lost and gone forever, dreadful sorrow, Clementine.
>
> Drove the horses to the water, every morning just at nine.
> Hit her foot against a splinter, fell into the foaming brine.
>
> – Popular American folk ballad[1]

The 2017 Tax Cuts and Jobs Act ("T.C.J.A.") amended subsection (j) of Code §163 to enact a brand-new version of the U.S. tax law's limitation on deductions claimed for business interest expense. The new version provides that a taxpayer's deduction is capped at 30% of its adjusted taxable income ("A.T.I.").[2] This represents a radical departure from old Code §163(j), as it shifts the focus from preventing earnings stripping transactions to a hard cap on the income tax benefit arising from debt placed in a taxpayer's capital structure.

The old Code §163(j) evaluated deductibility based on two thresholds: a debt-to-equity ratio and a 50% expense-to-A.T.I. ratio. Where the thresholds were exceeded, it disqualified interest expense deductions for related-party debt not subject to 30% Federal withholding tax, as well as third-party debt supported by related-party guarantees and certain R.E.I.T.-to-taxable-R.E.I.T.-subsidiary loans.[3]

It is worth noting that, in the Preamble to the new final Code §385 regulations, the I.R.S. cited to four aspects of the new-and-improved Code §163(j) as reducing the benefit of earnings stripping transactions, including its (i) elimination of the debt-equity ratio safe harbor; (ii) reduction to net interest deductions' maximum share of A.T.I. from 50% to 30%; (iii) extension of the interest expense limitation to all interest, not just related-party; and (iv) elimination of excess limitation carryforwards under old the Code §163(j).[4]

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1 Attributed to Percy Montrose in 1884, though sometimes also to Barker Bradford; it is commonly performed in the key of F major. A popular alternative version references ducklings instead of horses.

2 Pub. L. 115-97, §13301(a) (the 30% limitation is increased by taxpayer's business interest and floor plan financing interest income). Beginning in 2022, A.T.I. is computed without taking into account depreciation, amortization, and depletion, meaning that the effect of missing out on the exemption to the 30% limitation discussed herein will become more pronounced.

3 Regulations were proposed, but never finalized, under the prior Code §163(j) in 1991. See 56 Fed. Reg. 27907 (June 18, 1991). These are now withdrawn. New Code §163(j) is one aspect of U.S. tax reform that is consistent with broader efforts undertaken by many other countries pursuant to B.E.P.S. Action 4.

4 See T.D. 9880, 84 Fed. Reg. 59297-59302 (effective November 4, 2019, removing final Code §385 regulations enacted in October 2016).

Notably, the new Code §163(j) disallowance rule exempts from its purview taxpayers meeting Code §448(c)'s $25,000,000 gross receipts test and also allows certain trades or businesses (most notably for this article, a qualifying real property trade or business, or "R.P.T.O.B.") to elect out of the 30% limitation entirely. The election is irrevocable once made, until the taxpayer ceases to conduct the trade or business.

On August 8, 2018, the I.R.S. issued proposed regulations addressing the new Code §163(j), including mechanics by which R.P.T.O.B.'s could elect to be excepted from the 30% limitation.[5] Unfortunately, there are certain financing structures that, while somewhat common in the real estate industry, fall outside the conceptual rubric of the I.R.S.'s proposed regulations.

Similar to Clementine from the popular folk ballad, who falls in the river after her foot strikes a sharp splinter, certain taxpayers making leveraged investments in real estate through partnerships may accidentally trip into a "bad" outcome and thereafter have no recourse to the I.R.S. to cure the misstep – short of renegotiating the entire business deal.

"Notably, the new disallowance rule exempts from its purview taxpayers meeting Code §448(c)'s $25,000,000 gross receipts test."

This article identifies affected structures, explains why the proposed regulations appear not to reach them, and suggests that the I.R.S. may wish to revisit this matter as part of final regulations, which the I.R.S. has promised to issue by as early as the end of 2019, so as to enable ill-starred investors in U.S. real estate to have the benefit of the R.P.T.O.B. election.

As the U.S. real estate sector continues to be attractive,[6] for now (and until the I.R.S. acts to correct the matter), we would advise anyone considering a real estate investment to keep this "trap for the unwary" in mind – surely as dangerous for the unwary investor as the splinter that cost poor Clementine her life.

THE STATUTE

In Code §163(j)(7), Congress created a special definition of "trade or business" specifically for Code §163(j) purposes. The definition is framed in the negative, stating that a "trade or business" (subject to the 30% limitation) shall not include:[7]

- Any electing R.P.T.O.B.
- Any electing farming business

[5] REG-104397-18, 83 Fed. Reg. 39292.

[6] See, *e.g.*, Harriet Torry and Kate Davidson, "U.S. Housing Starts Dropped 9.4% in September," *Wall Street Journal*, October 17, 2019 (noting that housing starts fell in September 2019 but recently "the National Association of Home Builders reported . . . that builder confidence in the market for new single-family homes climbed in October to its highest level since February 2018").

[7] This is reminiscent of the T.C.J.A. drafters' approach in devising the deduction for "qualified business income," wherein they first crafted the definition of a "qualified trade or business" and then provided that it includes any trade or business "other than" a specified service trade or business or a trade or business of performing services as an employee (Code §199A(d)(1)). While there may be some superficial resemblance in terminology and concepts, under the Code §199A rules taxpayers are provided with a safe harbor for treating a "rental real estate enterprise" as a trade or business for Code §199A purposes. (See Rev. Proc. 2019-38). Thus, in the end, the approach is rather unlike the rules discussed herein.

- Some electricity, water, sewage disposal, gas or steam utility businesses, to extent that the rates they charge are established or regulated by certain arms of government

In a roundabout way, Congress thus tells us that the above businesses can enter a paradisiacal land where no Code §163(j) limitation applies! (Though note, in the first two cases, an election is required and certain costs may apply, such as a longer life for depreciable business assets.)

But what is an R.P.T.O.B.? And who exactly may make this election?

Code §163(j)(7)(B) clarifies that to understand this special election, we must first look to Code §469(c)(7)(C)'s definition of "real property," which is incorporated by reference.

CODE §469 "REAL PROPERTY" DEFINITION

As background to understanding Code §469(c)(7)(C), Congress enacted Code §469 to address a spate of tax-shelter activities as part of the Tax Reform Act of 1986 (the "1986 Act").[8] Congress defined a "tax shelter" as any investment in which a significant portion of the taxpayer's return comes from realizing tax savings, as shelters were organized to maximize certain taxpayers' losses and other tax attributes that could offset positive income.[9] In enacting Code §469, Congress placed substantial limits on taxpayers' ability to use deductions from one activity to offset income from other activities. In particular, the rule limited use of "bad" losses and excess credits from certain categories of suspicious activities (identified as "passive") so that tax attributes generated by those passive activities could not be used to reduce or avoid tax on income earned from other "active" sources. However, C-corporations, other than closely held corporations, were exempted from these rules.[10]

To start, in the 1986 Act, Congress erred on the side of treating all income from real estate activities as passive income. However, in 1993, Congress decided such treatment was unfair when applied to certain rental real estate businesses, in which the owners are heavily and actively involved.

Accordingly, it enacted Code §469(c)(7) to enable these ill-fated taxpayers to escape Code §469 if they could prove active management of their rental properties.[11] In this context, Code §469(c)(7)(C) was enacted, to define an R.P.T.O.B. as "any

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8 Pub. L. No. 99-514.

9 See Joint Committee on Taxation, Tax Reform Proposals: Tax Shelters and Minimum Tax (JCS–39–85), August 7, 1985, at 2.

10 See Code §469(a)(2)(C).

11 Omnibus Budget Reconciliation Act of 1993, Pub. L. 103-66, §13143(a) (adding Code §469(c)(7) to the Code effective for years after December 31, 1993) stating:

> The committee considers it unfair that a person who performs personal services in a real estate trade or business in which he materially participates may not offset losses from rental real estate activities against income from nonrental real estate activities or against other types of income such as portfolio investment income.

real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business." This tended to expand the class of persons who could benefit from the exception for active real estate businesses.

One might reasonably ask whether Code §163(j)(7)(B)'s cross-reference to Code §469(c)(7)(C) thus implicates other Code §469 rules and requirements for purposes of making the new Code §163(j)(7) R.P.T.O.B. election. For example, would the taxpayer need to meet the Code §469 requirement in order to actively manage property or materially participate in such management as a condition to benefit from Code §163(j)(7)(B)'s exemption? Fortunately, the answer is a clear no! The legislative history of the T.C.J.A. clarifies that the Senate's amendment to the House version of Code §163(j) introducing the Code §469 cross-reference, was intended to apply very broadly. Specifically, the Senate amendment indicated that the bill intended that:

> Any such real property trade or business, including such a trade or business conducted by a corporation or real estate investment trust, be included. Because this description of a real property trade or business refers only to the section 469(c)(7)(C) description, and not to other rules of section 469 (such as the rule of section 469(c)(2) that passive activities include rental activities or the rule of section 469(a) that a passive activity loss is limited under section 469), the other rules of section 469 are not made applicable by this reference.[12]

Thus, the owner of a qualifying R.P.T.O.B. should be able to benefit by making the election so long as the trade or business meets the very broad definition of an R.P.T.O.B. included in Code §469(c)(7)(C).

CERTAIN LEVERAGED FINANCING TRANSACTIONS INVOLVING PARTNERSHIPS

This brings us to identifying the taxpayers that may make (or have already made) the election and to discussing a relatively common leveraged financing deal structure that causes so much headache to investors who may have tripped into it prior to the T.C.J.A.'s enactment or issuance of proposed regulations by the I.R.S.

In the proposed regulations, the I.R.S. provided guidance on a variety of topics. However, the language that was adopted to provide election mechanics for R.P.T.O.B.'s in Prop. Treas. Reg. §1.163(j)-9(c) seemingly does not permit a corporate partner to make an election for the R.P.T.O.B. in which the corporate partner is engaged through owning a partnership interest, as in the chart below.[13]

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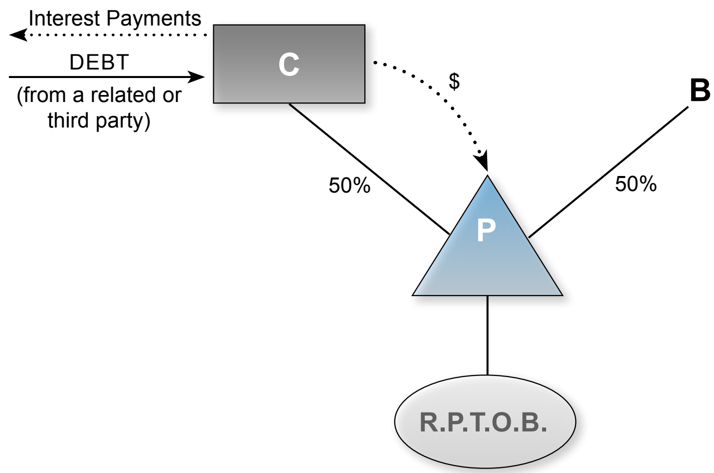
[12] Joint Committee on Taxation, General Explanation of Public Law 115-97, December 2018, at note 883 and accompanying text.

[13] The inability to elect under Prop. Treas. Reg. §1.163(j)-9 would extend to any partner, not just a corporate partner, but individuals do face other requirements before they can deduct business interest, including the rules contained in Code §163(d) regarding investment interest and the passive loss rules of Code §469.



As an example of this issue, as shown on the previous page, suppose that C (who happens to be a corporate partner), previously took out debt from a related or third-party lender and then invested it in a partnership, which conducts the relevant R.P.T.O.B.

Assume that P's sole source of revenue comes from the R.P.T.O.B. and that C and P have no income from any other sources. Based on the proposed regulations, while it appears P could make the R.P.T.O.B. election, if it does not do so C will likely not be qualified to make a Code §163(j)(7) R.P.T.O.B. election by itself on its corporate Form 1120 U.S. Federal income tax return vis-à-vis its flow-thru partnership income from P.[14] Thus, C's hands are tied based on what C and the remaining partners are able to agree. In particular, Prop. Treas. Reg. §1.163(j)-9(c)(4), which provides R.P.T.O.B. election mechanics, states in relevant part:

> An election for a partnership must be made on the partnership's return with respect to any trade or business that the partnership conducts. An election by a partnership does not apply to a trade or business conducted by a partner outside the partnership.

The second sentence does not address the converse fact pattern, *i.e.*, where a partner wishes to make an election with respect to a trade or business conducted through a partnership; though, perhaps the I.R.S. views that issue as disposed of in the first sentence. Thus, the proposed regulations provide little clear authority for a taxpayer who is a partner in an otherwise-eligible R.P.T.O.B. like C to make an independent, irrevocable partner-level Code §163(j)(7) election for the R.P.T.O.B., leaving such taxpayers drowning.[15] The result would be different if instead each partner directly owns an interest in a tenancy-in-common or a joint tenancy.[16]

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[14] Note if C's payment is to a related foreign party then such foreign party may be ineligible for the exemption to withholding for U.S.-source portfolio interest under Code §1441(c)(9) (although the relevant double income tax treaty may provide for some relief), and Code §267(a)(3) may also apply to defer C's deduction until the interest is paid.

[15] However, see **Conclusion** below addressing what C should do, if it took a position on its return that it was eligible to make the election for the portion of the R.P.T.O.B. that it owned via its partnership interest in P.

[16] In this case, each partner would be the sole person capable of making the R.P.T.O.B. election with regard to their separate shares of the T.I.C. or their

Confusingly, as part of the same regulatory package, the proposed regulations also include some examples under Code §469 fleshing out the R.P.T.O.B. definition. One of the examples suggests that a partner would be treated as directly engaged in an R.P.T.O.B. if the partnership was so engaged.[17] The I.R.S.'s purpose in including this example in the regulatory package adopting the R.P.T.O.B. election without clarifying that it carried no significance for the Code §163(j)(7) partnership election mechanics is perplexing. At the same time, the Preamble to the proposed regulations does contain a somewhat cryptic statement about "real estate" definitions, which may have been the I.R.S.'s way of dispelling an undue inference based on the example's language for partnership election mechanics under Prop. Treas. Reg. §1.163(j)-9(c)(4).[18]

Another way C might claim that it is engaged in the R.P.T.O.B. for purposes of making an election at the partner level (rather than via reference to the misleading example under Code §469), would be by applying the "look-thru" rules of Prop. Treas. Reg. §1.163(j)-10. Those rules permit partners to elect to look through to the underlying business of a partnership for purposes of allocating their partner-level interest expense to excepted trades or businesses. Unfortunately, there is no basis for concluding that the -10 look-thru provision also enables the partner to look

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respective portions of the joint tenancy. As a broader matter, for Code §163(j) purposes, C should be able to treat its flow-through partnership income as increasing its A.T.I. for purposes of computing its partner-level Code §163(j) limitation. However, that may be cold comfort to a taxpayer when they would otherwise qualify for the R.P.T.O.B. election and other partnership structures that differ little in any meaningful respects are able to completely escape the 30% limitation. If C is foreign, query whether it can include C-level interest expense as a deduction against effectively connected earnings and profits in computing branch profits tax, which would may make incurring debt at C's level even more costly.

17 Prop. Treas. Reg. §1.469-9(b)(2)(iii), ex. 5, describing a fact pattern where F owns and operates a luxury hotel through its interest in the limited partnership P, which provides significant personal services to hotel guests. The example concludes that "under these facts, F and P are treated as engaged in a real property trade or business for purposes of section 469(c)(7)(C) and this section."

18 In particular, the I.R.S. stated in the Preamble:

> As the Treasury Department and the IRS have previously recognized (see Notice of Proposed Rulemaking, 'Definition of Real Estate Investment Trust Real Property,' published in the Federal Register (79 FR 27508, 27510) on May 14, 2014), the term 'real property' appears in numerous Code provisions, which could ordinarily imply that . . . the term 'real property' should have the same meaning throughout the Code. However, the context and legislative purpose underlying a specific Code provision may necessitate a broader or narrower definition of the term 'real property' than may be applied for other Code provisions. These proposed regulations under section 469 provide a definition of real property that is, for example, narrower than the one provided in the REIT context. The definition provided in these proposed regulations would apply solely for purposes of section 469(c)(7), and these regulations should not be construed in any way as applying to, or changing, the definitions in other Code provisions.

through for purposes of stepping into the partnership's shoes to make the election under -9 with respect to its own R.P.T.O.B.[19]

PRACTITIONER COMMENTARY

Both prior to and after the I.R.S.'s issuance of the proposed regulations, practitioners flagged this specific fact pattern and also addressed Code §163(j) issues arising when leverage is introduced to partnerships more generally.[20] Some concluded that the proposed regulations' approach does not make for good tax policy because what occurs at the partnership level should not influence deductibility of interest at the partner level.[21] One firm suggested that the new misleading example (discussed above) might "further suggest" the partner in an R.P.T.O.B. partnership "may elect to treat its partnership interest as an electing [R.P.T.O.B.]."[22]

Congress's infelicitous entity approach to partnerships was further taken up in the New York State Bar Association's report, which proposed that "consideration should be given to seeking a statutory amendment of Section 163(j) to apply the limitation on deductibility of interest . . . at the partner level."[23] More insightfully (but still not

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19 If, on different facts, P invested in a partnership conducting a utility business subject to rates approved by a public body then, because under Code §163(j)(7) no election is required, the look-thru rules may be sufficient for P to treat its partnership interest as an excepted trade or business, without needing to file an election to benefit, though the possibility of inconsistent treatment would need to be addressed in such case also.

20 On the precise facts discussed herein, one practitioner questioned whether Code §163(j)'s limitation would even apply to debt "incurred by a C corporation to fund an investment in a partnership conducting a real property trade or business," noting that "[t]here would seem to be greater barriers to applying the [R.P.T.O.B.] exception with respect to debt incurred by a C corporation that funds an investment in REIT or C corporation stock." See Jim Sowell, "Tax Reform and Partnerships" (PowerPoint presentation, Alabama Federal Tax Clinic, November 14, 2018), at p. 67.

21 See Hershel Wein and Charles Kaufman, "The New Section 163(j): Partnerships Issues," *What's News in Tax, September 24, 2018, at pp. 16–17:*

> Pursuant to the entity theory of partnerships, the section 163(j) limitation applies at the partnership level. Nevertheless, it can be argued that the fact that the limitation applies at the partnership level should not influence whether the trade or business of a partnership can determine the deductibility of interest on debt incurred by a partner.

22 "Proposed Section Section [sic] 163(j) Regulations Have Implications for Real Estate Industry," EY, November 28, 2018. However, in a longer tax alert on Code §163(j) published just two days later, the example was omitted ("US Proposed Regulations Offer Much-Needed Guidance on Section 163(j) Business Interest Expense Limitation," EY, November 30, 2018).

23 See New York State Bar Association Tax Section, Report No. 1412: Report on Proposed Section 163(j) Regulations (February 26, 2019), at pp. 35, 37-39 (finding that as an overall matter, the proposed regulations' approach produced reasonable results, but sometimes at the cost of undue complexity such as with regard to the 11-step process for determining each partner's items of deductible business interest expense, carryforwards, and other items under §163(j)). Somewhat confusingly, N.Y.S.B.A. also suggested that Code §163(d) should be applied on an aggregate basis and §163(j) on an entity basis. See id. at p. 35.

helpful to C), one law firm commentator noted that Prop. Treas. Reg. Code §1.163(j)-9(c)(4) reserved the election at the "trade-or-business level, not necessarily for a particular entity."[24] This trade or business orientation, combined with Congress's entity approach to partnerships for Code §163(j), is the genesis of C's issue.

For now, those taxpayers who have not yet made an investment and are properly advised can get the benefit of learning from C's example and avoid falling into the river. However, in agreement with the broad sweep of the foregoing commentators' statements, we would respectfully request the I.R.S. to consider appropriate ways of rectifying this unjustified disparity in the final regulations in order to remove the troublesome splinter and save Clementine.

"Different challenges may arise if there is uncertainty around the level at which any given rule is to be applied, since taxpayers may cherry-pick and alter their view depending on which rules are at stake, potentially subverting the intent of the rules."

CONCLUSION

Some might cynically protest that the R.P.T.O.B. election's very existence is another unprincipled "giveaway" to the real estate industry; however, it is worse to make defective gifts that sometimes explode (and sometimes don't) and more unprincipled to treat otherwise identical taxpayers in markedly different ways.

In this article, we have explored one challenge with applying one rule exclusively at the partnership level. Different challenges may arise if there is uncertainty around the level at which any given rule is to be applied, since taxpayers may cherry-pick and alter their view depending on which rules are at stake, potentially subverting the intent of the rules.

Certain practitioners may suggest that, barring further clarification, there is nevertheless sufficient basis for a return position that the R.P.T.O.B. election is permissible at the partner level. However, it would appear that if a taxpayer took such an inconsistent position, it may be required to include the Form 8082, *Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)*, together with the election statement that is attached to the partner's tax return, forego bonus depreciation to which it would otherwise be entitled, and make appropriate adjustments.[25] Also, in the authors' experience, many partnership and limited liability company operating agreements prohibit a partner from filing an inconsistent position without obtaining their partners' consent. This could present a stumbling block to the election.

It is possible that unless Congress repeals Code §163(j)(4), which provides that partnerships are to be treated as entities for Code §163(j) purposes, the I.R.S. will not be able to independently alter the election mechanics adopted in the proposed regulations.

However, to address C's specific issue, the I.R.S. could harness the proposed -9 and -10 regulations, whenever finally adopted, to permit a clear election for partners in C's position, providing that, in limited circumstances where the partnership would otherwise qualify, partners may step into the entity's shoes to make the R.P.T.O.B. election. Presumably, the I.R.S. could thus rectify this unfair disparity, subject to the taxpayer making appropriate adjustments. While introducing further complexity to

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24 Peter M. Fass, "Real Estate Under §163(j) Interest Deduction Limitation," *New York Law Journal*, June 14, 2019.

25 This disclosure would help to forestall penalties for underpayment under Code §6662, and for the tax return preparer under Code §6694.

the -9 and -10 rules, this would ensure taxpayers like C are not unfairly deprived of a beneficial election available to similarly situated taxpayers who happen to have a slightly different financing structure.

By making this small fix, the I.R.S. will ensure that taxpayers investing in real estate through leveraged partnerships will not stub their toes and plunge into the “foaming brine” that awaits them under the current language in Prop. Treas. Reg. §1.163(j)-9, in response to which the I.R.S.’s only refrain will be to echo the old folk ballad – “dreadful sorry, Clementine!”

I.R.S. RELEASES RELIEF PROCEDURES FOR CERTAIN EXPATS WHILE WARNING BELLS RING FOR OTHERS

Authors
Galia Antebi
Hannah Daniels

Tags
Expatriation
Private Client
Tax Compliance
Tax Residency

The I.R.S. recently announced new procedures that will enable certain individuals to come into compliance with their U.S. tax and filing obligations in connection with the relinquishment of their U.S. citizenship. The newly announced Relief Procedures for Certain Former Citizens apply exclusively to individuals who relinquish their citizenship after March 18, 2010, the date the Foreign Account Tax Compliance Act ("F.A.T.C.A.") was enacted, and who meet other criteria discussed below. The new procedures are a welcome relief that will eliminate back taxes and penalties to those eligible.

At the same time, the I.R.S. also announced that a program to temporarily suspend notifications to the U.S. State Department regarding some severely delinquent taxpayers working with the Taxpayer Advocate Service ("T.A.S.") has come to an end.

BACKGROUND: THE CRY FOR HELP AND THE COVERED EXPATRIATE

Individuals born outside the U.S. to U.S. citizen parents (although they may lack even a U.S. passport) and those born in the U.S. to foreign parents (although they may have only lived in the U.S. for a few years, months, or even weeks) are U.S. citizens. And, yes, they are subject to the same tax and reporting obligations as those who live in the U.S. their entire lives. This information comes as a shock to many.

When these individuals grasp the gravity of their U.S. citizenship status, often after being ousted by their local bank for being U.S. citizens (thanks to F.A.T.C.A.), they may wish to renounce their U.S. citizenship. However, renouncing U.S. citizenship may not be possible without tax implications.

You may have read the story of U.K. Prime Minister and former Mayor of London Boris Johnson, who was born in the U.S. to foreign parents and has not lived in the U.S. since a very early age. He, purportedly, was surprised to receive a tax bill from the U.S. when he sold his home in London and, to avoid future tax liability, relinquished his U.S. citizenship (after paying the bill).

In addition to any prior tax obligations, when an individual relinquishes U.S. citizenship, an "exit tax"[1] may be imposed if the individual meets the definition of a "covered expatriate."[2] Additionally, under the Code, "succession tax"[3] may be imposed on gifts and bequests from covered expatriates.

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1 Code §877A.

2 See "Pre-Immigration Income Tax Planning, Part II: Covered Expatriates," *Insights* 4 (2015).

3 Code §2801.

The term “covered expatriate” notoriously applies to the rich (and the “near rich”) under one of two tests:

- An income tax liability test: average annual net income tax liability in the five years prior to the expatriation of $124,000, adjusted to inflation ($168,000 for 2019)
- A net worth test: net worth of $2 million or more

However, the definition also applies to those who cannot certify under penalty of perjury on Form 8854, *Initial and Annual Expatriation Statement*, that they met all applicable tax requirements for the five preceding tax years. In other words, accidental Americans, whose U.S. tax obligation previously escaped their knowledge, may be subject to the exit tax and potentially succession tax notwithstanding that they may be far from wealthy. And, on top of that, they will owe back taxes for years that were not timely filed and are now filed in anticipation of an expatriation under the streamlined procedures or otherwise.

THE RELIEF PROCEDURES

The new procedures allow qualifying individuals who intend to relinquish their U.S. citizenship or who have relinquished their citizenship after F.A.T.C.A. was enacted (March 18, 2010) to comply with their U.S. tax and reporting obligations without paying any outstanding taxes, interest, and penalties and without being treated as covered expatriates.

It should be noted that the exit tax is paid by covered expatriates only if the deemed sale of worldwide assets on the day before expatriation results in a tax liability in excess of $600,000, adjusted for inflation (*i.e.*, $725,000 for 2019). Therefore, to most accidental Americans who had no knowledge of their U.S. tax obligation, the covered expatriate status is not as worrisome as the back taxes and late filing penalties they will face if they formally expatriate without these relief procedures.

What Does a Submission Under the Procedures Entail?

Individuals who wish to rely on the new procedures must first renounce their citizenship and ensure they have other citizenship. Following the renouncement of citizenship, taxpayers must submit to the I.R.S. proof of loss of nationality or of cancellation of the certificate of naturalization together with the following documents:

- Identification in the form of a copy of a valid passport or birth certificate and government-issued identification
- Dual-status tax return for the year of expatriation, including Form 1040-NR, *U.S. Non-Resident Alien Income Tax Return*; Form 8854, *Initial and Annual Expatriation Statement*; Form 1040, *U.S. Individual Income Tax Return,* reporting worldwide income up to date of expatriation; and any other required information return, including but not limited to Form 8938, *Statement of Specified Foreign Financial Assets*
- Form 1040, *U.S. Individual Income Tax Return*, for the five tax years preceding the expatriation and all applicable information returns for those years

In a page dedicated to the new procedures, which includes frequently asked questions,[4] the I.R.S. states in its answer to Question 18 that, while submission of delinquent F.B.A.R.'s is not required under the procedures, individuals who have an F.B.A.R. filing requirement should file. Eligible individuals who file F.B.A.R.'s before filing or contemporaneously file with their submission under the procedures will not be asserted F.B.A.R. penalties. Those who fail to file F.B.A.R.'s with or prior to their submission under the procedures may be assessed F.B.A.R. penalties (if their submission is selected for examination).

"To most accidental Americans who had no knowledge of their U.S. tax obligation, the covered expatriate status is not as worrisome as the back taxes and late filing penalties they will face if they formally expatriate without these relief procedures."

Eligible Individuals

The relief procedures apply to individuals who have not filed U.S. tax returns, either as U.S. citizens or residents. Any past compliance failure must have been non-willful. Non-willful conduct generally includes negligence, inadvertence or mistake, or good faith misunderstanding of the law's requirement. Additionally, eligible individuals must have a net worth of less than $2 million and must owe a limited amount of back taxes. Specifically, to qualify, one must

- have relinquished his U.S. citizenship after March 18, 2010;
- not have any filing history as a U.S. citizen or resident (except if an individual has previously filed Form 1040-NR, *U.S. Non-Resident Alien Income Tax Return*, believing they were not in fact a U.S. citizen),
- have an average annual net income tax liability for the five taxable years prior to the expatriation that does not exceed the amount stated for the covered expatriate definition,
- have a net worth that is less than $2 million at the time of expatriation and at the time of making the submission under these procedures,
- have an aggregate total tax liability of $25,000 or less for the five tax years preceding expatriation and in the year of expatriation (after application of all applicable deductions, exclusions, exemptions and credits, including foreign tax credits but excluding any exit tax, penalties, and interest), and
- agree to complete and submit all required Federal tax returns for the six tax years at issue, including all required schedules and information returns.

If an individual makes a submission under this procedure without qualifying, the I.R.S. will process the returns "using normal processing procedures," and the individual will be liable for all back taxes, interest, and penalties associated with those returns.

What About Green Card Holders?

In a webinar hosted by the I.R.S. last month, the I.R.S. stated that more guidance on its new tax relief procedures will address individuals who surrendered their green cards.[5] Lara Banjanin from the Office of Associate Chief Counsel (International) said

4 "Relief Procedures for Certain Former Citizens: Relief Procedures FAQs," I.R.S., last reviewed or updated October 24, 2019.

5 I.R.S., "Relief Procedures for Certain Former Citizens," (webinar, October 10, 2019).

that it is anticipated that such additional guidance will address green card holders whose net worth is below $2 million, whose income tax liability is below the threshold for a covered expatriate, and who has been compliant with U.S. tax obligations for the five years prior to expatriation.

How Long Are the Procedures Available?

There is no set termination date for these procedures. However, the I.R.S. will announce a closing date before the program's end. In the above-mentioned I.R.S. webinar, Daniel N. Price from the Office of Chief Counsel said that taxpayers should use the procedures "sooner rather than later."

EXPATRIATES AND PASSPORT REVOCATION

In December 2015, the Fixing America's Surface Transportation Act ("F.A.S.T. Act") was signed into law. Under the F.A.S.T. Act, the I.R.S. is required to notify the State Department of "taxpayers the IRS has certified as owing a seriously delinquent tax debt."[6] This means "owing over $52,000 in back taxes, penalties and interest for which the IRS has filed a Notice of Federal Tax Lien and the period to challenge it has expired or the IRS has issued a levy." Under the F.A.S.T. Act, the State Department is required to deny passport applications or renewals and, in some instances, revoke passports at the I.R.S.'s request. Over the life of this program, more than $1 billion has been collected from individuals. As of May 2019, based on information published by the T.A.S., the I.R.S. sent out almost 389,000 certification notices to the State Department.

Following a T.A.S. request, the I.R.S. temporarily suspended passport certification procedures for those that had open cases with the T.A.S. However, in mid-October the I.R.S. announced that it will end its temporary suspension of notifications to the State Department for some severely delinquent tax debtors, stating that:

> [The I.R.S. has] determined that a blanket, systemic exception for anyone with an open TAS case is overly broad and could undermine the effectiveness of the statute enacted by Congress in the FAST Act to collect a seriously delinquent tax debt.

However, as the I.R.S. points out, taxpayers still have opportunities to avoid certification to the State Department. This certification is not something that happens overnight. Taxpayers can also qualify for a relief program such as a payment agreement or an offer in compromise.

Additionally, in a recent statement, the I.R.S. said it will also not certify a taxpayer to the State Department or will reverse a certification under any of the circumstances below:

- The taxpayer is in bankruptcy
- The taxpayer is identified by the I.R.S. as a victim of tax-related identity theft
- The I.R.S. has determined the taxpayer's account is currently not collectible due to hardship

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[6] I.R.S., "Update on Passport Certifications and Taxpayer Advocate Service," news release, October 16, 2019.

- The taxpayer is located within a Federal disaster area
- The taxpayer has a request pending with the I.R.S. for a good faith installment agreement
- The taxpayer has a pending good faith offer in compromise with the I.R.S.
- The taxpayer has an I.R.S.-accepted adjustment that will satisfy the debt in full

CONCLUSION

The relief procedure for certain citizens is considered very taxpayer-friendly and can be a great opportunity for individuals needing to come into tax compliance in order to relinquish their U.S. citizenship. Individuals most likely to qualify and utilize the procedures are those who have lived outside the U.S. for most of their lives, and may not have been aware of tax obligations here in the U.S., and whose net worth and tax liabilities are of (very) limited amounts. Those who do not qualify may come into compliance using the existing offshore and domestic streamlined procedure.

It is interesting to see that at the same time the I.R.S. released a relief procedure they also announced an end to their temporary suspension of State Department certifications under the F.A.S.T. Act. As a result, severely delinquent tax debtors may not be able to get a new U.S. passport (or to renew an existing one). And those with current U.S. passports could find them revoked.

S.A.L.T. CAP REPEAL CASE DISMISSED

Authors
Lisa Singh
Nina Krauthamer

Tags
Deductions
S.A.L.T.
Tax Returns

Lisa Singh is an extern at Ruchelman P.L.L.C. She is currently pursuing her corporate law degree at New York Law School.

THE ARGUMENT

The state and local tax ("S.A.L.T.") deduction cap that is now in effect was enacted in 2017 as part of the Tax Cuts and Jobs Act. It allows individuals and married taxpayers filing jointly who itemize deductions to deduct only up to $10,000 annually for state and local income, property, and sales taxes. Married individuals filing separately are capped at $5,000. Before the cap, S.A.L.T. deductions were unlimited.

Fearing, among other effects, that individual residents of these states would move to lower-income tax states, New York, New Jersey, and Connecticut instituted legal action in Federal district court to invalidate the provision. N.Y. and N.J. argued that the cap infringed upon their constitutional right to tax and that it exceeded Congress's broad taxing power. They further argued that the cap was intended to harass high-property-tax states, such as N.Y. and California, by coercing them to change their tax policies. The states also claimed that the cap raised property taxes by eliminating the full Federal deduction of property taxes, thus preventing residential sales and decreasing revenues for the states that can tax on those sales.

THE DECISION

In September, the U.S. District Court for the Southern District of N.Y. rejected the claim, holding that there was no violation of Federal principles. The court explained that "the States have cited no constitutional principle that would bar Congress from exercising its authority to impose an income tax without a limitless S.A.L.T. deduction."[1]

The Federal government has the "exhaustive" power to impose and collect income taxes under Article 1, Section 8 of the U.S. Constitution, and that the states can enact their own tax policies as they wish. In particular, the district court stated:

> The cap is like any other feature of Federal law, makes certain State and local policies more attractive than others as a practical matter . . . but the bare fact that an otherwise valid Federal law necessarily affects the decisional landscape within which states must choose how to exercise their own sovereign authority hardly renders the law an unconstitutional infringement of State power.

Under the Constitution, states retain the power to impose high taxes but have no constitutional right to a Federal subsidy in the form of a Federal tax deduction.

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[1] *State of N.Y. v. Mnuchin*, S.D.N.Y., September 30, 2019, No. 18-CV-6427.

THE AFTERMATH

Although the legal challenge failed at the level of the district court, the question remains whether this is the end of the battle. According to N.Y. Governor Andrew Cuomo, the states involved in the suit will consider appealing the decision.

Notwithstanding Governor Cuomo's comment, the path forward is likely political. The House Ways and Means Committee, the chief tax-writing committee, is evaluating several bills that would increase the level of the S.A.L.T. cap or eliminate it entirely. One option under consideration would double the S.A.L.T. cap to $20,000 – either for all filers or for married taxpayers filing jointly. Whichever method is adopted in committee will likely be adopted in proposed legislation in the House of Representatives. If it is missing from a Senate version of the bill, its fate likely will be determined in the give-and-take that accompanies a technical corrections bill at the end of the congressional term.

In addition, certain states had proposed measures to allow taxpayers classify some tax payments as "charitable contributions," which would not be subject to the cap – however, June final rules issued by the I.R.S prohibit such proposals.[2]

One aspect of the issue is certain. Like much of the political debate, there seems to be no desire to stop the battle short of the 2020 elections.

2 T.D. 9864.

I.R.S. PLACING WATCHDOG AGENTS IN INTERNATIONAL FINANCIAL CENTERS

Authors
Lisa Singh
Stanley C. Ruchelman

Tags
Cryptocurrency
Money Laundering
Tax Avoidance

Over the past few years, global financial regulators and treasury departments have continuously sought out new ways to expose individuals engaged in cryptocurrency transactions. Yet, despite their efforts, individuals around the world have surpassed regulators' expectations and continued to abuse cryptocurrency, engaging in sophisticated cross-border money-laundering and tax evasion.

In 2015, approximately 21 million people globally owned virtual currencies, but according to I.R.S. Criminal Investigation, less than 900 people reported holding virtual currencies on U.S. tax returns that year. Rather than turn a blind eye to bad behavior, the I.R.S. (along with other taxing authorities) is ramping up its efforts to track down cryptocurrency users.

I.R.S. CRACKDOWN

In summer 2019, the I.R.S. sent letters to more than 10,000 people warning of the possibility of penalties for not reporting virtual investments. It also made changes in the Form 1040. It now inquires whether an individual received, sold, sent, exchanged or otherwise acquired any financial interest in any virtual currency within the taxable year.

Lisa Singh is an extern at Ruchelman P.L.L.C. She is currently pursuing her corporate law degree at New York Law School.

Last month, the I.R.S. published supplementary guidance on assisting taxpayers in understanding reporting obligations for specific transactions involving virtual currency.[1] In addition, the I.R.S. is increasing the number of cryptocurrency examiners in international cities where tech-savvy Americans may be avoiding reporting obligations.

WORLD-WIDE ENFORCEMENT

On November 1, 2019, officials from the Joint Chief Global Tax Committee ("J-5"), a group of criminal tax investigators from the U.S., the U.K., Australia, Canada, and the Netherlands, shared their most significant challenges and insights with regard to investigation strategies on mitigating cross-border money laundering and tax evasion. The J-5 cooperate in gathering information on cybercrimes and sharing that data on a real-time basis. The J-5

- develops strategies to gather information and intelligence,
- initiates procedures to conduct joint investigations, and
- collaborates on effective communications.

[1] Rev. Rul. 2019-24.

Chief of I.R.S. Criminal Investigation Don Fort (who participated in the J-5 meeting) stated, "This is not an exercise dealing with hypothetical scenarios. These are real investigators, using real data, finding real criminals through leads generated this week."[2]

A few days following the November J-5 meeting, an I.R.S. spokesperson addressing an A.I.C.P.A. meeting in Washington announced the expansion of watchdog activities in financial centers in Singapore, the Netherlands, and Dubai. The move seems appropriate, considering Asia and the Middle East have replaced Caribbean jurisdictions as popular locations for wealthy individuals to hold funds.

In a 2018 Deloitte study, it was estimated that almost 20% of the financial wealth in Singapore is held by Europeans and North Americans.[3] According to the study, Singapore is Asia's most mature and respected wealth management center for international clients.

"The I.R.S. plans to station one or more agents in Singapore, the Netherlands, and Dubai on a permanent basis to address virtual currency money laundering and tax avoidance concerns."

Singapore has also become known as a friendly home to large-scale crypto-related technologies and fintech innovation companies due to its lenient cryptocurrency regulations. The Monetary Authority of Singapore ("M.A.S.") – the country's central bank – currently does not regulate virtual currencies. Thus, buying and selling cryptocurrency in Singapore is not difficult for American investors looking to cash out digital investments.

This will soon change. The M.A.S. is proactively working on a set of robust cryptocurrency regulations.

In line with the enhanced regulations, the I.R.S. plans to station one or more agents in Singapore, the Netherlands, and Dubai on a permanent basis to address virtual currency money laundering and tax avoidance concerns.

2 Joint Chiefs of Global Tax Enforcement, "J-5 Countries Host Crypto 'Challenge' in Search of Tax Criminals," news release, November 8, 2019.

3 Deloitte, *International Wealth Management Centre Ranking 2018*, 3rd Ed.

About Us

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.

Our firm provides a wide range of tax planning and commercial legal services to clients across the Americas, Asia, Europe, and the Middle East. Clients include global investors, multinational corporations expanding into the U.S., and U.S. businesses with international operations. Our core practice focuses on cross-border transactions.

We maintain offices in New York and Toronto. The practice of the Toronto Office is limited to U.S. law and focuses on cross-border transfer pricing issues.

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Insights, the tax journal of Ruchelman P.L.L.C., provides in-depth reporting on the evolving landscape of U.S. and international taxation. It offers complex analysis of current issues, legislative updates, and practical introductions to the tax law from leading tax professionals in their respective countries.

Special features include an annual examination of the use of holding companies in European tax planning and a look at the year in review.

Contacts

If you have any questions regarding this publication, please contact the authors or one of the following members.

NEW YORK

150 EAST 58TH STREET, 22ND FLOOR, NEW YORK, NY 10155

Galia Antebi	antebi@ruchelaw.com	+1 212.755.3333 x 113
Andreas Apostolides	apostolides@ruchelaw.com	+1 212.755.3333 x 127
Beate Erwin	erwin@ruchelaw.com	+1 212.755.3333 x 116
Nina Krauthamer	krauthamer@ruchelaw.com	+1 212.755.3333 x 118
Jennifer Lapper	lapper@ruchelaw.com	+1 212.755.3333 x 124
Denisse Lopez	lopez@ruchelaw.com	+1 212.755.3333 x 133
Simon H. Prisk	prisk@ruchelaw.com	+1 212.755.3333 x 114
Neha Rastogi	rastogi@ruchelaw.com	+1 212.755.3333 x 131
Stanley C. Ruchelman	ruchelman@ruchelaw.com	+1 212.755.3333 x 111

TORONTO

130 KING STREET WEST, SUITE 2300, TORONTO, ON M5X 1C8

Michael Peggs	peggs@ruchelaw.com	+1 212.755.3333 x 232

Editorial Staff

Jennifer Lapper .... Managing Editor, Art Director

Denisse Lopez ....Copyeditor

WITH PHOTOS BY:

Galia Antebi, Jennifer Lapper, Simon Prisk, Stanley C. Ruchelman, and Francesca York.