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In this issue

Digital taxation

US releases trade investigation findings regarding France's Digital Services Tax; proposes imposition of tariffs

On 2 December 2019, the United States Trade Representative (USTR) announced the findings of an investigation under Section 301 of the *Trade Act of 1974* (Section 301) into France's Digital Services Tax (DST). The USTR determined that the French DST creates an unreasonable or discriminatory burden on US commerce and in response proposed that the US impose tariffs of up to 100% on approximately US$2.4 billion of French-origin goods.

The USTR's action came as a 90-day US-France agreement reached over the summer to forestall a trade war over the French DST expired.

France enacted a DST on 24 July 2019 that provides a 3% levy on global revenues generated by "digital interface" services provided to French users. The tax is retroactive to 1 January 2019 and applies to companies that have global, annual revenues in excess of €750 million, and that have €25 million of digital sales generated in France. The tax is estimated to impact 30 companies, which includes one French company, and is expected to raise approximately €500 million.

As the DST bill moved through the French legislative process, the USTR announced on 10 July the initiation of a Section 301 investigation into the French DST. The investigation had three objectives: to determine if the French tax was discriminatory against US companies; to assess the fairness of the retroactivity of the tax; and to determine if it was an unreasonable tax policy based on US and international tax norms.

On 2 December 2019, the USTR released a report of the investigation findings along with the issuance of a USTR notice summarizing the findings, proposed actions, and next steps. Based on the USTR's' findings, the US is entitled to take appropriate, responsive action under Section 301. On this basis, the USTR proposed tariffs of up to 100% on French-origin goods, preliminarily covering 63 tariff subheadings.

The USTR is seeking public comments regarding the specific products to be subject to tariffs and the level of duty rate increase, if any.

President Trump stated before a bilateral meeting with President Macron at the North Atlantic Treaty Organization (NATO) summit on 3 December that the US conducts significant trade with France and he believes that a resolution may be attainable with respect to the USTR proposed tariffs.

USTR Robert Lighthizer also stated that the USTR is "exploring whether to open Section 301 investigations into the digital services taxes of Austria, Italy, and Turkey" as the USTR is "focused on countering the growing protectionism of EU member states, which unfairly targets U.S. companies, whether through digital services taxes or other efforts that target leading U.S. digital services companies."

US Treasury Secretary tells OECD that United States has 'serious concerns' over Pillar 1

US Treasury Secretary Steven Mnuchin told the OECD on 3 December 2019, that the US government has "serious concerns" about aspects of the project to address the tax challenges of digitalization and suggested that the goals of Pillar 1 — which focuses on an approach to the new nexus concept and an approach for new and revised profit allocation rules — could be "substantially achieved" by making it a safe-harbor regime.

In a letter to the OECD Secretary General, Secretary Mnuchin said the concerns are specifically with "potential mandatory departures from arm's-length transfer pricing and taxable nexus standards." The letter said the United States fully supports a "GILTI-like Pillar 2 solution."

Secretary Mnuchin said the US looks forward to working with the OECD "along these lines," and that it is important for talks to reach agreement to prevent unilateral Digital Services Taxes (DST), which the US opposes and which, according to Mnuchin, "threaten the longstanding multilateral consensus on international taxation."

The letter follows a 2 December announcement by the Office of the US Trade Representative, proposing additional duties of up to 100% on US$2.4 billion in French products in response to the French DST. (See the above article in this issue of the *Washington Dispatch*.)

US distributors who purchase from related parties will almost certainly have transfer prices affected by the imposition of 301 duties. Along with the strategic importance of mitigating duty impact while aligning the income tax and customs approaches, mechanics for reporting any transfer pricing adjustments to US Customs should also be reviewed. This process may be particularly complex when duties are present for only a portion of the year, and in many cases, actions need to be taken in advance of importations.

US Customs has very specific rules for reporting adjustments to prices made after importation, such as transfer pricing adjustments. These rules require that the importer take specific actions before importation of goods for which prices may be adjusted, including adding customs specific language to transfer pricing policies. If implemented, these new 301 duties will likely take effect early in 2020. Importers are well advised to address these requirements now in order that they be in place when 301 duties are imposed.

Treasury and IRS news

US issues final and proposed BEAT regulations, with some relief for taxpayers

Treasury and the IRS issued final and proposed regulations on the Base Erosion and Anti-abuse Tax (BEAT) under Section 59A (the final BEAT regulations and the 2019 proposed regulations, respectively). Both sets of regulations were published in the Federal Register on 6 December 2019.

The final BEAT regulations are largely consistent with the proposed BEAT regulations released on 13 December 2018 but adopt several significant changes.

In particular, the final BEAT regulations contain an exception for specified nonrecognition transactions under Sections 332, 351, 355, or 368 that should generally allow for more transactions to occur without triggering BEAT, though careful consideration of the new guidance is warranted, including the new anti-abuse rules.

Equally important (and less taxpayer-favorable) is the addition of specific anti-abuse rules that address the Government's concern that a foreign-related party may engage in a transaction that results in a basis step-up of amortizable or depreciable property immediately before transferring the property to a taxpayer in a specified nonrecognition transaction.

The final regulations add some taxpayer-favorable rules for financial transactions. For example, taxpayers with a large number of Section 988 transactions, such as banks, will benefit from the inclusion of Section 988 losses from third-party transactions in the denominator when computing the base erosion percentage. On the other hand, many taxpayers will likely be disappointed that the IRS and Treasury rejected commentators' suggestion to expand the qualified derivatives payment (QDP) exception to include transactions that are not subject to the mark-to-market method of accounting (e.g., certain hedging transactions).

The 2019 proposed regulations would allow taxpayers to elect to forego a deduction so that it is not taken into account as a base erosion tax benefit so long as the deduction is waived for all US income tax purposes. While it may be helpful to forgo a deduction to avoid the "cliff" effect that may apply if a taxpayer is close to the 3% base erosion percentage threshold, electing to waive a deduction will likely mean weighing the benefit of a BEAT exemption (i.e., if the waived deduction results in the taxpayer's base erosion percentage falling below the required threshold to qualify as an applicable taxpayer) against the possible disadvantages stemming from the waived deduction, including potential increased tax cost, and the risk of unforeseen collateral effects on the taxpayer's tax filing position. Modeling will be key to evaluating the implications of making the election.

IRS final and proposed regulations provide additional guidance for determining allowable foreign tax credits

On 2 December 2019, the IRS released final and proposed regulations on determining allowable foreign tax credits under the Internal Revenue Code.

The final foreign tax credit (FTC) regulations are largely consistent with the proposed regulations released in 2018, with some modifications. In particular, the final regulations include a new safe harbor provision for transitioning pre-2018 FTC carryforwards to post-2017 tax years to account for the new foreign branch income category and provide for accounting for foreign tax redeterminations in prior tax years.

The proposed FTC regulations (New Proposed Regulations) would change the manner in which deductions for research and experimental (R&E) activities are allocated and apportioned. In particular, the New Proposed Regulations would require

Tax extenders package with CFC look-through signed into law

President Trump on 20 December 2019 signed into law limited tax extenders legislation that was included as part of year-end appropriations bills. Among the provisions, the legislation extends the Code Section 954(c)(6) controlled foreign corporation (CFC) look-through rule through 2020. The CFC look-through rule was set to expire at the end of 2019.

R&E expenditures to be allocated to the taxpayer's gross intangible income, which does not include dividends, subpart F income, or Global Intangible Low-Taxed Income (GILTI) inclusions, under a new gross-receipts based method.

Further, and perhaps more important, Prop. Reg. Sections 1.861-20 and 1.904-6 would provide detailed guidance for allocating and apportioning current-year foreign taxes to separate Section 904(d) categories of income. Prop. Reg. Section 1.861-20 also provides specific allocation and apportionment rules for foreign taxes attributable to:

- Timing or base differences (an exclusive list of base differences is provided)
- Various transactions that are disregarded for US purposes
- Income of entities that are fiscally transparent under foreign law but treated as corporations for US tax purposes (a reverse hybrid)
- Gains from the sale or exchange of a foreign disregarded entity

The New Proposed Regulations also provide guidance under Section 905(c) for applying the "relation back" doctrine to foreign tax redeterminations that relate to pre-*Tax Cuts and Jobs Act* (TCJA) tax years.

The final regulations and New Proposed Regulations provide highly anticipated guidance on many open questions about the FTC regime post-TCJA. On a positive note, the final regulations expand the transition rules for carryovers of foreign tax credits, overall foreign losses (OFLs), overall domestic losses (ODLs), separate limitation losses (SLLs) and net operating losses (NOLs) by creating safe harbors that do not require taxpayers to apply the foreign branch rules under the final regulations.

The final regulations and New Proposed Regulations under Section 905(c) provide important guidance on foreign tax redeterminations and the need to redetermine a taxpayer's US tax liability, including notifying the IRS, following the repeal of Section 902 pooling adjustments. Nevertheless, the compliance burden on taxpayers will be significant.

The requirement to fully reflect the impact of all foreign tax redeterminations for foreign income taxes paid or accrued by a foreign corporation, in the year to which the taxes relate, means that taxpayers will need to carefully track these matters and regularly file amended returns to avoid losing foreign tax credits or incurring penalties.

For expense allocation and apportionment, the New Proposed Regulations would not allocate any R&E expenditures to the GILTI category, which may benefit taxpayers with excess credits in that category. Pending the forthcoming regulations under Section 250, consideration should be given to both the FTC and Foreign Derived Intangible Income (FDII) impact of retroactively applying Prop. Reg. Section 1.861-17. It is important to model the alternative approaches currently available for years preceding the effective date of the New Proposed Regulations, years beginning before 1 January 2020, to determine whether to adopt them early.

The New Proposed Regulations would adopt a rigid approach to allocating and apportioning stewardship expenses, mandating allocation of the expense to dividends and inclusions, including subpart F and GILTI. It is now more important for taxpayers to determine which expenses are properly identified as stewardship. Taxpayers frequently treat supportive expenses as stewardship expenses even when the expenses do not meet the narrow definition of stewardship. Again, modeling is important to determine the effect of these new rules.

The rules for allocating and apportioning foreign income taxes under Prop. Reg. Section 1.861-20 (together with Prop. Reg. Section 1.904-6 and 1.960-1) would introduce another complex regime, particularly the special rules for disregarded transactions. While the rules provide needed guidance in certain cases - reverse hybrids, for example - the inclusion of additional items as base differences and the increased likelihood of more foreign income taxes being non-creditable undoubtedly surprised many taxpayers and practitioners.

IRS issues final withholding and reporting regulations

The IRS in late December 2019 issued final regulations (TD 9890) relating to withholding and reporting tax on certain US-source income paid to foreign persons. More specifically, the regulations – under Code Sections 1441, 1471, and 6049 – provide guidance on certain due diligence and reporting rules that apply to persons making certain US-source payments to foreign persons. The final rules also provide guidance on certain aspects of reporting by foreign financial institutions on US accounts.

The final regulations are effective 2 January 2020.

IRS issues final Section 871(m) regulations on dividend equivalent payments on derivatives referencing US equities, extends transition relief

The IRS issued final regulations (TD 9887, 2019 final regulations) under Section 871(m) with guidance for entities that hold certain US equities and financial products referencing US-source dividends.

In Notice 2020-2, issued concurrently with the 2019 final regulations, the IRS announced that it is extending the transition relief provided in Notice 2018-72 for two additional years and that it plans to amend the Section 871(m) regulations to reflect the delayed effective/applicability dates. This guidance is relevant for entities making payments to non-US entities on derivatives and other financial instruments referencing US equity securities.

The 2019 final regulations adopt the 2017 proposed regulations without substantive change and withdraw the corresponding 2017 temporary regulations.

The extension of the phase-in period for certain provisions of the Section 871(m) regulations and guidance permitting withholding agents to apply transition rules for payment in 2021 and 2022 provide financial industry participants additional time to implement the complex systems and processes necessary to comply with the rules of the Section 871(m) regulations.

IRS issues proposed regulations on sourcing income from sales of certain personal property

The IRS on 23 December 2019, released proposed regulations (REG-100956-19) modifying the rules for determining the source of income from sales of inventory produced within the US and sold without the US, or vice versa. The regulations provide the first guidance issued under Section 863(b)(2) since the section was amended by the *Tax Cuts and Jobs Act*.

These proposed regulations contain new rules for determining the source of income from sales of personal property (including inventory) by nonresidents that are attributable to an office or other fixed place of business that the nonresident maintains in the US.

The proposed regulations further modify certain rules for determining whether foreign source income is effectively connected with the conduct of a trade or business within the US.

Administration hopeful pending tax treaties with Chile, Hungary, and Poland will be approved in 2020

A senior Treasury official told a Washington audience before the holidays that he hoped that pending US tax treaties with Chile, Hungary, and Poland would be approved by the Senate in 2020, "although there is still a rocky road in front of us." Treasury Assistant Secretary for Tax Policy, David Kautter, on 20 December 2019 was quoted as saying that disagreements among Treasury and Congressional lawmakers regarding the Base Erosion and Anti-abuse Tax have held up the treaties' approval and subsequent ratification.

Another Treasury official at the same conference was quoted as saying that the department is in the process of reviewing US treaty policy in the wake of the 2017 *Tax Cuts and Jobs Act* (TCJA), and the review is not limited to the pending treaties. She said the Government is evaluating both treaties that have been signed as well as agreed to in substance in light of the TCJA, and also existing US treaties to determine if they may require a protocol.

The Treasury official further disclosed that the IRS is committed to negotiating and implementing bilateral agreements on the automatic exchange of country-by-country (CbC) reports. She indicated that there has been progress in regard to a number of negotiations, including with Germany and France. The US has indicated that it plans to negotiate bilateral CbC agreements, instead of applying a single multilateral competent authority agreement. The official added that the US Government remains adamantly opposed to public disclosure of CbC reports.

The proposed rules would also measure the basis of US production assets based on the "alternative depreciation system" under Section 168(g)(2) — given that such assets might otherwise, due to bonus depreciation, have zero basis.

The regulations would apply to tax years ending on or after 30 December 2019, although taxpayers may elect in certain circumstances to apply the regulations to earlier tax years.

IRS further delays certain Section 987 foreign currency regulations

On 6 December 2019, Treasury and the IRS announced (Notice 2019-65) that they intend to amend the final Section 987 regulations issued in 2016 (T.D. 9794, the 2016 Final Regulations), as well as certain related final regulations issued in 2019 (T.D. 9857, the 2019 Final Regulations), to further delay their applicability date by one additional year.

As background, the government released final (T.D. 9794), temporary (T.D. 9795), and proposed regulations (REG-128276-12) under Section 987 on 7 December 2016.

The Trump Administration in Notice 2017-38 identified Section 987 as a significant tax regulation requiring additional review under Executive Order 13789.

As a result, there were several deferrals of these rules. In Notice 2017-57 and again in Notice 2018-57, the government twice announced that future guidance would defer the applicability dates of certain provisions of the 2016 Final Regulations and temporary regulations by one additional year. Consequently, the 2016 Final Regulations and certain provisions of the temporary regulations would have applied (absent the latest guidance) to tax years beginning on or after *three years* after the first date of the first tax year following 7 December 2016 (i.e., 1 January 2020, for in-scope, calendar-year taxpayers).

With this latest release of Notice 2019-65, these regulations will now apply to tax years beginning on or after 7 December 2020 (i.e., 1 January 2021, for in-scope, calendar-year taxpayers). Notably, the applicability date of Reg. Section 1.987-12 is not delayed, so the deferral event and outbound loss event rules of Reg. Section 1.987-12 generally apply to events occurring on or after 6 January 2017.

The Treasury and the IRS also reiterated their intent to consider changes to the final regulations to permit taxpayers to elect to apply simplified alternative rules for transitioning to the final regulations and alternative rules for determining Section 987 gain or loss.

Taxpayers may rely on the provisions of Notice 2019-65 before amendments to the final regulations are issued.

The delayed applicability date provides taxpayers additional time to create and implement the complex systems and processes necessary to transition to the Final Section 987 Regulations. Additionally, as reiterated in Notice 2019-65, Treasury and the IRS are considering alternative rules that could simplify compliance with Section 987.

In the meantime, taxpayers must compute Section 987 gain or loss under a reasonable method and must also apply the deferral or outbound loss event rules of Reg. Section 1.987-12, which currently apply. Additionally, taxpayers need to consider the interaction of Section 987, US tax reform provisions and recently issued final regulations. Specifically, US owners of Section 987 qualified business units (QBUs) will have to consider how their current Section 987 calculations:

- Affect taxable income for purposes of the Base Erosion and Anti-abuse Tax (BEAT) provisions of Section 59A
- Affect adjusted taxable income for purposes of the interest expense limitation provisions of Section 163(j), and
- Interact with the foreign branch income basket rules under Section 904(d)

CFC owners of Section 987 QBUs will also need to consider the effect of their Section 987 determinations on their Section 951A Global Intangible Low-taxed Income (GILTI) calculations and potential effects on subpart F income.

Treasury grants another extension of time for reporting signature authority (FBAR, Form 114) over certain foreign financial accounts

On 20 December 2019, the Treasury's Financial Crimes Enforcement Network (FinCEN) issued Notice 2019-1, further extending the filing deadline for certain individuals who previously qualified for an extension of time to file a Report of Foreign Bank and Financial Accounts (FBAR) with respect to signature authority under Notice 2018-1 and preceding guidance.

As such, the notice is only relevant for persons who were previously granted extensions of time to report signature authority under FinCEN Notices 2011-1 and 2011-2, and most recently extended by FinCEN Notice 2018-1.

FinCEN Notice 2019-1 grants a further extension of time to file FBARs with respect to signature authority for 2019 and prior years under extension. It is important to note, as stated in the *Surface Transportation and Veterans Health Care Choice Improvement Act of 2015*, Public Law 114-41 changed the due date to 15 April and directed that a six-month extension of the filing deadline to 15 October be made available. As of the date of Notice 2019-1, all filers are granted an automatic extension of time to file calendar-year 2019 FBARs without the need to specifically request the extension.

OECD news

Officials discuss OECD BEPS 2.0 Project

Pascal Saint-Amans, director of the OECD's Center for Tax Policy and Administration, told a Washington conference in December that OECD staff, working with the 136 countries in the Inclusive Framework, plan to forge ahead to develop additional details that would create a new taxing right aimed at reallocating more taxable profits of multinational enterprises (MNEs) to market jurisdictions. They will leave for future action the more political determination as to how to address US Treasury concerns that a deviation from arm's length principles (ALP) would be difficult to gain political consensus in the US Congress.

Documents being developed for purposes of a meeting of the Inclusive Framework in late January 2020, are expected to provide further details regarding this new taxing right, under so-called Pillar One of the OECD project, as well spell out how additional refinements and simplifications to the ALP, addressing dispute resolution and dispute prevention, could work.

The objective is for the Inclusive Framework to agree to an outline of the Pillar One work in late January 2020, endorsing with modifications and further detail the Pillar One proposal for a "unified approach" released on the Secretariat on 9 October 2019. If there is a consensus within the Inclusive Framework, Saint-Amans said the plan would be to provide a public report to the G20 finance ministers in late February 2020, and that report would be subject to comment in the hopes of reaching a final agreement on Pillar One in July 2020.

Saint-Amans cautioned that he hoped his timetable will hold despite the uncertainty created by a 3 December letter from US Treasury Secretary Mnuchin to the OECD Secretary General stating that the US position is that Pillar One only be imposed on MNEs on a voluntary basis. Saint-Amans pointed out that Secretary Mnuchin's letter did say that the United States remains committed to the OECD process to forge an international consensus, and noted that while the Secretary's letter created uncertainty as to the future of the Pillar One project, it is normal for there to be last minute changes in positions by countries as part of the negotiating process.

As for Pillar Two, which is a separate work stream intended to ensure that MNEs pay a minimum level of tax, the plan appears to be that the OECD will release another public consultation document by April 2020, that will expand upon and tie together the issues raised in the 8 November Pillar Two consultation document. As the Secretariat noted at the 9 December public consultation on Pillar Two, this new consultation is expected to discuss in more detail how the income inclusion rule, or minimum tax, will fit together with backstop rules, including the undertaxed payments rule, the switch over rule and the subject to tax rule.

Speaking at the same conference, US Treasury Deputy Assistant Secretary for International Affairs Chip Harter said that the OECD negotiations really come down to whether a consensus can be reached that would trade off better administrability of the ALP for a new simplified formula for determining nexus and profit allocation rules for larger, consumer-facing MNEs. Harter expressed concerns that the Pillar One approach was evolving in a manner that could bring into scope more MNEs than some countries would like, and would move the international tax system towards a partial destination-based system, which raises some concerns.

Therefore, Harter explained, the Secretariat was refining the proposals to narrow them further. However, despite the work to do so, Secretary Mnuchin felt that businesses were deeply divided by the proposals, and that this division would complicate the US political process for adopting the OECD proposals. He explained the revised US approach (i.e., creating a voluntary Pillar One mechanism) as one that many MNEs should find attractive because they would achieve more certainty through the so-called Amount B and Amount C refinements to the ALP, even if they would pay more foreign tax under Amount A.

OECD hosts public consultation on global anti-base erosion (GloBE) proposal under Pillar Two of BEPS 2.0 project

On 9 December 2019, the OECD hosted a public consultation on the consultation document entitled "Global Anti-Base Erosion (GloBE) Proposal – Pillar Two" (the Consultation Document), which was released by the OECD on 8 November 2019 in connection with the ongoing project on addressing the tax challenges of the digitalization of the economy.

The OECD received close to 200 written comment submissions on the Consultation Document. Representatives from business, labor groups, non-governmental organizations (NGOs), and academia participated in the consultation to discuss their perspectives on the specific technical issues covered in the document. Government officials from jurisdictions that are part of the 136-member Inclusive Framework attended the consultation in order to hear the stakeholder perspectives. EY submitted a comment letter and a global team from EY participated in the consultation.

At the opening of the consultation, the OECD Secretariat and the German government official who chairs the Inclusive Framework, addressed the BEPS 2.0 project as a whole in light of the recent exchange of letters between US Treasury Secretary Steven Mnuchin and OECD Secretary-General Angel Gurria regarding the US position on the project.

The officials stressed that work will continue on the project, noting that the G20 Finance Ministers have pledged to move forward. A critical upcoming meeting of the Inclusive Framework in late January 2020, may very well determine the fate of Pillar One, however, given the change in the US position requesting that Pillar One be viewed as a safe harbor rather than a mandatory change to existing transfer pricing rules.

With respect to Pillar Two, the OECD Secretariat laid out a timeline for future work on the GloBE proposal in the near term, including plans to issue an additional and more detailed consultation document on Pillar Two early in 2020. The comments made by stakeholders during the consultation session reflected clear differences in views about the GloBE proposal between the business community and NGOs.

OECD releases additional CbC guidance

The OECD on 23 December 2019 announced that the Inclusive Framework on BEPS had released additional interpretative guidance for tax administrations and multinational enterprise groups on the implementation and operation of CbC Reporting (BEPS Action 13). The new guidance makes clear that under the BEPS Action 13 minimum standard, the automatic exchange of CbC reports filed under local filing rules is not intended. A summary of CbC reporting notification requirements in Inclusive Framework member jurisdictions was also posted on the OECD website.

OECD releases seventh batch of peer review reports on BEPS Action 14

On 28 November 2019, the OECD released the seventh batch of peer review reports relating to the implementation by Brazil, Bulgaria, China, Hong Kong, Indonesia, Russia, and Saudi Arabia of the BEPS minimum standard on Action 14 (*Making Dispute Resolution Mechanisms More Effective*).

Overall, the reports conclude that five of the seven assessed jurisdictions meet the majority or most of the elements of the Action 14 minimum standard. Russia meets half of the elements of the Action 14 minimum standard, and Saudi Arabia meets less than half of the elements.

OECD engaged in modeling economic impact of Pillars 1 and 2

An OECD official in December 2019 disclosed that the organization is engaged in ongoing economic modeling of the Pillar 1 and Pillar 2 proposals that will be released beginning in early 2020. The official was quoted as saying that while the OECD continues to refine its analysis, it appears that there would be modest global net tax revenue gains under Pillar 1, with low and middle income economies benefiting more than more advanced economies. The global net tax revenue gains under Pillar 2 would be greater than under Pillar 1, but those results are less certain due to the lack of details, including the minimum tax rate and whether some form of blending of income subject to varying tax rates would be adopted.

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