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Is GILTI Already Country-by-Country?

As part of the Tax Cuts and Jobs Act ("TCJA"), Congress substantially reformed the international tax system adding a new 10.5 percent effective minimum tax on global intangible low-taxed income ("GILTI"). GILTI is calculated as the *total* active income earned by a US multinational's foreign subsidiaries that exceeds 10 percent of the foreign subsidiaries' depreciable tangible property. The US multinational can generally deduct 50 percent of the GILTI and claim a foreign tax credit for 80 percent of foreign taxes paid or accrued on GILTI.

GILTI is applied on an aggregate basis – total active income of all of a US multinational's foreign subsidiaries. During enactment of GILTI as part of TCJA, the drafters referred to GILTI as the "one CFC rule." In other words, treat the income of all the foreign subsidiaries of a US multinational as coming from one controlled foreign corporation ("CFC"). President-elect Joe Biden has proposed applying GILTI on a country-by-country basis (as well as increasing the effective tax rate on GILTI to 21 percent).

The Organisation for Economic Co-operation and Development ("OECD"), as part of its Inclusive Framework on BEPS, has developed two pillars to address the tax challenges arising from the digitalization of the economy. Under Pillar One, part of the residual profits of a multinational may be reallocated from the multinational's home country to the market country where the users or consumers reside, irrespective of physical presence (referred to as Amount A). In addition, an amount is allocated for baseline distribution and marketing functions that take place in the market jurisdiction (referred to as Amount B). Under Pillar Two, a global minimum tax would be imposed on corporate profits -- referred to as Global Anti-Base Erosion or GloBE. Pillar Two or GloBE has a lot of similarities to the GILTI regime – it is a minimum tax on foreign earnings (the income inclusion rule, or IIR). The OECD proposes applying the IIR on a country-by-country basis. As a result, President-elect Biden's proposal to apply GILTI country-by-country would be consistent with the current OECD approach for the IIR.

In June 2019, Treasury and IRS issued proposed regulations with a new GILTI high-tax exception election that would apply to any high-taxed CFC income that would otherwise be tested income. In July 2020, Treasury and IRS released final GILTI high-tax exception regulations. The high-tax exception, if elected, excludes from GILTI, income of a CFC that incurs a foreign tax at a rate greater than 90 percent of the US corporate tax rate, which would be 18.9 percent (90 percent of 21 percent). The final regulations adopt a tested unit approach in calculating the foreign effective tax rate as opposed to the qualified business unit approach of the proposed regulations. Under the final regulations, there are three tested units:

(1) a CFC;

(2) an interest in a pass-through entity held, directly or indirectly, by a CFC, provided either the pass-through entity is a tax resident of a foreign country, or the pass-through entity is not subject to tax as a resident, but is treated as a corporation (or another entity that is not fiscally transparent) for purposes of the CFC's tax law; and

(3) a branch or portion of a branch, the activities of which are carried on, directly or indirectly, by a CFC, provided either the branch gives rise to a taxable presence in the country in which it is located, or the branch gives rise to a taxable presence under the owner's tax law, and this law provides an exclusion, exemption, or other similar relief (such as a preferential rate) for income attributable to the branch.

Under a tested unit combination rule, all tested units of a US shareholder that are tax resident or located in the same foreign country are treated as a single tested unit. The combination rule applies without regard to whether the tested units are subject to the same foreign tax rate and is not dependent on the tested units having the same functional currency. The Treasury Department and the IRS agreed that a tested unit combination rule would reduce compliance burdens, would be consistent with the policies underlying the GILTI high-tax exclusion, and may minimize the effect of timing and other differences between the US and foreign tax bases.

The result of the tested unit combination rule in the final regulations is that the foreign effective tax rate for purposes of applying the GILTI high-tax exclusion is determined on a country-by-country basis. This means that, in one aspect, GILTI is already applied on a country-by-country basis. In addition, Treasury also issued proposed regulations in July 2020 to conform the subpart F high-tax exception with the GILTI high-tax exception. The result is that the subpart F high-tax exception would also apply on a tested unit basis rather than on an item-by-item basis within each CFC as under current law. Under the proposed regulations, a single election would be made for both the GILTI high-tax exception and the subpart F high-tax exception. It is worth noting the GILTI regulations are reportedly under scrutiny and may be withdrawn by the Biden administration.

By: Christopher H. Hanna, Dallas, Joshua D. Odintz and Alexandra Minkovich, Washington, DC

Understanding the 2020 Election Results and Their Impacts on Tax Policy

As a Presidential candidate, former Vice President Joe Biden announced a detailed and ambitious set of tax policy proposals. President-elect Joe Biden's tax policy plans, like rolling back several provisions of President Trump's 2017 Tax Cuts and Jobs Act, are potentially derailed given the Republicans will control at least 50 Senate seats and possibly 52. Even if Democrats win both Senate run-off races in Georgia, a 50-50 split in the Senate may require President-elect Biden to modulate his tax proposals to win support from moderates in both parties. In this article, we will examine who might be included in President-elect Biden's administration and what tax policy agenda they'll pursue.

Personnel Is Policy

Several figures in President Trump's administration will not serve in the Biden administration because they are political appointees and, per custom, will resign by noon on Inauguration Day. These individuals include Steven Mnuchin, Secretary of Treasury, Justin Muzinich, Deputy Secretary of Treasury, David Kautter, Assistant Secretary of Treasury, and Michael Desmond, Chief Counsel of the IRS and Assistant General Counsel in Treasury. Although Charles Rettig, the IRS Commissioner, is a political appointee, the Commissioner serves for a five-year term (which, in this case, expires in 2022) and will remain in office at least in the near term.

President-elect Biden has tapped Janet Yellen as his nominee to replace Steven Mnuchin as Secretary of Treasury and Adewale ("Wally") Adeyemo as his nominee to replace Justin Muzinich as Deputy Secretary of Treasury. Both picks are experienced government officials whose confirmations would make history--Yellen as the first female Treasury Secretary in the department's history and Adeyemo as the first Black Deputy Secretary in the department. Yellen is an economist at the Brookings Institution and previously served as the Chair of the Federal Reserve from 2014 through 2018 and as Chair of the White House Council of Economic Advisors during the Clinton administration. During the Obama administration, Adeyemo was the Deputy National Security Advisor for International Economics and Deputy Director of the National Economic Council. Adeyemo also held several senior management positions in President Obama's Treasury, including senior adviser and deputy chief of staff, as well as chief negotiator for the never-enacted Trans-Pacific Partnership's provisions on macroeconomic policy. Adeyemo also served at the Consumer Financial Protection Bureau when that agency was first established.

Lily Batchelder, a current professor at the NYU School of Law, leads President-elect Biden's transition team for tax issues. Similar to her peers on the transition team and the Treasury nominees announced to date, Batchelder has extensive government experience, including stints working on Capitol Hill and as the Deputy Assistant to the President and Deputy Director at the National Economic Council during the Obama administration. The transition team's tax responsibilities include coordinating with current Treasury and IRS personnel to understand existing projects and priorities and prepare for a smooth transition during the tax filing season, identify potential nominees for Chief Counsel and Assistant Secretary for Tax Policy, identify other potential tax hires, and further develop the tax proposals that President-elect Biden released during the presidential campaign. Additionally, the transition team may also work on tax provisions that could be included in subsequent legislation for COVID-19 relief, stimulus, or infrastructure. The transition team can also review tax guidance issued during the Trump administration and make recommendations for action (e.g., withdrawal of a regulation).

Key developments to watch include President-elect Biden's pick for Assistant Secretary for Tax Policy and IRS Chief Counsel, and whether President-elect Biden asks Commissioner Rettig to resign so he can nominate a new IRS Commissioner. In addition, the current Treasury Inspector General for Tax Administration, J. Russell George, has served in his position since 2004. At the time of writing, Biden has not announced other members of his administration for nomination to key tax positions.

Congress

President-elect Biden will assume responsibility for US fiscal policy when he is sworn in on January 20, 2021. The Democrats will also retain control of the House by a slim margin as the Associated Press has called 433 of 435 races: 222 Democrat seats and 211 Republican seats. These numbers may shift slightly, as President-elect Biden has expressed interest in nominating some Democratic House members to Cabinet-level positions. Control for the Senate is still hanging in the balance and will be determined by two January runoff elections in Georgia. If the Democrats win both Georgia runoff elections, Democrats could potentially unify behind a common goal of tax reform. Without any votes to spare (Republicans will hold at least 50 Senate seats), tax reform will require a Democratic consensus and use of the "reconciliation" process. Reconciliation is a budget process that allows legislation to be passed with a simple majority (instead of a 60-vote filibuster-proof majority), making it an attractive vehicle for controversial legislation. However, reconciliation carries risks with it—most notably, anything passed through reconciliation cannot increase the deficit outside of the budget window (10 years), so any provisions that would increase the deficit automatically sunset after 10 years. As readers may remember, the Republicans used the reconciliation process to enact the Tax Cuts and Jobs Act of 2017, which included sunsetting provisions and other legislative choices to satisfy reconciliation's requirements rather than to achieve preferred policy outcomes.

What's on President-elect Biden's Tax Agenda?

What would tax reform under President-elect Biden look like? Biden campaigned on tax reform that would promote a "Made in America" future, including (1) tax credits to incentivize hiring US workers and producing US goods and services, and (2) tax penalties to discourage offshore manufacturing and service jobs that fulfill US market demands. Biden favored increasing the corporate tax rate from 21% to 28% and instituting a 10% surtax on profits of offshore US companies for sales back to the United States. The 10% surtax would apply to goods and services, *e.g.*, a US company's offshore call center serving US customers. Biden also supported a "Made in America" tax credit consisting of a 10% advanceable tax credit for companies' investments that will create jobs for US workers. The 10% tax credit would be available for revitalizing closed facilities (*e.g.*, reopening a closed factory), retooling facilities for competitive manufacturing in the next generation (*e.g.*, an auto company retooling to produce electric vehicles), re-shoring US production, expanding US facilities (but not simply relocating existing US jobs), and expanding manufacturing payroll. Biden's plan did not address the implications of a 28% corporate tax rate on foreign-derived intangible income ("FDII"), which is tied to the corporate income tax rate.

President-elect Biden has also proposed substantial changes to the global intangible low-taxed income ("GILTI") regime, including increasing the rate to 21%, eliminating the benefit of QBAI, and imposing the tax on a country-by-country basis. While some may view these proposed changes to GILTI as radical, they are similar to President Obama's proposal for a minimum tax on international income (19% rate imposed on a country-by-country basis, although President Obama's proposal included a QBAI-like feature) and some of the discussions currently underway at the OECD on Pillar Two. In addition, President-elect Biden proposed a minimum tax on book income for certain large corporations.

Because of the Senate hurdles to tax reform and enduring COVID-19 pandemic, it is likely the Biden administration will prioritize COVID-19 relief once assuming office and that significant tax legislation will take a back seat until the virus and the economy are under control. Senator Chris Coons of Delaware, an adviser to the Biden campaign, suggested that a Republican Senate would result in Democrats seeking quick action on a stimulus package in early 2021. As of this writing, Biden endorsed a $908 billion COVID-19 stimulus package proposed by a bipartisan group of lawmakers as a "down payment" that would provide immediate relief to those suffering from the COVID-19 recession, though he believed it would not be a comprehensive answer.

Biden campaigned on responding to the COVID-19 pandemic by (1) utilizing all of his available authorities, including the Defense Production Act, (2) launching a task force responsible for keeping as many people on payroll as possible through big- and small-business aid, and (3) providing direct assistance to individuals through stimulus checks, increases to Social Security and unemployment insurance, and partial student loan forgiveness.

Should the Biden administration achieve a COVID-19 stimulus package, it may turn its attention to tax law regulatory changes. House Democrats requested that President Trump "immediately instruct agencies to avoid promulgating midnight rules" during its lame-duck period. In 2017, President Trump and the Republican Congress used the 1996 Congressional Review Act to nix 16 regulations issued by President Obama between Trump's election and inauguration. If Democrats win both Georgia runoff elections, they may use the Congressional Review Act, which requires approval from both houses of Congress, to overturn recent regulatory action under President Trump. Under the Congressional Review Act, Congress has 60 session days to review and consider whether to revoke any of President Trump's "midnight rules." It is unclear whether Trump's administration will release any Treasury regulations before Inauguration Day. Historically, incoming Presidents have issued an executive order "freezing" regulations that were finalized by their predecessor but had not yet become effective. Incoming Presidents also routinely instruct agencies to halt the review and approval of any guidance that is currently in process until the incoming administration has an opportunity to review that guidance.

Absent the Congressional Review Act, Treasury led by Janet Yellen may use regulatory changes to modify tax law interpretation and administration. Specifically, Yellen's Treasury may examine and modify rules related to GILTI, carried interest, and the estate tax. For example, a 1993 IRS ruling, Rev. Proc. 93-27, provides the basis for the current tax interpretation of carried interest. Treasury could revoke Rev. Proc. 93-27 and issue revised guidance in its place. Mainstream news outlets have already reported that the GILTI "high-tax exception" rules are at risk of reversal under the incoming administration, and taxpayers should watch any developments here closely. Regulatory changes require several steps. To change finalized rules, Treasury would need to propose to withdraw the rules and provide a basis for reinterpreting the law and a sufficient period for notice and comment from the public. Moreover, interpretive changes may face potential litigation and court scrutiny. Overall, this could be a lengthy process without achieving significant change. Treasury and the IRS will also be preoccupied administering components of any COVID-19 stimulus package and also ensuring compliance with 2020 legislation, such as the CARES Act, during the upcoming tax season. Finally, we expect President-elect Biden to seek additional funding for the IRS, particularly to be used on audits and enforcement.

In sum, depending on the Senate runoff election results, future tax legislation may be restrained. Any tax legislation under a Republican Senate would require the support of one or more Republicans and unanimous support of Democrats. An evenly divided Senate would allow proposed legislation to advance if there's consensus among Democrats through a tie-breaking vote by Vice President-elect Kamala Harris. In any event, it seems likely individual Senators of either party could impact any future tax proposals. While it's possible for meaningful tax changes to advance, the prospect of a divided government favor more incremental, balanced proposals and a focus on using the regulatory process to advance the incoming administration's tax goals.

By: Jonathan Talley, Chicago, Alexandra Minkovich, Joshua D. Odintz, Washington, DC, and Christopher H. Hanna, Dallas

Coca-Cola Loses Transfer Pricing Case: *Coca-Cola v. Commissioner*, 155 T.C. No. 10 (2020)

On November 18, 2020, the United States Tax Court issued a ruling on the transfer pricing dispute between the Coca-Cola Company and the Internal Revenue Service regarding the intercompany royalties paid by Coca-Cola's foreign manufacturing affiliates during 2007–2009. The Tax Court upheld the IRS's adjustment increasing Coca-Cola's aggregated taxable income during 2007–2009 by $9 billion, resulting in tax deficiencies of more than $3 billion.

Background

Coca-Cola had significant operations outside the United States during the years at issue. The following entities played an important role in Coca-Cola's international structure relating to the transactions at issue in the Tax Court case:

- The Coca-Cola Co., a US corporation, was the ultimate parent company and the legal owner of Coca-Cola's intellectual property (collectively with relevant US entities, "Coca-Cola US");
- The Supply Points: foreign manufacturing affiliates that manufactured and sold concentrate to bottlers. The Supply Points had plants in Brazil, Chile, Costa Rica, Egypt, Ireland, Mexico, and Swaziland;
- The Bottlers: generally unrelated manufacturers that purchased concentrate from the Supply Points to produce and sell finished beverages; and
- The ServCos: foreign service affiliates responsible for in-country consumer marketing and liaising with local bottlers.

In order to manufacture and sell concentrate, the Supply Points licensed from Coca-Cola US certain intangible property, including trademarks, brand names, logos, patents, secret formulas, and proprietary manufacturing processes (the "IP").

During 2007–2009, Coca-Cola reported income from the Supply Points using a "10-50-50" method:

- The Supply Points retained 10% of their gross sales; and
- Coca-Cola US and the Supply Points split remaining profit evenly (50-50).

The "10-50-50" method was a formulary apportionment method agreed to by the IRS and Coca-Cola in a closing agreement executed in 1996, for the purpose of resolving Coca-Cola's issues for its tax years 1987–1995. Coca-Cola also applied the same method to allocate income between the Supply Points and Coca-Cola US going forward. The compensation specified in the closing agreement was in the nature of royalties due to the use of intangible property. The closing agreement allowed the Supply Points to pay their royalties in forms of actual royalties, or by repatriating funds, such as dividends.

IRS's Position

The IRS argued that the "10-50-50" method did not result in arm's length pricing and selected the comparable profits method ("CPM") to reallocate income between the Supply Points and Coca-Cola US. The IRS argued that independent Coca-Cola bottlers were comparable to the Supply Points because they all operated in the same industry, faced similar risks, had similar contractual relationships with Coca-Cola, and used the same brand names, trademarks and logos. In addition, they also shared the same income stream in the same supply chain. The IRS then selected a group of 24 bottlers and calculated an average return on operating assets ("ROA") that it applied to each of the Supply Point to calculate an arm's-length operating profit. The remaining income generated by each Supply Point, in excess of the deemed arm's-length operating profit, was reallocated to Coca-Cola US.

Coca-Cola's Position

As an initial matter, Coca-Cola argued that the IRS acted arbitrarily by deviating from the "10-50-50" method agreed to in the closing agreement because the agreement represented the IRS's acknowledgement that the pricing was arm's length. In addition, Coca-Cola contended that the IRS's allocation was arbitrary and capricious because it did not take into account valuable marketing intangible assets owned by the Supply Points that were created when the Supply Points financed consumer advertising in foreign markets. Coca-Cola argued in the first instance that the CPM was not an appropriate transfer pricing methodology because both controlled parties—Coca-Cola US and the Supply Points—contributed non-routine intangibles. Second, Coca-Cola argued that if the CPM were deemed appropriate, and the bottlers used as comparables, the Supply Points' marketing intangibles should be included in their asset base for purposes of calculated the appropriate return on assets.

Coca-Cola also submitted three expert reports, each proposing an alternative approach to price the license of Coca-Cola US's intangible property to the Supply Points: a comparable uncontrolled transaction ("CUT"), a residual profit split method ("RPSM") and an asset management model (unspecified method). For purposes of applying each method, Coca-Cola's experts combined all Supply Points and ServCos into one conceptual counterparty (the "Field") in the controlled transaction.

The Tax Court Opinion

The Tax Court began by holding that the IRS was not bound by the 1987–1995 closing agreement because it explicitly stated neither that the "10-50-50" method was arm's length, nor that the parties intended the agreement to apply to future years,.

Next, the Tax Court evaluated Coca-Cola's claim that it owned valuable marketing intangibles, to both address whether the IRS's CPM / ROA analysis was arbitrary, capricious, or unreasonable and also whether Coca-Cola's affirmative valuation methods were appropriate. The Tax Court looked at two theories advanced by the Coca-Cola to prove that the Supply Points owned valuable marketing intangibles: legal ownership and economic substance. The Court also evaluated a secondary argument by Coca-Cola that the Supply Points owned intangible assets in the form of "long-term licenses." The Tax Court rejected each of these arguments in turn.

First, the Court looked to Treas. Reg. § 1.482-4T(f)(3)(i)(A), applicable to the tax years at issue, which provided that "the legal owner of an intangible pursuant to the intellectual property law of the relevant jurisdiction . . . or contractual terms . . . will be considered the sole owner of the respective intangible . . . unless such ownership is inconsistent with the economic substance of the underlying transactions." The Tax Court reviewed the trademark registrations and terms of the contracts between Coca-Cola US and both the Supply Points and the ServCos. The Tax Court held that the Supply Points were not the legal owners of valuable marketing intangibles because the Coca-Cola Co. was the registered owner of virtually all of Coca-Cola's intangible assets used to produce and sell the Coca-Cola's beverages. In addition, the contracts between Coca-Cola US and the Supply Points provided that the Supply Points were granted no rights or ownership interest in Coca-Cola's intangible property. Further, Coca-Cola US's contracts with the ServCos explicitly provided that all marketing intangibles were the property of Coca-Cola US. Thus, the Tax Court concluded that the Supply Points were not the legal owners of any marketing intangibles under either the intellectual property law of the relevant jurisdictions nor Coca-Cola's contracts.

Second, the Tax Court held that Coca-Cola could not rely on economic substance to disavow the terms of its own transactions because only the Commissioner may set aside contractual terms as inconsistent with economic substance. Further, even if it could, the Tax Court held that the Supply Points did not in substance own any marketing intangibles because their only involvement in consumer marketing was reimbursing certain marketing expenses incurred by the ServCos. The Tax Court rejected the idea that simply spending money on consumer advertising gives rise to freestanding intangible assets. Instead, the Tax Court held that these expenses enhanced the value of the trademarks and other intangible assets owned by Coca-Cola US. Finally, the Tax Court rejected

Coca-Cola's argument that the Supply Points owned intangible assets in the form of "long-term licenses" because the contracts were terminable at will, did not grant territorial exclusivity, and did not guarantee production.

Based on its conclusion that the Supply Points owned no valuable intangible assets, the Tax Court affirmed the IRS's use of the CPM and the third-party bottlers as comparables, because both the bottlers and the Supply Points performed manufacturing and distribution functions.

With respect to Coca-Cola's affirmative expert reports, the Tax Court rejected the "Field" concept used by all three experts on the basis that the regulations require that income be allocated among "controlled taxpayers" and the Field is not a taxpayer or a legal entity. The court further criticized Coca-Cola's attempt to use "master franchising transactions" used by companies like McDonalds and Domino's Pizza as a CUT. The Tax Court determined that master franchising agreements and the licenses between Coca-Cola US and the Supply Points did not have comparable functions, responsibilities, industries, products, or contract terms. In addition, the Tax Court found that the assumptions and adjustments made to isolate an income stream generated solely from licensing intangibles were unsound.

The Tax Court also disagreed with the Coca-Cola's RPSM, which identified consumer advertising and franchise leadership as functions performed by the Field that created valuable marketing IP, and used historic spend on advertising as the basis for the split of residual profits. In addition to dismissing the Field concept and the Supply Points' ownership of IP, the court found that advertising spend was an inappropriate basis on which to split residual profit, because Coca-Cola US brought to the table many other valuable intangibles, such as its secret formulas, manufacturing processes, etc.

Finally, the third method offered by Coca-Cola was an asset management model, which treated and compensated Coca-Cola US as an asset manager in a hedge fund because of its focus on governance and high-level strategy, among other activities. The Tax Court concluded that this approach inappropriately compensated Coca-Cola US only for its services and ignored its contributions and ownership of IP.

Based on its conclusions, the Tax Court upheld the IRS's main transfer pricing adjustments in full, but did allow Coca-Cola to offset a portion of the IRS's adjustment by the amount of dividends paid by the Supply Points during 2007–2009.

By: Robert Walton, Chicago, Mireille Oldak and Katherine Yang, Washington, DC

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IRS Gives Passthroughs a Break on the $10,000 SALT Deduction Cap

On November 10, 2020, the Internal Revenue Service announced in Notice 2020-75 its intent to publish regulations that will give owners of certain passthrough entities a way out of the existing $10,000 state and local tax deduction cap. Namely, Notice 2020-75 (the "Notice") announces that the proposed regulations will "clarify that State and local income taxes imposed on and paid by a partnership or an S corporation on its income *are allowed as a deduction by the partnership or S corporation* in computing its non-separately stated taxable income or loss for the taxable year of payment"—and that these deductible taxes will not be subject to the $10,000 limitation on the deduction of state & local taxes imposed as part of the Tax Cuts & Jobs Act ("TCJA") in 2017. *Id.* (emphasis added).

Section 164(b)(6) of the Internal Revenue Code, as added by the TCJA, limits an individual's deduction under section 164(a) (the "SALT deduction") to $10,000 ($5,000 in the case of a married individual filing a separate return) for the aggregate amount of the following state and local taxes paid during the calendar year: (i) real property taxes; (ii) personal property taxes; (iii) income, war profits, and excess profits taxes; and (iv) general sales taxes. In enacting the SALT deduction limitation, Congress provided that "taxes imposed at the entity level, such as a business tax imposed on pass-through entities, that are reflected in a partner's or S corporation shareholder's distributive or pro-rata share of income or loss on a Schedule K-1 (or similar form), will continue to reduce such partner's or shareholder's distributive or pro-rata share of income as under present law." H.R. Rep. No. 115-466, at 260 n. 172 (2017). Because entity-level taxes continue to decrease a partner's or S corporation shareholder's flow-through income, several states have enacted laws that impose either a mandatory or an elective tax directly on the passthrough entities themselves while allowing owners to take an offsetting credit, deduction or exclusion—effectively permitting the state tax to be paid without being subject to the federal SALT deduction limitation. At this point, seven states (Connecticut, Louisiana, Maryland, New Jersey, Oklahoma, Rhode Island and Wisconsin) have enacted some type of passthrough entity-level tax regime (Connecticut's tax is mandatory, while the remaining states' regimes are elective). Although these entity-level taxes appeared to comport with the letter of the SALT deduction law under TCJA, as Notice 2020-75 acknowledged, there remained "uncertainty as to whether entity-level payments made under these laws . . . must be taken into account in applying the SALT deduction limitation at the owner level."

The forthcoming proposed regulations, which are intended to provide "certainty to individual owners of partnerships and S corporations in calculating their SALT deduction limitations," will provide that the entity-level tax payments (referred to as "Specified Income Tax Payments" in Notice 2020-75), are deductible by partnerships and S corporations in computing their non-separately stated income

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or loss. The Notice defines Specified Income Tax Payments as "any amount paid by a partnership or an S corporation to a State, a political subdivision of a State, or the District of Columbia (Domestic Jurisdiction) to satisfy its liability for income taxes imposed by the Domestic Jurisdiction on the partnership or the S corporation." The Notice confirms that Specified Income Tax Payments are deductible by the partnership or S corporation in computing its taxable income for the taxable year in which the payment is made. The Notice further confirms that "[a]ny Specified Income Tax Payment made by a partnership or an S corporation is not taken into account in applying the SALT deduction limitation to any individual who is a partner in the partnership or a shareholder of the S corporation."

The proposed regulations will apply to Specified Income Tax Payments made on or after November 9, 2020; however, the proposed regulations also will allow taxpayers to apply the same rules set forth in Notice 2020-75 to payments made in any tax year ending after December 31, 2017, and made before November 9, 2020, provided that the payment is made to satisfy the liability for income tax imposed on the partnership or S corporation pursuant to a law enacted before to November 9, 2020.

Now that the IRS has formally approved the deductibility of the passthrough entity-level taxes that have already been adopted by several states, it appears likely that more states will follow in their footsteps, assuming that the SALT deduction cap is kept in place by the incoming Congress and administration (noting that there is already a movement to *increase* the SALT deduction limitations for married-filing-jointly taxpayers, spearheaded by Senator Susan Collins). The SALT deduction limitation has been a hot button political item since the enactment of TCJA, with the substantial burden of this tax falling on individual residents in high income tax states such as New York and California. In fact, in 2018, four states (New York, New Jersey, Maryland and Connecticut) challenged the SALT deduction limitation under the US Constitution; however, this effort failed to gain traction in the federal courts. *See State Of New York et al. v. Mnuchin et al*., No. 1:2018cv06427 (SDNY, dismissal order signed Sept. 30, 2019). States have also attempted to implement workarounds to the SALT deduction limitation by establishing funds to which residents could make "charitable contributions" (and receive a corresponding charitable deduction against federal income taxes) in lieu of paying income taxes. This workaround was rendered ineffective by regulations issued by the IRS in 2019. However, the IRS has now given states a path forward towards adopting laws that will allow their residents to escape the full brunt of the SALT deduction cap.

By: Nicole Ford, New York

OECD Statistics Show New MAP Cases (and Global Audits) on the Rise in 2019

On November 18, 2020, the Organisation for Economic Co-operation and Development ("OECD") released the Mutual Agreement Procedure ("MAP") statistics for 2019 ("MAP Statistics"). The 2019 MAP Statistics are a continuance from Base Erosion and Profit Shifting ("BEPS") Action 14, which seeks to improve the resolution of tax-related disputes between jurisdictions.

The MAP Statistics cover 105 jurisdictions in 2019 (up from 89 jurisdictions in 2018) and nearly all MAP cases worldwide, and include information on opening and closing case inventory, evolution of case inventory, types of outcomes for cases closed, average time for cases closed, and closing case ratios. The MAP Statistics are reported in total cases and by case type – either transfer pricing cases (i.e., attribution of profits to a permanent establishment or determination of profits between associated enterprises under Articles 7 and 9 of the OECD Model Tax Convention, respectively) or other cases (i.e., all cases that do not involve transfer pricing).

Inherent in the MAP Statistics is a rise in audits in 2019, and taxpayers are seeking relief through the MAP process.

Caseload

Although more MAP cases were closed in 2019 than in 2018, the number of new MAP cases increased. More than 7 MAP cases per day were started in 2019. Transfer pricing cases increased by nearly 25% while other cases increased by more than 5%. The following table shows the jurisdictions with the most cases started in 2019:

Total Cases Started		**Transfer Pricing Cases Started**		**Other Cases Started**	
Jurisdiction	**#**	**Jurisdiction**	**#**	**Jurisdiction**	**#**
Germany	659	Italy	283	Belgium	442
Belgium	493	Germany	241	Germany	418
United Kingdom	409	United States	188	United Kingdom	288
France	381	India	184	France	217
Italy	361	France	164	Luxembourg	196

In North America, the United States started 350 total cases, 188 transfer pricing cases, and 162 other cases; Canada started 75 total cases, 50 transfer pricing cases, and 25 other cases; and Mexico started 18 total cases, 14 transfer pricing cases, and 4 other cases.

The following table shows the jurisdictions with the most cases closed in 2019:

Total Cases Closed		Transfer Pricing Cases Closed		Other Cases Closed	
Jurisdiction	**#**	**Jurisdiction**	**#**	**Jurisdiction**	**#**
Belgium	630	Germany	218	Belgium	593
Germany	615	France	210	Germany	397
France	448	United States	142	France	238
United States	303	Italy	141	United Kingdom	227
United Kingdom	299	India	115	Luxembourg	178

In North America, the United States closed 303 total cases, 142 transfer pricing cases, and 161 other cases; Canada closed 60 total cases, 40 transfer pricing cases, and 20 other cases; and Mexico closed 7 total cases, 4 transfer pricing cases, and 3 other cases.

Similar to 2018, Germany, Belgium, and France were near the top of the pack in both total cases started and total cases closed. In the United Kingdom, the total cases started increased from 251 to 409 and the other cases stared increased from 171 to 288 in 2019, representing increases of 63% and 68%, respectively. Both Italy and India saw significant increases in the number of transfer pricing cases started in 2019 (44% and 38%, respectively).

Of the total MAP cases closed in 2019, approximately 85% of transfer pricing cases were fully resolved, which is up from 80% in 2018. However, for non-transfer pricing cases, the number of fully resolved cases dropped from 75% to 70%. Similar to 2018, only 2% of the total MAP cases were closed without a mutual agreement (i.e., no relief was granted).

Time to Close Cases

The average time to close transfer pricing cases decreased by 2.5 months, from 33 months to 30.5 months, between 2018 and 2019. Meanwhile, the average time to close non-transfer pricing cases increased by 8 months, from 14 months to 22 months, during the same period. In the United States, the average time to close MAP cases for 2016 through 2019 is as follows:

Case Type	2016	2017	2018	2019
Transfer Pricing Cases	31.61	24.43	34.98	35.20
Other Cases	28.65	26.02	32.78	15.36
All Cases	30.99	24.78	34.37	24.66

As shown above, the United States made significant progress in decreasing its average time to close cases in 2019, reversing the spike in 2018. Perhaps this was in response to prior criticism by the OECD of the MAP processing times for the United States in the MAP Peer Review Report (Stage 2) published in August

2019, which exceeded the Action 14 target of 24 months. In that report, the OECD said that the United States should "make more adequate use of the available resources in order to be able to resolve MAP cases in a timely, efficient, and effective manner" and that "further resources may be necessary." In 2020, APMA responded by hiring over 25 new personnel; increasing the number of teams from 6 to 9, which should improve processing times.

Public Consultation

Along with the release of the MAP Statistics, the OECD also released a consultation document, seeking stakeholder input on proposals for the 2020 review of the Action 14 Minimum Standard regarding the following items:

a) Experiences with, and views on, the status of dispute resolution and suggestions for improvements, including experiences with MAP in those jurisdictions that obtained a deferral;

b) Additional elements to strengthen the Action 14 Minimum Standard; and

c) Additional elements to strengthen the MAP Statistics Reporting Framework.

Interested parties are invited to submit comments in Word format by January 11, 2021 via email to taxpublicconsultation@oecd.org. The public consultation meeting on the 2020 review of BEPS Action 14 will be held virtually on February 1, 2021.

Implications

One thing is clear from the MAP Statistics, which is that taxpayers are facing increased audits around the globe and are investing resources in the MAP process, as shown by the increased number of new cases. This upward trend seems likely to continue as no significant reduction in MAP activity is expected despite the pandemic (i.e., audit activity has remained prevalent). Three jurisdictions with a steeply ascending trajectory in the number of total cases since 2016 are Italy, India, and the UK, which suggests companies should carefully consider their advance audit planning strategies in these countries in particular.

Additionally, the current variability in approaches to digital taxation among countries potentially exposes companies to double taxation, which may result in an even further increase in MAP cases despite the aggressive timeline proposed by the OECD to reach a consensus agreement by mid-2021. That said, if countries can agree on safe harbors or benchmarks for routine transactions and communicate them publicly, then many cases could be kept from the purview of MAP. However, transfer pricing issues related to the ongoing pandemic also may complicate certain MAP cases. Taxpayers may want to consider alternatives to MAP for transfer pricing issues, such as advance pricing agreements ("APAs"), to proactively address potential disputes. APAs are often an efficient means of achieving transfer pricing certainty while avoiding prolonged, resource intensive audits.

By: Donna McComber, Kent Stackhouse,* and *Wenham Shen, Washington, DC

Treasury: More Enforcement, Centralized Compliance Effort Required for Expatriation Provisions (Code Section §877A)

On September 28, 2020, the Treasury Inspector General for Tax Administration (the "TIGTA") published the Final Audit Report (the "Report"). The Report was originally initiated to determine the effectiveness of the IRS efforts in ensuring compliance with the expatriation tax provisions under sections 887 and 877A, and related efforts to reduce taxpayer's burden.

Based on the conclusions of the Report, the system lacks a centralized compliance effort aimed at enforcing the expatriate rules. TIGTA found numerous instances of potential non-filing, underreporting of income and payment compliance issues by expatriates. Finally, TIGTA discovered that high net worth expatriates oftentimes neglected the payment of exit tax.

TIGTA emphasized the significance of the centralized compliance effort without which, it claimed, Congress's attempts to create disincentives to expatriation via section 877A will not be effective.

Section 877, 877A and the HEART Act

When United States citizens relinquish their citizenship or when long-term residents terminate their United States residency, they must file Form 8854, *Initial and Annual Expatriation Statement.* By filing this form, they certify compliance with all Federal tax laws during the five years preceding the year of expatriation. In doing so, taxpayers must also determine whether they meet the definition of a covered expatriate.

In 2008, Congress created a "mark-to-market" exit tax regime through section 877A, enacted as part of the Heroes Earnings Assistance and Relief Tax Act of 2008 ("HEART Act"). Section 877A generally imposes an income tax (exit tax) on expatriates by providing that all worldwide property of a "covered expatriate" is treated as sold on the day before the expatriation date at its fair market value.

A covered expatriate is an individual who expatriated on or after June 17, 2008, and meets one of the following rules: (1) Tax Liability Rule; (2) Net-Worth Rule; or (3) Certification Rule. An individual meets these rules if: (1) the average annual net income tax of such individual for the period of five taxable years ending before the date of the loss of United States citizenship is greater than $171,000 (for TY 2020, subject to inflation adjustment); (2) an individual's net worth is $2 million or more on the date of expatriation or termination of residency; or (3) an individual fails to certify on Form 8854 compliance with all United States Federal tax obligations for the five years preceding the date of expatriation or termination of residency.

TIGTA Audit Findings and Recommendations

TIGTA found that the IRS lacked the essential controls needed to effectively determine compliance with section 877A, highlighting the weaknesses of the existing system and advising the IRS to implement specific course of actions to improve compliance as described below:

Lack of Social Security Number on *Certificate of Loss of Nationality of the United States* ("CLN"), Form DS-4083

When a taxpayer expatriates, the Department of State completes the CLN. The usefulness of this form is limited due to its lack of a Social Security Number, which is indispensable for verification of filing and payment compliance by IRS. Furthermore, the CLN does not provide any financial information, required by the IRS to determine tax compliance of the expatriates with the section 877A.

To improve the compliance and effectiveness of the data collection, TIGTA recommends to contact the Department of State, via the Federal Intergovernmental Program, and request the addition of the Social Security Number data field to the CLN. In addition, the TIGTA recommends to explore the feasibility of receiving the CLN electronically to reduce delays in the transmission process.

CLN Submissions without *Initial and Annual Expatriation Statement*, Form 8854

An expatriating individual is generally required to send Form 8854 detailing the individual's income, assets, and liabilities. Form 8854 is critical in determining whether an expatriate is a covered expatriate. However, between June 2008 and December 2018 about 41% of those individuals who received CLNs did not send a required copy of Form 8854 to the IRS Philadelphia Campus to report their prior income tax liabilities, net worth and certify compliance. Without the form, expatriates are considered covered expatriates, even if the other two tests of the section 877 are not met.

The IRS developed two forms for use when a copy of the CLN is received from the Department of State without Form 8854 from the expatriate: (1) Letter 2399C, *Failure to File - Initial Form 8854*, sent to notify the expatriates about their failure to file Form 8854, and (2) a follow-up Letter 4135C, *Failure to Respond to Initial Form 8854 Request*, which is failure to respond to Letter 2399C. These forms are currently outdated and are rarely used.

The TIGTA recommends updating both letters (Letter 2399C and Letter 4135C) for compliance under the HEART Act, and developing Internal Revenue Manual procedures to send the aforementioned letters to obtain Form 8854 when the CLN is received without Form 8854 attached.

Lack of Procedure to Analyze and Determine if the Expatriates Meet the Requirements under Section 877A and Pay Exit Tax on the Deemed Sale of their Worldwide Assets

Among other responsibilities, the IRS's Low Income Housing Credit Unit ("LIHC") located in the IRS Philadelphia Campus is responsible for maintaining the expatriate database. LIHC is also responsible for transcribing data from Form 8854. However some of the significant fields for purposes of the section 877A enforcement, such as property owned on the date of expatriation (Part IV, Section B), balance sheet (Part V, Schedule A), or income statement (Part V, Schedule B) are not transcribed.

TIGTA recommends to evaluate the information reported on Form 8854 and to determine what data fields should be added to the expatriate database to ensure tax compliance of expatriating taxpayers.

Lack of Procedures within the LIHC Unit to Transcribe and Correct Errors with Form 8854

The expatriate database and Form 8854 do not include annual Form 8854 filed from expatriates who elected to defer exit taxes. In addition, the expatriate database's data fields used by LIHC have not been updated for the HEART Act and do not line up with the TY 2018 Form 8854.

Furthermore, after reviewing a sample of records, TIGTA concluded that the LIHC unit failed to research prior tax liabilities for the expatriates who did not self-report the liabilities they had prior to the five year mark. Moreover, the LIHC unit lacks the procedure to correspond and obtain the missing information with those taxpayers who claim to have a net worth of zero.

Without this information, the IRS is unable to determine if the expatriate is a covered expatriate subject to income tax under section 877A.

Therefore, TIGTA recommends establishing Internal Revenue Manual procedures for transcribing Form 8854 data, correcting Form 8854 data when information as filed by expatriates is missing or incomplete, and preparing analysis as needed to determine if an expatriate is a covered expatriate and subject to tax under section 877A.

Lack of Centralized Compliance Effort Aimed at Enforcing the Expatriate Rules

Although the IRS does examine some of the expatriate tax returns, not all of the returns are identified by either the expatriate database or as part of any special expatriation examination program. More importantly, the information from Form 8854 attached to Form 1040-NE, *United States Nonresident Alien Income Tax Return*, is not transcribed, as the transcription only occurs if an expatriate mails Form 8854 to Philadelphia Campus. Once the Form arrives, the LIHC unit enters the information into the expatriate database. Since many of the returns filed by expatriates are not reviewed for examination potential, thousands of expatriating taxpayers annually go unchecked.

TIGTA recommends establishing a process to compile information on all expatriates to determine whether expatriates file Form 8854 with their individual tax return Form 1040-NR, or file Form 8854 with the Philadelphia Campus. Once compiled, this information can be used to identify the highest risk expatriate returns for the tax compliance.

Conclusion

Looking at the audit results and the recommendations, the first thought that comes to one's mind is that this audit comes very timely. This will not come as a surprise that the government will very soon have a critical need to recover from the economic setback in the post Covid-19 environment. In July of 2019, IRS's Large Business and International ("LB&I") Division management already announced its compliance campaign focusing on United States citizens and long-term residents did not meet the filing requirements or tax obligations with the IRS. Under that campaign LB&I Division management stated the intent to select varying degrees of covered expatriates through different treatment streams consisting of soft letters, outreach and education, and examinations. Further, in June of 2020, the IRS already announced the plan to increase audits that target high net worth individuals and the entities associated with them. Considering that, a mere group of 35 covered expatriates, who expatriated between January 1, 2017 and December 31, 2018, reported a combined net worth of $289 million, it is only a matter of time before we witness a significant increase in the audits of expatriates once the recommended IRS procedures are implemented and become part of the reality.

By: Ida Varshavsky and Jonathan Gomer, Zurich

Canada is Increasing its Requirements on Non-Residents to Register for and Collect its Indirect Taxes

On November 30, 2020, Canada's Minister of Finance announced, as part of the government's Fiscal Update (available here), proposals to both increase GST/HST registration and collection obligations for non-resident suppliers and introduce a Digital Services Tax ("DST"). The GST/HST proposals (which were accompanied by draft legislation) are proposed to come into effect July 1, 2021. The DST proposal (which was not accompanied with draft legislation) is proposed to come into effect January 1, 2022, unless multilateral consensus is reached before then. Further details on these proposals, as well as somewhat similar measures imposed or announced at the provincial level are discussed below.

Federal Fiscal Update Measures

GST/HST Proposals

Background - The GST/HST is a broad-based value-added tax on supplies made in Canada levied at a rate of 5%-15% (depending on the province). The proposed changes include new GST/HST registration and collection obligations for supplies in respect of:

1. Services (both digital and traditional) and intangible property supplied by non-residents;
2. Goods supplied through Canadian fulfillment warehouses (or other locations in Canada); and
3. Short-term accommodations

In general terms, the applicable registration threshold amount for these measures would be CAD 30,000 of actual or expected sales over a 12 month period (*e.g.*, sales made by the person required to register, sales made by a third-party through the person's platform). Persons registered under simplified registration regimes described below would be assigned calendar quarter reporting periods and would be able to apply for authorization to report and remit GST/HST in USD or Euros.

Services and intangible property supplied by non-residents - Under current GST/HST rules, non-residents who do not carry on business in Canada are generally not required to register for and collect GST/HST on their supplies made in Canada. The proposals would require such non-residents to register for and collect GST/HST on their supplies of services (both digital and traditional) and intangible property made to Canadian-resident consumers under a simplified registration system. Registration under the simplified system would be completed through an online portal. The collection obligation would generally only apply to B2C transactions, insofar as the collection obligation would only apply on sales made to Canadian-residents who are not GST/HST-registered. Vendors would generally be allowed to determine a customer's usual place of residence on the basis of two specified indicators (including home address, billing address, IP address, bank/payment information, SIM card, landline). Input tax credits (effectively, credits for GST/HST incurred by suppliers on their inputs) would not be available for vendors registered under the simplified registration system.

In addition to non-resident *suppliers* of services and digital products, operators of digital platforms that facilitate sales by third-party vendors (“Distribution Platforms”) would also be required to register for and collect GST/HST on supplies of services and intangible property made by third-party, non-resident vendors to Canadian consumers through the platform. Such supplies would be deemed to be made by the Distribution Platform.

These proposals for non-resident collection of services and intangibles are generally in line with amendments made to the Quebec sales tax (“QST”) effective January 1, 2019. QST is a broad-based value-added tax on supplies made in the province of Quebec levied at a rate of 9.975%.

Goods supplied through fulfillment warehouses – Tax registration and collection obligations would also be increased with respect to the supply of tangible goods by non-residents. Namely, under the proposed rules, Distribution Platforms would be required to register under the current GST/HST registration system and collect GST/HST on goods that are located in inventory in Canada (e.g., at fulfillment warehouses in Canada) and sold by non-registered vendors through the platform. Distribution Platform operators would be deemed suppliers of such goods under the proposed rules. In addition, non-resident vendors who do not carry on business in Canada would be required to register under the current GST/HST registration system and collect GST/HST on goods that are located in Canadian inventory that they sell to Canadian-residents, where the goods are not supplied through a Distribution Platform.

Short-Term Accommodations – Under the proposals, GST/HST would be required to be collected on short-term accommodations by either property owners or accommodation platform operators. Where the property owner is not GST/HST-registered, the platform would be deemed to be the supplier of the accommodations (and thus required to collect GST/HST). GST/HST would not apply on services supplied by platforms to owners who are not GST/HST-registered; however, platforms would be required to collect GST/HST on service fees charged to guests.

DST Proposal

The Fiscal Update also noted that the government proposes to implement a DST to apply starting January 1, 2022, in the event a consensus solution on a DST is not reached at the OECD prior to that time. The proposal indicates that the DST would apply until such time as an acceptable common approach comes into effect. Unlike for the GST/HST measures discussed above, the Fiscal Update did not include draft DST legislation or other specifics but noted that further details will be announced in Budget 2021 (which is typically released in or about March). The governing Liberal Party previously proposed in its campaign platform for the fall 2019 federal election, to impose a 3% DST replicating the proposed DST announced by the French government (description found here).

Provincial Measures

The provinces of Manitoba, Saskatchewan and British Columbia impose provincial sales taxes ("PST"), which are sales and use taxes similar to those imposed in many US states, applicable to retail sales of tangible property and certain taxable services. Recent measures have been made and proposed measures have been announced to require non-residents to register for and collect PST on PST-taxable sales, as further described below.

Saskatchewan PST

New rules passed into law July 3, 2020 (but retroactive to January 1, 2020) purport to require online marketplace facilitators and online accommodation platforms to register for and collect Saskatchewan PST on retail sales made through their marketplaces/platforms. These changes follow changes made in 2017 and 2018, purporting to expand obligations on non-resident vendors to register for and collect PST on retail sales in Saskatchewan.

British Columbia PST

New rules passed into law in early 2020 and set to come into effect on April 1, 2021 purport to require non-resident vendors of software and telecommunication services made for use on or with an electronic device situated in BC to register for and collect British Columbia PST on such sales, even if the vendor has no physical presence in BC. Notably, a "telecommunication service" is defined broadly for BC PST purposes to include, *inter alia*, downloading and streaming of music and videos.

By: Bryan Horrigan, Toronto

Proposed Changes to Canada's Stock Option Rules

In its November 30, 2020 Fiscal Update, the Canadian federal government introduced modified proposals to amend Canada's employee stock option rules to (i) cap the employee stock option deduction available to an employee of a "large corporation" and (ii) permit a "large corporation" with a corporate tax deduction in respect of certain employee stock options (the rules discussed herein may also apply to certain options granted to employees by mutual fund trusts). The proposed amendments would generally apply to employee stock options granted on or after July 1, 2021.

Under the current rules, employees can deduct 50% of the stock option benefit arising on exercise where certain conditions are met (special rules apply to employee stock options granted by Canadian-controlled private corporations). This preferential tax treatment effectively results in employee stock options being taxed at capital gains rates (instead of employment income rates). From the employer perspective, the current rules generally deny a corporate tax deduction in respect of shares that are sold or issued to the employee on exercise of employee stock options.

The Canadian federal government initially proposed a cap on employee stock options eligible for the employee deduction and a potential corporate tax deduction for employers in its Federal Budget 2019. At that time, it was announced that certain corporations, including Canadian-controlled private corporations and “start-ups”, and their employees would be excluded. These rules were put on hold in December, 2019.

The modified proposals introduced in the Fiscal Update would place a CAD 200,000 limit on the amount of employee stock options that may vest (i.e., become exercisable) for each employee in each calendar year and continue to qualify for the employee stock option deduction. This CAD 200,000 amount would be determined by reference to the fair market value of the underlying shares at the time of grant. For example, if an employee were granted options to acquire 100,000 shares in year one with a fair market value of CAD 50 per share at the time of grant, and options in respect of 25% of those shares vested in each of years two to five, the employee would only be entitled to claim an employee stock option deduction in respect of options over 4,000 shares vesting in each year (CAD 200,000 / CAD 50 = CAD 4,000). The determination of the year in which an employee stock option vests would be made at the time of grant. If the year of vesting could not be determined at that time, the option would be considered to vest on a pro rata basis, for an up to five-year period ending on the last day the option could become exercisable. Employee stock options granted under different agreements that vest in the same year would generally qualify for the employee stock deduction in the order of grant, until the cap is exceeded.

The modified proposals further provide that an employer may be able to claim a corporate tax deduction in respect of employee stock options in excess of the cap where certain conditions are met, including that the employee stock option deduction would have otherwise been available (i.e., had the cap not been exceeded), and that the employer has complied with certain notification requirements (both with respect to the employee and the Canada Revenue Agency). The potential corporate tax deduction would generally be equal to the amount of the employee stock option benefit required to be included in the employee’s taxable income for Canadian tax purposes, and could be claimed in the employer’s tax year in which the employee exercises the option. In order for the employee stock option deduction to be available, the exercise price of an option must generally be at least equal to the fair market value of the underlying shares at the time of grant. As such, a corporate tax deduction will generally continue to be unavailable for other types of share-settled awards granted to employees, such as restricted stock units.

While there was some uncertainty under the rules as originally proposed, the modified proposals appear to permit an employer to claim a corporate tax deduction in respect of stock options granted to its employees by a non-arm's length corporation (e.g., a foreign parent corporation) that are in excess of the cap, provided that the requirements for a deduction are otherwise met. This will generally require the employer to make a reimbursement payment to the corporation that granted the options. In order to avoid potential tax benefit issues (and Canadian withholding tax), a written agreement should be put into place with respect to any such payments that will be made cross-border before the employee stock options are granted.

Employers subject to the new rules would also be able to choose to grant "non-qualified" employee stock options that would not be eligible for the employee stock option deduction, but may instead be eligible for a corporate tax deduction (even if the proposed cap would not otherwise apply). The rules as currently drafted appear to provide that only the employer can grant options designated as non-qualified options, although such grants may be over shares of another corporation in the group. As such, care must be taken in structuring employee stock option plans for corporate groups where a corporate tax deduction is desired.

The new rules (both the cap on the employee stock option deduction and the potential corporate tax deduction) would generally not apply to options granted by Canadian-controlled private corporations or corporations whose annual gross revenue does not exceed CAD 500 million. Where a corporation is a member of a corporate group that prepares consolidated financial statements, consolidated revenue would be used for the purpose of determining whether the new rules applied. Employee stock options that are not granted by the employer, but by a non-arm's length corporation (e.g., a parent corporation) would generally be subject to the new rules if either the employer or the grantor exceeded the annual gross revenue threshold.

As first indicated above, the new rules would apply to employee stock options granted on or after July 1, 2021, other than in respect of certain options granted in exchange for options granted before that time on a tax deferred basis.

By: Stephanie Dewey, Toronto

A Dive into 2021 Mexican Tax Reform

The pandemic declared by the World Health Organization has substantially disrupted Mexico's economic performance as many activities have been interrupted to prevent the SARS-CoV2 virus ("COVID-19") from spreading. The Mexican president will direct government efforts and policies to support the most vulnerable population during this crisis. The president goes on to say that the economic and social panorama of Mexico is encouraging, and the Mexican

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government is committed to continue investing in projects that generate employment. These include the Mayan Train, the Felipe Ángeles International Airport, the New Dos Bocas Refinery and the Interoceanic Corridor of the Isthmus of Tehuantepec.

For additional information, please see, "*A Dive into 2021 Mexican Tax Reform*," available on InsightPlus.

By: Jorge Narvaez Hasfura, Mexico City

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