Year-in-Review

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This special issue of the Washington Dispatch is a compilation of significant US international tax developments and guidance issued during the period of 1 January through 31 December 2019, addressing inbound and outbound taxation. The material is divided by subject area with most recent events listed first.

Table of contents

Tax Cuts and Jobs Act (TCJA)

Section 965 transition tax

IRS announces campaign to audit Section 965 transition tax compliance

The IRS Large Business and International (LB&I) Division opened a new campaign to examine companies' compliance with the Section 965 transition tax enacted by the *Tax Cuts and Jobs Act* (TCJA); the IRS made the announcement on its website on 4 November 2019.

The IRS will conduct examinations of the reported Section 965 liability on selected tax returns, in most cases looking at the returns for both 2017 and 2018. In addition, those staffing the campaign will provide technical assistance to teams examining Section 965 issues, "with a focus on identifying and addressing taxpayer populations with potential material compliance risk." LB&I will also risk-assess returns selected as part of the campaign for other material issues, especially those "related to TCJA planning."

The announcement of the Section 965 campaign aligns with the IRS's heightened focus on TCJA compliance. LB&I has publicly stated that it intends to examine tax planning around the TCJA, including the components underlying the calculation of a taxpayer's Section 965 liability.

IRS representatives have indicated that the IRS will be looking closely at taxpayers' earnings and profits calculations, the classification of assets as cash versus non-cash, and how taxpayers determined their foreign tax credits, among other issues. Exam personnel will also look at how Section 965 intersects with other TCJA provisions, such as the Base Erosion and Anti-abuse Tax, Global Intangible Low-taxed Income and Foreign Derived Intangible Income. This is particularly significant given the extended six-year statute of limitations on assessments that applies to Section 965 liabilities.

IRS releases Section 965 transition tax information

The IRS on 16 July 2019, announced (IR-2019-128) the release of additional information to assist taxpayers in meeting filing and payment obligations for the Section 965 transition tax on untaxed foreign earnings. The IRS provided answers to questions on Section 965 to address questions that do not specifically relate to the 2017 and 2018 tax returns, including how to make subsequent installment payments when the transition tax is paid over eight years.

No delay in Section 965 final regulations effective date

The IRS issued a correction to the final Section 965 regulations on 9 April 2019, amending the preamble to dispense with a 60-day delay in the effective date of the regulations. The *Congressional Review Act* generally requires a 60-day delayed effective date for "major" rules, unless Treasury and the IRS determine that the 60-day delay is "unnecessary and contrary to the public interest."

The Office of Management and Budget's Office of Information and Regulatory Affairs had determined that the regulation was a major rule, but Treasury and the IRS deemed the delay not necessary. The final Section 965 regulations (T.D. 9846) were published on 5 February 2019, and were effective on that date.

Final Section 965 regulations clarify filing Form 965-A or 965-B with transfer agreements

The IRS in early February 2019 published the final Section 965 transition tax regulations in the Federal Register. The final regulations clarified that Form 965-A or 965-B must be filed with a transfer agreement only if the eligible Section 965(h) transferor or eligible Section 965(i) transferor was required to file the form.

As a transition rule, the regulations provide that a transfer agreement must be filed by 7 March 2019, with respect to a triggering or acceleration event that occurs on or before 5 February 2019.

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 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.

Final Section 965 regulations largely follow proposed regulations, but include significant changes

On 15 January 2019, final regulations under Section 965 (the Final Regulations) were made available on the IRS website. The Final Regulations are generally consistent with the proposed regulations published on 9 August 2018 (the Proposed Regulations), but make certain modifications. Notable changes include:

- Determining the aggregate foreign cash position of a consolidated group by treating the consolidated group as a single United States (US) shareholder
- Excluding certain commodities from the cash position of a specified foreign corporation (SFC)
- Requiring a US shareholder of an SFC at any point during the inclusion year to include in gross income its pro rata share of a SFC's Section 965 amount, even if the SFC ceases to be an SFC during the transition year
- Treating certain changes in method of accounting (i.e., those that would result in an increase in the Section 965(a) inclusion amount) as regarded for Section 965 purposes
- Clarifying the inclusion ordering rules, including for Section 1248 amounts and amounts paid between SFCs that are disregarded for Section 965 purposes
- Clarifying that Section 965(b) previously taxed earnings and profits (PTI) are treated as included under Section 951 for purposes of Section 1248(d)(1)
- Allowing a US shareholder to limit the basis adjustments required under the basis–shifting election to avoid gain recognition from the election
- Allowing US shareholders to elect to not disregard payments between SFCs occurring between earnings and profits (E&P) measurement dates
- Making foreign taxes associated with a hovering deficit available to the extent of current E&P of the SFC with the hovering deficit
- Taking only actual Section 956 inclusions into account in the "without" calculation when calculating the net tax liability for purposes of the Section 965(h) installment election

Taxpayers should determine the effects of the revisions made from the Proposed Regulations to the Final Regulations on their Section 965 net tax liability as these revisions may materially affect a taxpayer's Section 965 net tax liability. As with the Proposed Regulations, the rules provided in the Final Regulations are retroactive and apply to a foreign corporation's last tax year that begins before 1 January 2018, and to a US shareholder's tax year in which or with which the foreign corporation's year ends.

Section 951A global intangible low-taxed income (GILTI)

IRS issues final and proposed GILTI and subpart F regulations, include favorable and unfavorable provisions for taxpayers

On 14 June 2019, the US government released final and proposed regulations on global intangible low-taxed income (GILTI) under Section 951A and proposed regulations on subpart F income under Section 951.

Section 951A requires a US person that is a US shareholder of a controlled foreign corporation (CFC) for any tax year to include in its gross income for that tax year (US shareholder inclusion year) its GILTI for that year (GILTI Inclusion). In contrast to a subpart F income inclusion, a US shareholder's GILTI Inclusion is based on the aggregate of the shareholder's pro-rata share of certain items (e.g., tested income, tested loss and qualified business asset investment (QBAI)) from all the CFCs in which the shareholder is a US shareholder for that year. Under current law, subject to a taxable income limitation, a corporate US shareholder is allowed a deduction equal to 50% of its GILTI inclusion under Section 250.

The final GILTI regulations are largely consistent with the proposed GILTI regulations released last year, with some modifications. On the other hand, the proposed GILTI regulations would provide for a GILTI "high-taxed exclusion," which would exclude from a US shareholder's GILTI amount certain items of income of its CFCs that are subject to a foreign effective rate of tax of at least 18.9% (i.e., 90% of the highest rate under Section 11).

The proposed Section 951 regulations would treat a domestic partnership as an aggregate of its partners for identifying the US shareholder(s) required to include any subpart F income owned by CFCs of the domestic corporation. The proposed GILTI regulations would apply prospectively to tax years of a foreign corporation beginning on or after the date final regulations are published in the Federal Register. The proposed subpart F income regulations would similarly apply prospectively, though taxpayers may apply the aggregate treatment to earlier tax years in certain cases.

The final and proposed regulations are a mixed bag for taxpayers. The following are the most significant favorable provisions in the final and proposed regulations:

- Treating a US partnership generally as an aggregate for GILTI purposes in the final regulations (and similarly providing rules under the proposed regulations that would treat a US partnership generally as an aggregate for subpart F inclusion purposes)
- Exempting domestic partnerships from GILTI inclusions (in the final regulations) and subpart F inclusions (in the proposed regulations)
- Narrowing the scope of the pro-rata share anti-abuse rule (Reg. Section 1.951-1(e)(6))
- Abandoning the burdensome proposed tested loss "recapture" regime for net used tested losses (original Prop. Reg. Section 1.951A-6)
- Providing an election to eliminate disqualified basis for all US tax purposes (and thus avoid losing foreign tax credits under Section 901(m))

The unfavorable provisions, however, are significant and include:

- Proposing a narrow GILTI high-tax exception that applies only after regulations are finalized
- Expanding the GILTI anti-abuse rule to prevent deductions from disqualified basis from being considered when determining tested income, subpart F income and effectively connected income (ECI)
- Denying Section 245A dividends received deductions (DRDs) for Section 78 dividends from fiscal-year corporations (absent this rule, US shareholders owning fiscal-year foreign corporations might claim a Section 245A deduction for Section 78 dividends attributable to Section 965 inclusions in 2018)

The final GILTI regulations, with some exceptions, are generally effective for tax years of foreign corporations beginning after 31 December 2017, and to tax years of US shareholders in which or with which those foreign corporations' tax years end.

The proposed GILTI and subpart F income regulations will be effective for tax years of foreign corporations beginning after the date the final regulations are published, and to tax years of US shareholders in which or with which those foreign corporations' tax years end. The treatment of a domestic corporation as foreign for subpart F income purposes can, however, be applied for a foreign corporation's tax years beginning after 31 December 2017, and for tax years of a domestic partnership in which or with which the foreign corporation's tax years end, provided that certain related parties also apply the regulations.

Section 59A base erosion and anti-abuse tax (BEAT)

IRS 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.

EU comments on Section 59A BEAT provision

In early spring 2019, the European Union (EU) commented to Treasury and the IRS on the proposed regulations under the Section 59A Base Erosion and Anti-abuse Tax (BEAT). The European Commission wrote that although they support the BEAT objective to reduce tax avoidance and aggressive tax planning, the proposed regulations "introduce trade distortions or discrimination that would appear to be incompatible with World Trade Organization (WTO) rules and other international commitments taken by the US."

More specifically, the Commission contends that the BEAT is "discriminatory in a manner that is inconsistent with the … WTO requirement of national treatment in trade in services because it would in effect apply only to outbound payments to foreign related companies, and would not apply to comparable payments to US related companies."

Section 59A, enacted by the *Tax Cuts and Jobs Act*, is currently under review by the OECD Forum on Harmful Tax Practices, which has indicated it will not issue any decisions until the related final regulations are released.

Section 250 FDII/GILTI deductions

EC comments on US FDII proposed regulations

The European Commission in early May 2019, sent a letter to the US Treasury Department commenting on the Section 250 proposed regulations, suggesting that the Foreign Derived Intangible Income (FDII) deduction violates international trade law. According to the letter, "The design of the FDII deduction is incentivizing tax avoidance and aggressive tax planning by offering a possibility to undercut local tax rates in foreign economies."

The Commission further described the FDII as an "incentive for foreign economies to lower corporate tax rates in a 'race to the bottom.'" The letter included a statement that the European Commission was "ready to protect the economic interest of the European Union in light of discriminatory rules and practices."

IRS issues proposed Section 250 regulations on calculating FDII and GILTI deduction

In early March 2019, Treasury and the IRS issued proposed regulations under Section 250 (REG-104464-18) that provide guidance for calculating the deduction allowed to a domestic corporation for its Foreign-Derived Intangible Income (FDII) and Global Intangible Low-taxed Income (GILTI). The proposed regulations primarily provide guidance for calculating a domestic corporation's FDII; proposed regulations for calculating GILTI were released 13 September 2018.

Section 250 generally allows a domestic corporation a deduction for its FDII and GILTI inclusions for a tax year. For tax years beginning after 31 December 2017, but on or before 31 December 2025, a domestic corporation may claim a deduction equal to 37.5% of its FDII, and 50% of the sum of its GILTI and any Section 78 dividend with respect to GILTI (Section 78 GILTI dividend). For tax years beginning after 31 December 2025, these percentages decrease to 21.875% and 37.5%, respectively.

The proposed regulations provide guidance for determining the components of a domestic corporation's FDII calculation – namely, deduction eligible income (DEI), deemed tangible income return (DTIR), deemed intangible income (DII) and foreign-derived deduction-eligible income (FDDEI). Detailed rules are further provided to determine the sub-components of certain components.

Guidance is also provided to coordinate the calculation of the allowed Section 250 deduction with the application of other limitations in the Code (Sections 163(j) and 172(a)) that are based on a domestic corporation's taxable income for a tax year. Finally, special rules are provided for individuals that make a Section 962 election for a tax year, consolidated groups, and tax-exempt corporations.

The proposed regulations restate and confirm much of what is in Section 250. More importantly, however, they provide helpful guidance for many open questions not addressed clearly by the statute, the most critical of which is how to determine foreign use. In this regard, the proposed regulations require extensive documentation to prove foreign use, which is perhaps simply a compliance exercise, although obtaining documentation could be difficult in business-to-consumer transactions.

The proposed regulations under Section 250 would apply to tax years ending on or after 4 March 2019. For tax years before that date, the proposed regulations provide that taxpayers may use any reasonable documentation maintained in the ordinary course of business, provided the documentation meets the reliability requirements.

Section 245A dividends received deduction

Temporary and proposed DRD regulations reflect GILTI-centric view of international tax rules enacted under TCJA

On 14 June 2019, Treasury and the IRS released proposed and temporary regulations (REG-106282-18) under Sections 245A and 954(c)(6). Subject to certain limitations, Section 245A allows a domestic corporation to deduct 100% of the foreign-source portion of any dividend received from a specified 10%-owned foreign corporation (Section 245A DRD).

The regulations deny, in whole or in part, the Section 245A dividends-received deduction (DRD) to dividends sourced from earnings and profits (E&P) generated from certain transactions occurring after 31 December 2017, but before the close of a tax year to which the provisions of Section 951A do not apply (the GILTI gap period).

No plans to loosen anti-corporate inversion regulations

An IRS official in February 2019 disclosed there are no plans to ease restrictions included in the final anti-corporate inversion regulations released in July 2018. The official was quoted as saying that Congress could have rolled back the inversion rules when it enacted the *Tax Cuts and Jobs Act*, but declined to do so. The official suggested there remains strong policy concerns regarding corporate inversions.

They also deny, in whole or in part, the Section 245A DRD to dividends sourced from E&P generated from tested income or subpart F income that would have been included in a US shareholder's income under Sections 951(a) or 951A(a), but for the transfer or dilution of that shareholder's direct or indirect interest in a controlled foreign corporation (CFC). The regulations extend these provisions to dividends received by an upper-tier CFC from a lower-tier CFC by denying the Section 954(c)(6) exception to foreign personal holding company income to similarly sourced dividends.

The temporary regulations apply retroactively to distributions made on or after 1 January 2018 (the effective date of the Section 245A DRD). This effective date will likely have detrimental and unexpected consequences for certain taxpayers.

Section 1446(f) withholding

Proposed regulations under Section 1446(f) would clarify scope of withholding on transfers of partnership interests

On 7 May 2019, the government issued proposed regulations (REG-105476-18) under Section 1446(f), which imposes a new withholding tax on transfers by non-US persons of interests in partnerships that are engaged in a US trade or business.

Section 1446(f) is an enforcement mechanism for the substantive tax imposed by Section 864(c)(8), which imposes tax on non-US partners that sell interests in such partnerships to the extent the gain is allocable to the partnership's US business assets.

The proposed regulations, if issued in final form, would end the suspension currently in force on withholding for transfers of interests in publicly traded partnerships (PTPs), and require banks, brokers and custodians to perform withholding on such transfers by non-US persons of those PTP interests.

The proposed regulations also would modify the Notice 2018-29 rules that currently apply to transfers by non-US persons of interests in partnerships that are not publicly traded. The proposed regulations would also activate the provision in Section 1446(f)(4) requiring partnerships to withhold on partnership interests previously transferred by a non-US partner if the correct tax was not withheld at the time of the transfer.

The effective dates of the proposed regulations vary.

Section 863(b)(2) sourcing

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.

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.

Subpart F

IRS issues final regulations on ownership attribution rules for CFC purposes

The IRS, on 18 November 2019, issued final regulations (T.D. 9883) on the attribution of ownership of stock or other interests under Sections 954 and 958 for purposes of determining whether a person is a related person with respect to a controlled foreign corporation (CFC) under Section 954(d)(3). The final regulations also provide rules for determining whether a CFC is considered to derive rents in the active conduct of a trade or business for purposes of computing foreign personal holding company income.

The final regulations adopt proposed regulations (REG-125135-15) issued in May 2019 without change. (See, *IRS issues proposed regulations under Sections 954 and 958; important consequences for subpart F and GILTI regimes, among other provisions*, on page 15.)

The final regulations are generally effective for taxable years of CFCs ending on or after 19 November 2019 and taxable years of United States shareholders in which or with which such taxable years end but apply earlier in certain cases.

The final regulations have important consequences for computing subpart F income and global intangible low-taxed income inclusions (as well as for other provisions). They could cause amounts that a taxpayer had not treated as subpart F income to qualify as subpart F income (and vice versa). The regulations generally finalize two major changes.

First, they modify how certain constructive ownership rules under Section 318(a) apply for purposes of characterizing a person as a "related person" with respect to a CFC under Section 954(d)(3). Notwithstanding that the regulations are generally effective prospectively, these modifications apply to an amount that a CFC receives or accrues on or after 17 May 2019, if the receipt or accrual is "accelerated" with a principal purpose of avoiding the modifications.

Second, they modify the manner in which royalties paid or accrued by a CFC are treated for purposes of applying the "safe harbor" threshold of the "active marketing exception" to foreign personal holding company income by treating them the same manner as rents earned by the CFC.

IRS Chief Counsel Advice concludes 952(c) election to include otherwise excludible insurance income in subpart F income of CFCs' US shareholders is obsolete

In a Chief Counsel Advice Memorandum (AM 2019-001 or GLAM) released on 4 October 2019, the IRS provides a legal analysis for determining the availability of the election under Section 952(c)(1)(B)(vii)(I) (the 952(c) election). The 952(c) election permits a US shareholder of a controlled foreign corporation (CFC) to include in subpart F income certain insurance income that would otherwise be excluded because it was attributable to the CFC's insurance activities in the country in which the CFC was created or organized (same-country exception).

Ultimately, the GLAM concludes that the 952(c) election "has been inoperable since 1998" and was made obsolete in 2015, even though the 952(c) election actually remains in the Internal Revenue Code.

The GLAM explains that the subpart F rules applicable to insurance companies have undergone significant legislative changes since 1986. The *Tax Reform Act of 1986* enacted the same-country exception; another legislation package in 1988 enacted the 952(c) election; and the current version of the subpart F rules for insurance companies (the active financing exception (AFE)) was enacted in 1998. Because the 952(c) election "was a creature of" the same-country exception rules "that became defunct after AFE was made permanent" in 2015, the GLAM concludes that the 952(c) election is obsolete.

The IRS's arguments for finding the 952(c) election obsolete appear to be unsupported in legislative history or other authorities. They also do not address other equally or more valid arguments for finding that the 952(c) election remains available.

IRS issues proposed regulations and Rev. Proc. 2019-40 on repeal of Section 958(b)(4)

The US government on 1 October 2019, released [proposed regulations] that would limit the impact of the repeal of Section 958(b)(4) in determining the controlled foreign corporation (CFC) status of a foreign corporation when applying certain provisions of the Code. Before its repeal by the *Tax Cuts and Jobs Act*, Section 958(b)(4) prevented a US subsidiary from being treated as owning stock in a foreign-owned brother-sister subsidiary for purposes of determining whether the brother-sister foreign subsidiary was a CFC.

The proposed regulations do not provide broad relief from the repeal of Section 958(b)(4), but instead offer targeted relief by effectively causing select Code provisions to apply as if Section 958(b)(4) had not been repealed. The proposed regulations notably would:

- Modify Section 267(a)(3) to allow a taxpayer to deduct accrued but unpaid amounts (other than interest) owed to a CFC when (i) the payment is not subject to withholding tax under a treaty, and (ii) the CFC does not have any US shareholders (as defined in Section 951(b)) that own (within the meaning of Section 958(a)) stock of the CFC
- Determine CFC status without regard to the repeal of Section 958(b)(4) for purposes of the Section 1297(e) Passive Foreign Investment Company asset test
- Determine CFC status without regard to the repeal of Section 958(b)(4) for purposes of the CFC foreign tax credit look-through rules under Section 904(d)(3)
- Provide additional rules, including narrowing the gain recognition agreement triggering event exception in Reg. Section 1.367(a)-8(k)(14) and determining CFC status for purposes of applying Section 332(d)(3) to the liquidation of an applicable holding company

The proposed regulations generally would apply on or after 1 October 2019. For payments accrued before 1 October 2019, taxpayers may apply these rules for payments accrued during the last taxable year of a foreign corporation beginning before 1 January 2018 and each subsequent year, if certain conditions are satisfied.

On the same day, the IRS also issued Rev. Proc. 2019-40 related to the repeal of Section 958(b)(4). According to the IRS, the revenue procedure "limits the inquiries required by U.S. persons to determine whether certain foreign [controlled] corporations are controlled foreign corporations" as a result of the repeal of Section 958(b)(4) and "allows certain unrelated minority U.S. shareholders to rely on specified financial statement information to calculate their subpart F and GILTI inclusions and satisfy reporting requirements" for certain foreign controlled CFCs if more detailed tax information is unavailable.

The revenue procedure applies to the last taxable year of a foreign corporation beginning before 1 January 2018 and each subsequent year, and with respect to the taxable years of US shareholders in which or with which such taxable years of such foreign corporation end.

Final Section 956 regulations generally follow proposed regulations, but with two major modifications

Treasury and the IRS on 22 May 2019, issued final regulations under Section 956 (TD 9859). Consistent with the proposed regulations published on 5 November 2018, the final regulations reduce a US shareholder's Section 956 amount when a hypothetical distribution from the controlled foreign corporation (CFC) would have resulted in a dividend eligible for a deduction under Section 245A.

The final regulations provide a two-step process: First, the "tentative Section 956 amount" is computed. Second, the "tentative Section 956 amount" is reduced by the amount of the Section 245A dividends received deduction (DRD) that the corporate US shareholder would be allowed based on a "hypothetical distribution" of an amount equal to the "tentative Section 956 amount" from the CFC. Both steps are computed on a share-by-share basis. The final regulations made no changes to the special rule denying a Section 245A DRD for a Section 956 inclusion when the hypothetical distribution would result in a hybrid dividend.

The final regulations make two important modifications to the proposed regulations:

- Revising the ordering rule to attribute the hypothetical distribution only to previously taxed income (PTI) resulting from subpart F income and untaxed earnings and profits
- Applying the final regulations to domestic partnerships with US corporate shareholders

The final regulations apply to a CFC's tax years beginning on or after 22 July 2019. Consistent with the proposed regulations, however, taxpayers may apply the final regulations to tax years beginning after 31 December 2017, provided that the taxpayer and its related US persons consistently apply the final regulations to all their CFCs.

Although the final regulations provide a more favorable result for domestic corporate US shareholders, the rules do not "turn off" Section 956. Earnings of a CFC other than undistributed foreign earnings (for example, effectively connected income) can continue to result in a Section 956 inclusion.

Similarly, the relief in the final regulations will not apply to the extent a distribution from the CFC would be treated as a hybrid dividend under Section 245A(e). Finally, individuals and other US shareholders ineligible for a Section 245A DRD receive no relief from Section 956 inclusions. In these instances, the impact of a Section 956 inclusion will often be made worse if the proposed regulations under Section 960, when finalized, disallow foreign tax credits related to Section 956 inclusions. Thus, taxpayers should continue to monitor exposure to Section 956 inclusions.

The final regulations' resolution of the problem caused by the interplay between the proposed regulations and the Section 959(c) ordering rule should be a welcome change for taxpayers. This will particularly be the case if the proposed regulations under Section 960 are finalized in current form. The final regulations also provide helpful guidance on the computation of Section 956 inclusions of a US shareholder that is a domestic partnership with one or more domestic corporate partners.

It will generally benefit taxpayers to adopt the final regulations early. The final regulations will allow domestic corporate US shareholders to more easily access cash held by their CFCs in certain fact patterns that would have otherwise resulted in a Section 956 inclusion taxed at the 21% corporate tax rate.

IRS issues proposed regulations under Sections 954 and 958; important consequences for subpart F and GILTI regimes, among other provisions

Treasury and the IRS released proposed regulations in May 2019, under Sections 954 and 958 (REG-125135-15) that would have important consequences for computing subpart F income and Global Intangible Low-taxed Income (GILTI) inclusions (as well as for other provisions). In general, the proposed regulations would be effective only prospectively, i.e., for tax years of controlled foreign corporations ending on or after the date Treasury publishes the proposed regulations in final form (and to the tax years of US shareholders in which or with which those tax years end). (See, *IRS issues final regulations on ownership attribution rules for CFC purposes*, on page 13.)

The proposed regulations generally would result in two major changes:

- First, they would modify how certain constructive ownership rules under Section 318(a) apply for purposes of characterizing a person as a "related person" with respect to a controlled foreign corporation (CFC) under Section 954(d)(3). Notwithstanding that the proposed regulations are generally effective only prospectively, these modifications would apply immediately to an amount that a CFC receives or accrues on or after 17 May 2019, if the receipt or accrual is "accelerated" with a principal purpose of avoiding the modifications.
- Second, they would modify how royalties paid or accrued by a CFC are treated for purposes of applying the "safe harbor" threshold of the "active marketing exception" to foreign personal holding company income (FPHCI, a component of subpart F income) for certain rents earned by the CFC.

Congress repealed former Section 958(b)(4) as part of the *Tax Cuts and Jobs Act* (TCJA). That provision had prevented Section 318(a)(3)'s "downward" constructive ownership rules from attributing stock owned by a non-US person to a US person. Neither the proposed regulations themselves nor their preamble refers to Section 958(b)(4). It does not appear that the release of the proposed regulations will affect whether Treasury issues regulations on the repeal of former Section 958(b)(4).

Foreign tax credit

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 (FTCs) under the Internal Revenue Code.

The final foreign tax credit 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 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.

Capital markets

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. (See, *IRS finalizes certain temporary FX regulations addressing recognition and deferral of Section 987 gain or loss*, on page 20.)

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.

IRS proposed rules address tax consequences of elimination of LIBOR, other interbank offered rates

In early October 2019, in light of the pending phaseout of the London interbank offered rate (LIBOR) and variant interest rates, the IRS issued proposed regulations (REG-118784-18) addressing tax issues resulting from the transition to the use of reference interest rates other than interbank offered rates (IBORs) in debt instruments and other contracts.

IBORs, including the US-dollar LIBOR (USD LIBOR), are planned to be phased out by the end of 2021, which has far-reaching financial and tax implications because the USD LIBOR is widely-used as a reference rate in a broad range of financial instruments. The Alternative Reference Rates Committee (ARRC) of the Federal Reserve, tasked with selecting alternative rates, selected the Secured Overnight Financing Rate (SOFR) as the replacement for USD LIBOR. Other jurisdictions have selected other reference rates to replace IBORs for their respective currencies.

In connection with the IBOR transition, the ARRC requested guidance from the US Treasury Department on tax issues associated with the elimination of IBORs and the transition to other rates such as SOFR. Because the new reference rates differ from the IBORs they are intended to replace, it is expected that contracts will generally provide for a change to the spread over the interest rate (a spread adjustment) or a one-time payment for the change in value. ARRC also requested guidance on issues resulting from any spread adjustments or change-in-value payments.

To facilitate the transition away from IBORs and minimize resulting market disruption, the IRS issued the proposed regulations with an aim to reduce associated tax uncertainty and taxpayer burden. To this end, the proposed regulations include revisions and additions to the rules under Sections 1001, 1275, 860G and 882. Taxpayers may rely on the proposed rules before final regulations are issued to the extent specified in the proposed regulations.

The proposed regulations provide welcome guidance on one of the most pressing issues – whether the transition to a new interest rate benchmark will result in the realization of gain or loss on an IBOR-based instrument. Nonetheless, the proposed regulations leave many questions unanswered, including:

- The treatment of the one-time payment to compensate the other party upon transition to a new benchmark.
- The treatment of a modification between related parties where the fair market value requirement of the qualified rate definition is not met.
- Continued qualification for integrated transaction treatment.

Because the transition from IBOR may impact debt instruments, as well many non-debt instruments that reference IBOR (including interest rate swaps, cross-currency swaps and equity swaps) taxpayers need to begin identifying their IBOR-based instruments. Once those transactions are identified, taxpayers will need to consider how they will transition those instruments from IBOR and how such transition will be treated under the proposed regulations, including any impacts to GAAP accounting for the tax consequences under ASC 740.

New US cryptocurrency tax guidance addresses some open questions, leaves others unanswered

On 9 October 2019, the IRS issued guidance in the form of a revenue ruling and frequently asked questions on the tax treatment of cryptocurrency transactions. In Revenue Ruling 2019-24, the IRS ruled that a "hard fork" (e.g., when one cryptocurrency becomes two) will not cause taxpayers to recognize income under Section 61. Taxpayers will recognize ordinary income, however, if they receive new units of cryptocurrency (i.e., an "airdrop") following the hard fork.

The ruling left many issues unanswered, however. No determinations have been made on the applicability of the wash sale rules, de minimis exceptions, the tax treatment of initial coin offerings and security token offerings, the tax treatment for those receiving tokens in connection with providing proof of stake, or how cryptocurrency interacts with international tax rules. In addition, guidance is needed on whether merely trading cryptocurrencies in the United States can give rise to income that is effectively connected with a US trade or business.

In frequently asked questions (FAQs), the IRS expands on its 2014 cryptocurrency guidance (Notice 2014-21) by providing more examples of (i) when taxpayers recognize gain or loss on an exchange of cryptocurrency, (ii) how to calculate basis in cryptocurrency, and (iii) when taxpayers recognize income on other cryptocurrency-related transactions.

The IRS has also started adding references to virtual currency to a few forms and their instructions. A taxpayer must report ordinary income from virtual currency on Form 1040, *U.S. Individual Tax Return*, Form 1040-SS, Form 1040-NR, or Form 1040, *Schedule 1, Additional Income and Adjustments to Income (PDF)*, as applicable. Taxpayers must calculate and report capital gain or loss from virtual currency and other capital transactions in accordance with IRS forms and instructions, including Form 8949, *Sales and Other Dispositions of Capital Assets*, and then summarize capital gains and deductible capital losses on Form 1040, *Schedule D, Capital Gains and Losses*.

Now that guidance has been released, taxpayers should review previously filed returns to confirm that they accurately reported gains and losses from cryptocurrency transactions. Taxpayers might need to consider amending returns to comply with the new guidance. For example, taxpayers that failed to include the FMV of cryptocurrencies airdropped after a hard fork should consider whether they must amend a previously filed tax return.

In addition, taxpayers should consider whether an accounting method change is warranted for previously filed tax returns, as FAQ 37 allows taxpayers to either specifically identify or default to FIFO when computing basis for cryptocurrency sales or exchanges. In the absence of guidance, some taxpayers may have used an impermissible accounting method to compute tax basis. Taxpayers that may have used an impermissible method of accounting should consider applying for a change of accounting method.

Taxpayers and tax return preparers should continue monitoring progress on Form 1040, Schedule 1, Additional Income and Adjustments to Income. If the form is finalized as currently drafted, taxpayers and tax return preparers may have to file Schedule 1 solely to indicate whether they engaged in cryptocurrency transactions.

IRS begins to increase enforcement efforts in cryptocurrency space

The IRS in summer 2019 began sending letters (Letter 6173, Letter 6174, or Letter 6174-A) to approximately 10,000 taxpayers with regard to cryptocurrency transactions. This action signals a serious step-up in enforcement efforts by the IRS in the cryptocurrency space since the 2 July 2018 announcement of the virtual currency campaign, that indicated that the IRS was not contemplating a voluntary disclosure program specifically to address tax non-compliance involving virtual currency.

Additionally, some taxpayers are reporting receipt of CP2000 notices from the IRS, which assert that the taxpayer has underpaid tax with respect to cryptocurrency transactions. Unlike Letters 6173, 6174, and 6174-A, the CP2000 notice contains the IRS's calculation of underpaid tax, plus interest.

The IRS has issued limited guidance on the taxation of cryptocurrencies, namely Notice 2014-21. The Notice generally treats "convertible virtual currency" as property, rather than currency, for federal tax purposes.

Gain or loss on cryptocurrency transactions is calculated in the same manner as other property sales: gain/loss = amount realized — adjusted basis. Both the amount realized and adjusted basis must be converted to US dollars for federal tax reporting purposes. The character of the gain/loss depends on whether the cryptocurrency is a capital asset in the taxpayer's hands.

By issuing these letters, the IRS is apparently giving taxpayers a chance to amend returns to correct underreported income related to, or improper reporting of, their cryptocurrency transactions. Taxpayers who do not take advantage of this opportunity risk exposure to increasingly aggressive (and potentially less forgiving) future IRS enforcement, including possible imposition of penalties and interest charges on underreported tax. Although the letters are not actual examinations, failure to respond may result in the IRS initiating an audit.

In addition, taxpayers should be aware that while gains/losses realized in connection with the sale or exchange of cryptocurrencies should generally be recognized for federal income tax purposes, additional tax issues arise in connection with cryptocurrencies for which little guidance is currently available.

For example, little guidance is available on the impact of a "fork" in a particular blockchain that could give rise to two different digital assets (and the need to assess taxability of any new assets resulting from such fork, as well as potential basis adjustments). Additionally, little guidance is available on transactions involving assets received pursuant to an "airdrop" in which the owner of a digital wallet in one cryptocurrency is given rights to a new wallet/cryptocurrency as a method of broadly distributing the new cryptocurrency.

There are numerous other issues impacting those trading or investing in cryptocurrencies for which little guidance is available. Accordingly, both taxpayers and their advisors should consult with professionals that have experience in dealing with these matters.

IRS finalizes certain temporary FX regulations addressing recognition and deferral of Section 987 gain or loss

In T.D. 9857 effective 13 May 2019, the government finalized – with certain clarifications – Reg. Sections 1.987-2T and -4T (related to combinations and separations of qualified business units (QBUs) subject to Section 987) and Reg. Section 1.987-12T (addressing recognition and deferral of Section 987 gain and loss upon certain QBU terminations and certain other transactions involving partnerships).

In addition, Treasury and the IRS withdrew Section 1.987-7T (regarding the allocation of assets and liabilities of certain partnerships for purposes of Section 987). No changes were made to the applicability dates of the final Section 987 regulations (T.D. 9794) or certain other temporary (T.D. 9795) and proposed (REG-128276-12) Section 987 regulations. Those regulations were previously delayed by Notice 2018-57 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). (See, *IRS further delays certain Section 987 foreign currency regulations*, on page 17.)

Treasury and the IRS continue to study other provisions of the temporary regulations under Section 987 that were not specifically addressed by T.D. 9857.

The finalization of the temporary regulations makes permanent the combination and separation rules of *former* Reg. Sections 1.987-2T and -4T and the deferral event and outbound loss event rules of *former* Reg. Section 1.987-12T, which were otherwise scheduled to expire on 6 December 2019.

Partnerships

IRS announces it will allow domestic partnerships and S corporations to file under proposed GILTI regulations

In Notice 2019-46, published 22 August 2019, the IRS announced that it will issue regulations permitting certain domestic partnerships and S corporations to apply proposed, rather than final, regulations on determining inclusions of Global Intangible Low-taxed Income (GILTI), for tax years ending before 22 June 2019. The Notice also provides penalty relief for a domestic partnership or S corporation that acted consistently with Prop. Reg. Section 1.951A-5 on or before 21 June 2019, but filed tax returns consistent with the final regulations under Reg. Section 1.951A-1(e).

In addition to penalty relief, the forthcoming regulations would provide relief from possible compliance, administrative and logistical burdens resulting from revising and amending differences between the proposed and final GILTI regulations. They would also provide relief from certain technical issues regarding attributes of a domestic pass-through entity resulting from 2018 GILTI inclusions.

For domestic partnerships or S corporations to apply the relief provided under the Notice, certain notification and reporting requirements must be satisfied. Domestic partnerships and S corporations may rely on the Notice until the forthcoming regulations are issued.

The Notice provides welcome relief for domestic partnerships and S corporations, including private companies, private equity and alternative asset management funds, and "fund of funds," that acted consistently with Prop. Reg. Section 1.951A-5 on or before 21 June 2019, but file their tax returns in accordance with the final regulations under Reg. Section 1.951A-1(e). This penalty relief would apply, provided the Notice's Notification and Distribution requirements are met.

Although it is still recommended that domestic pass-throughs revise and re-issue their Schedule K-1s to remove GILTI inclusions in accordance with the final regulations, that was not practicable in many cases. Many filings were prepared before the issuance of the final regulations; revising and re-issuing Schedule K-1s to remove relatively minor GILTI inclusions would have presented an administrative and logistical burden.

IRS releases final regulations addressing partnership allocations of creditable foreign tax expenditures

On 24 July 2019, the IRS published final regulations (T.D. 9871) under Section 704(b) relating to the allocation of creditable foreign tax expenditures (CFTEs) by a partnership (the 2019 final regulations). The 2019 final regulations adopt, with minor changes, the temporary (T.D. 9748) and proposed (REG-100861-15) regulations addressing CFTEs published on 4 February 2016 (the 2016 temporary and proposed regulations).

As background, CFTEs are generally foreign income taxes paid or accrued by a partnership that are eligible for a credit under Section 901(a) or a US income tax treaty. The IRS and Treasury determined that a partnership's allocation of CFTEs cannot have substantial economic effect within the meaning of Section 704(b) and the regulations. Thus, CFTEs must be allocated in accordance with the partners' interest in the partnership to be respected.

The existing regulations under Section 704(b) provide a safe harbor rule for a partnership to allocate CFTEs in a manner deemed to be in accordance with the partners' interest in the partnership. To apply the safe harbor, a partnership must: (i) determine the partnership's CFTE categories, (ii) determine the partnership's net income in each CFTE category, and (iii) allocate the partnership's CFTEs to each category. To satisfy the safe harbor, a partnership's allocations of CFTEs in a category must be in proportion to the allocations of the partnership's net income in the CFTE category.

The 2019 final regulations, like the 2016 temporary and proposed regulations, address: (i) the effect of a transferee partner's Section 743(b) adjustment on a partnership's net income in a CTFE category, (ii) the effect of certain allocations and guaranteed payments in computing a partnership's net income in a CFTE category, and (iii) certain disregarded payments within a partnership. The 2019 final regulations are effective 24 July 2019.

IRS Chief Counsel legal memo addresses IP transfer to US partnership

In a lengthy internal legal memorandum (ILM 201917007), the IRS Office of Chief Counsel addressed the application of Section 367(d) to a particular set of facts. The facts at issue are completely redacted, which makes interpreting the ILM challenging. Nonetheless, the ILM may offer insights regarding the IRS's views on Section 367(d), the definition of "domestic partnership" in Section 7701(a)(4), and the partnership abuse-of-entity rule in Reg. Section 1.701-2(e).

The ILM appears to adopt a broad view of the abuse-of-entity rule's scope, which may not apply when entity treatment is prescribed and the Code or a regulatory provision clearly contemplate entity treatment and the ultimate tax results. The ILM may suggest that references to rules designating a partnership as a "person" separate from its partners may, in certain instances, be insufficient to show that entity treatment is prescribed.

The ILM is surprising in that it does not specifically address Reg. Section 1.701-2(f), Example 3. In that example, a foreign corporation and a domestic corporation formed a domestic general partnership. As a "United States person" under Section 7701(a)(30) and a "domestic partnership" under Section 7701(a)(30)(B), the domestic partnership was respected as a US shareholder for purposes of determining the controlled foreign corporation (CFC) status of the partnership's wholly owned foreign corporation. The example concludes that the Commissioner may not treat the domestic partnership as an aggregate of its partners for Section 904 purposes.

The IRS asserts that the Section 7701(a)(4) definition of domestic partnership does not apply because it is "manifestly incompatible with the purposes of Reg. Section 1.367(d)-1T(e)(1)." This approach to challenging a transaction, though not entirely new (e.g., see IRS Notice 2010-41), appears to represent a rare assertion by the IRS that a Section 7701 definition does not apply because the definition contravenes the purposes of another Code provision.

While the IRS's views on the scope of the abuse-of-entity rule and the definition of domestic partnership are unexpected, the specific facts at issue in ILM 201917007 were likely determinative. Because the facts are completely redacted, it is hard to draw broad conclusions from the ILM. Nonetheless, taxpayers should be aware of the views expressed in the ILM.

Passive Foreign Investment Company (PFIC)

IRS proposed regulations address passive foreign investment companies, clarify longstanding PFIC issues

On 10 July 2019, Treasury and the IRS issued proposed regulations (REG-105474-18) under the passive foreign investment company (PFIC) rules, providing guidance under Sections 1291, 1297 and 1298.

The proposed regulations:

- Clarify which exclusions from passive income under the subpart F rules are relevant for PFIC purposes
- Specify that various look-through rules under the subpart F definition of passive income are irrelevant for PFIC testing purposes, and that the look-through rules under the PFIC provisions are the only ones to be used for PFIC testing purposes

- Discuss in more detail the operation of the PFIC look-through rules for 25% subsidiaries, including 25% domestic subsidiaries, and payments from related parties
- Provide that an interest of less than 25% in a partnership is a passive asset and produces passive income for PFIC testing purposes
- Clarify application of attribution rules for purposes of determining whether a partner in a partnership is subject to the PFIC rules when the partnership owns PFIC stock through a non-PFIC foreign corporation
- Reduce the likelihood that a foreign real estate corporation will be a PFIC

The proposed regulations also offer guidance concerning the Section 1297(b)(2)(B) exception for insurance companies. The PFIC Insurance Exception rules provide guidance regarding, among other things, whether income of a foreign corporation is excluded from passive income because the income is derived in the active conduct of an insurance business by a qualified insurance corporation. The proposed regulations provide guidance on definitional and computational matters.

The proposed regulations would apply to tax years of US persons that are shareholders in certain foreign corporations prospectively, beginning on or after the date of publication of the final regulations in the Federal Register. Until the regulations are finalized, taxpayers may generally rely on the proposed regulations for all open tax years as if they were final regulations, provided the regulations are consistently applied.

Foreign Investment in Real Property Tax Act (FIRPTA)

IRS releases proposed regulations on FIRPTA tax exception for qualified foreign pension funds' gain/loss attributable to certain interests in US real property

On 6 June 2019, the IRS issued proposed regulations (REG-109826-17) addressing the qualification for the exception from taxation under Section 897(l) for gain or loss attributable to the disposition of, and distributions with respect to, US real property interests (USRPIs) held by qualified foreign pension funds (QFPFs), and certain entities wholly owned by one or more QFPFs (qualified controlled entities).

The proposed regulations also address related withholding requirements under Sections 1445 and 1446.

The proposed regulations largely adopt comments received on regulations issued in 2016 under Section 1445. Generally, they provide detailed requirements for treatment as a QFPF or a qualified controlled entity eligible for the Section 897(l) exception, including rules defining acceptable purposes under which QFPFs may be established, the benefits that may be provided, allowable beneficiaries, limitations on how much of the fund's assets may inure to a single beneficiary, and what information on beneficiaries and distributions the fund must provide to its home country tax authorities.

The proposed regulations would require qualified controlled entities (QCEs) to be wholly owned, directly or indirectly through other QCEs or partnerships, by one or more QFPFs (no de minimis ownership by a person that is not a QFPF or a QCE is allowed) and provide a testing period rule for this purpose. The proposed regulations also include examples illustrating the definitions and how the rules apply to certain investment structures involving QFPFs and QCEs.

Although the new regulations are proposed to apply to USRPI dispositions and distributions described in Section 897(h) that occur on or after the date that final regulations are published in the Federal Register, the proposed regulations may be relied upon for dispositions or distributions occurring on or after 18 December 2015, as long as the taxpayer consistently complies with the rules set out in the proposed regulations.

Certain provisions of the proposed regulations will apply as of 7 June 2019 (the date the proposed regulations were published in the Federal Register). The immediately effective provisions "contain definitions that prevent a person that would otherwise be a qualified holder from claiming the exemption under Section 897(l) when the exemption may inure, in whole or in part, to the benefit of a person other than a qualified recipient," the Preamble explains.

Tax treaties

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

A senior US Treasury official told a Washington audience in December 2019 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.

US-Luxembourg, US-Switzerland tax protocols entered into force

On 9 September 2019, Pierre Gramegna, Minister of Finance of Luxembourg, and J. Randolph Evans, US Ambassador to Luxembourg, announced that the respective ratification procedures of the protocol to the US tax treaty with Luxembourg had been completed, thus bringing the protocol into force. The protocol introduces a new information exchange article, incorporating the exchange of information standard reflected in both the 2008 OECD Model Treaty and the 2006 US Model Treaty.

The US Treasury announced that the Protocol to the 1996 tax treaty between the United States and Switzerland entered into force on 20 September 2019, upon the exchange of instruments of ratification in Bern.

Treasury announces entry-into-force dates of tax treaty protocols with Japan and Spain

The US Treasury Department on 30 August 2019, announced the entry-into-force dates of protocols to the US tax treaties with Japan and Spain. The protocol with Japan entered into force on 30 August 2019, and the protocol with Spain entered into force on 27 November 2019. The four protocols (Japan, Spain, Luxembourg and Switzerland), which had been stalled in the US Senate for many years, were approved by the full Senate on 16 and 17 July 2019.

See below article for details regarding the four tax protocols.

US Senate approves long-delayed tax protocols with Luxembourg, Switzerland, Japan and Spain

The US Senate on 16 and 17 July 2019, gave its advice and consent to approve the following four tax protocols:

- Luxembourg – 2009 Protocol to amend the 1996 Treaty (Luxembourg Protocol)
- Switzerland – 2009 Protocol to amend the 1996 Treaty (Swiss Protocol)
- Japan – 2013 Protocol to amend the 2003 Treaty (Japanese Protocol)
- Spain – 2013 Protocol to amend the 1990 Treaty (Spanish Protocol)

The protocols had been stalled in the Senate for many years. Senator Rand Paul (R-KY) had expressed concerns about privacy issues associated with the exchange of information provisions in the agreements. The Senate Foreign Relations Committee voted the four protocols out of committee on 25 June 2019.

Generally, all four protocols modernize provisions in the respective tax treaties, conforming them to more recent US bilateral tax treaties as well as US law and international standards. The protocols generally conform to provisions in the 2006 US Model Treaty, which was the US's most recent model treaty at the time these protocols were under negotiation.

The Senate Foreign Relations Committee has not yet considered the new US tax treaties with Chile, Hungary and Poland, which may require reservations to account for the 2017 enactment of the Base Erosion and Anti-abuse Tax (BEAT). (See, *Trump Administration hopeful pending tax treaties with Chile, Hungary, and Poland will be approved in 2020*, on page 23.)

The four protocols approved by the Senate are narrower in scope, so no reservations were required for them for the BEAT.

Luxembourg

The Luxembourg protocol introduces a new information exchange article that incorporates the standard in both the 2008 OECD Model Treaty and the 2006 US Model Treaty. It generally provides for full exchange of information upon request for all types of federal taxes in both civil and criminal matters, without regard to a domestic tax interest requirement or domestic bank secrecy rules. (It does, however, include safeguards to protect the confidentiality of the information exchanged.)

Switzerland

The Swiss Protocol was signed on 23 September 2009 (and thereafter corrected on 16 November 2010). It amends the US-Switzerland Treaty signed 2 October 1996. The Swiss Protocol updates the provision relating to exchange of information, addresses the taxation of dividends received by pensions and similar funds, and provides for mandatory arbitration procedures as to certain unresolved cases.

Japan

The Japanese Protocol generally modernizes provisions of the US-Japan Treaty. Key items of the Japanese Protocol include:

- Revised dividend withholding tax exemption
- General exemption on cross-border interest payments
- New definition of indirect interest in real property
- Mandatory binding arbitration procedures
- Revised exchange of information provisions
- Expanded and strengthened provisions regarding assistance in the collection of taxes

Spain

The Spanish Protocol contains the most significant changes compared to the other three protocols. It generally modernizes several provisions of the US-Spain Treaty. Some of the key provisions are:

- A revised dividend withholding tax exemption
- New fiscally transparent entity rules
- A general exemption from source-country tax on cross-border interest, royalties and capital gains
- A new comprehensive limitation on benefits (LOB) provision
- Mandatory binding arbitration procedures
- Revised exchange of information provisions

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Taxpayers should carefully review the protocols and the entry-into-force provisions to determine whether and to what extent they are or will be affected by these new developments.

IRS publishes revised 2019 Tax Treaty Table 1 with numerous updates and footnote clarifications

Earlier in 2019, the IRS published a revised version of its "Tax Treaty Table 1" on the IRS website (Table 1). Table 1 lists the income tax and withholding rates on income other than personal service income, including rates for interest, dividends, royalties, pensions and annuities, and social security payments. The table is referenced by, but no longer included in IRS Publication 515, *Withholding of Tax on Nonresident Aliens and Foreign Entities*.

In general, the revised table contains updates and clarifications that can be categorized as follows:

- Footnote revisions clarifying treaty rate eligibility requirements
- Corrections to footnote references to withholding tax rates
- Removal of certain footnotes and marking them as "reserved" for future updates
- Update of treaty article citation references
- Change or correction of certain treaty rates on interest income

Withholding agents whose systems rely on Table 1 should carefully review the numerous changes and related treaty articles and update their systems as needed.

The IRS included cautionary notes in revised Table 1 to remind users that, although Table 1 is a convenient reference tool used by many withholding agents for withholding rates, it should not be viewed as a substitute for the relevant treaty provisions. To determine whether a reduced rate of tax or an exemption is available, withholding agents instead should review the text of each applicable treaty, the Treasury Department Technical Explanation accompanying the treaty, IRS rulings, and relevant competent authority agreements.

Transfer pricing

Ninth Circuit denies en banc rehearing in *Altera*

On 12 November 2019, the Ninth Circuit Court of Appeals denied a request by the taxpayer in *Altera v Commissioner* for a rehearing before the full court on the issue of whether participants in a cost-sharing arrangement (CSA) must share stock-based compensation costs (SBC costs). A Ninth Circuit panel previously upheld 2003 IRS regulations requiring CSA participants to share SBC costs.

The taxpayer had 90 days from 12 November 2019 to apply for certiorari to the US Supreme Court.

US government aware transfer pricing may be used to reduce TCJA tax liability

An IRS official in early November 2019, warned taxpayers that the US government is aware that transfer pricing could be used to reduce Base Erosion and Anti-abuse Tax (BEAT) and other *Tax Cuts and Jobs Act* (TCJA) tax liability.

While taxpayers are currently reviewing their transfer pricing policies in light of the TCJA and are entitled to pick a price within a range of acceptable arm's-length prices, the official was quoted as saying the IRS will target inappropriate prices that are chosen to avoid BEAT. "A taxpayer who attempts to avoid BEAT by using non-arm's-length transfer pricing may be subject to a transfer pricing adjustment that will flow through and result in a BEAT adjustment," the official said.

US Tax Court rules no Section 6662 penalties after IRS abused discretion in canceling APAs

On 28 October 2019, the US Tax Court determined in Eaton Corp. & Subs v. Commissioner, (*Eaton III*) that a corporation is not liable for penalties under Section 6662 for income tax adjustments made under court rules as part of a 2017 decision (Eaton II) in which the Court held that the IRS abused its discretion in canceling two advance pricing agreements (APAs). In this latest decision, which supplements the 2017 decision, the Court concluded that the penalties do not apply because the adjustments in the earlier decision were not made under Section 482. This is the third in a series of related *Eaton Corporation* cases dating back to 2013.

This series of cases has limited applicability to other taxpayers. The IRS has rarely attempted to cancel an APA.

US Court of Appeals affirms Tax Court's decision in *Amazon* case

The US Court of Appeals for the Ninth Circuit on 16 August 2019, released its opinion in *Amazon.com, Inc. & Subsidiaries v. Commissioner*. Ruling on the Commissioner's appeal, the Court affirmed the Tax Court's decision of 23 March 2017. In that decision, the Tax Court concluded that, under the then-applicable transfer pricing regulations, the definition of "intangible" does not include residual business assets, such as the value of employees' experience, education and training (known as "workforce in place"), nor a culture of innovation, going concern value, goodwill and other unique business attributes and expectancies (which the parties refer to as "growth options").

The Court of Appeals went out of its way to point out that its opinion interprets the definition of "intangible property" under the transfer pricing regulations promulgated in 1994 and 1995 and not the subsequently issued 2009 regulations or the statutory amendment introduced with the *Tax Cuts and Jobs Act of 2017* (TCJA).

In Footnote 1 at the beginning of the opinion, the Court of Appeals explicitly stated that, if the case were governed by the 2009 regulations or by the 2017 statutory amendment of the TCJA, the Commissioner's position would undoubtedly be correct.

While the opinion interprets the outdated 1994/1995 transfer pricing regulations, it also offers several insights for taxpayers that go beyond their temporal scope. The statement in Footnote 1 may be considered dicta and thus not legal precedent, but taxpayers should still consider the potential implications on post-2009 cost-sharing arrangements.

In 2009, Treasury issued temporary regulations broadening the scope of what is included in the buy-in payment upon entering a cost-sharing arrangement.

In the TCJA, Congress amended the definition of intangible property set forth in Section 936(h)(3)(B) to explicitly include workforce, goodwill and going concern. While the Ninth Circuit opinion clearly differentiates its conclusions from subsequent rule changes, there are potentially three separate periods of guidance for taxpayers to consider as they evaluate the impact of the opinion on their specific facts and circumstances.

IRS withdraws "*Altera* Memo" Directive on cost-sharing arrangement stock-based compensation

In light of the US Ninth Circuit's decision in June 2019, reversing the Tax Court's 2015 decision in *Altera v. Commissioner*, the IRS Large Business and International Division (LB&I) formally withdrew the so-called *Altera* Memo (Directive LB&I-04-0118-005) on 31 July 2019, in LB&I-04-0719-008 (Withdrawal of Directive LB&I-04-0118-005).

The LB&I Commissioner noted that examiners should continue applying Reg. Sections 1.482-7A(d)(2) and 1.482-7(d)(3), including opening new examinations regarding cost-sharing arrangement stock-based compensation issues. LB&I stated that "these issues may be factually intensive, and transfer pricing teams should develop the facts to support their analysis and conclusions."

The withdrawal memo also noted that IRS Issue Teams should consult the Practice Network and Counsel for support in analyzing the issue and that LB&I will monitor further developments related to the Ninth Circuit's decision.

Ninth Circuit panel reverses Tax Court in *Altera*, holding stock-based compensation to be a compensable cost under Section 482

On 7 June 2019, in a 2-1 ruling, a Ninth Circuit Court of Appeals panel reversed the Tax Court's holding in *Altera v. Commissioner*, and upheld a 2003 regulation that requires participants in a cost-sharing arrangement (CSA) to share stock-based compensation costs. The Ninth Circuit panel concluded that the 2003 regulations were valid under the *Administrative Procedure Act* (APA).

The Ninth Circuit panel held that, "[i]n sum, we disagree with the Tax Court that the 2003 regulations are arbitrary and capricious under the standard of review imposed by the APA. While the rulemaking process was less than ideal, the APA does not require perfection."

The ruling was the second time the Ninth Circuit had reversed the Tax Court's opinion. The Ninth Circuit heard the case for the second time after withdrawing its initial opinion, in which Judges Sidney R. Thomas and Stephen R. Reinhardt voted to reverse the Tax Court's 2015 decision, due to the death of Judge Reinhardt. In this second opinion, Judge Susan P. Graber, replacing Judge Reinhardt, voted with Judge Thomas to reverse the Tax Court's decision.

Following the issuance of the 7 June 2019 opinion, the taxpayer had 45 days to apply for either a panel rehearing or a rehearing "en banc" by the full Ninth Circuit Court of Appeals or both; Altera requested a rehearing "en banc" on 22 July 2019, which was denied on 12 November 2019. (See, *Ninth Circuit denies en banc rehearing in Altera*, on page 25.)

IRS LB&I withdraws CSA directive

The IRS Large Business and International (LB&I) Division issued a directive withdrawing Directive LB&I-04-0118-004 (RAB Share Directive), dated January 2018, which provided instructions for IRS examiners on transfer pricing issue selection regarding Reasonably Anticipated Benefits (RABs) in Cost Sharing Arrangements (CSAs). Directive LB&I-04-0118-004 directed examiners to cease developing adjustments to CSAs exclusively based on changing a taxpayer's multiple RAB shares to a single RAB share when subsequent platform contribution transactions are added to an existing CSA, until a Service-wide position was finalized.

The new directive, effective 21 May 2019, provides that examination of these CSA issues can now continue "with the application of the most reliable method depending on the facts and circumstances of each case to determine the appropriateness of using single or multiple RAB shares with respect to a single CSA."

IRS releases 2018 APA results

The IRS in Announcement 2019-3, released a report in late March 2019 on the US advance pricing agreement (APA) program covering the 2018 calendar year. A total of 107 bilateral APAs were executed in 2018, with Japan (39%) and Canada (20%) representing the largest number of countries. There were 203 APA applications filed in 2018, with Japan (34%) and India (21%) representing the largest number.

Although most of the transactions covered in APAs executed in 2018 involved the sale of tangible goods or the provision of services, over 20% involved the use of intangible property. The median time for completion of an APA in 2018 was 40.2 months, up from 33.8 months in 2017.

IRS APMA releases Functional Cost Diagnostic Model to be used in certain APAs

On 26 February 2019, the IRS Advance Pricing and Mutual Agreement Program (APMA) released an excel-based financial model that APMA intends to use when reviewing certain Advance Pricing Agreement (APA) requests. The stated purpose of the model is to allow the IRS "to better understand the controlled taxpayers' contributions to the proposed covered transactions, including the respective contributions each controlled taxpayer makes to the exercise of control over the economically significant risks surrounding the proposed covered transactions."

To that end, the Functional Cost Diagnostic Model (FCD Model) collects, identifies, organizes and analyzes the costs incurred by each controlled taxpayer related to the covered transactions. It then computes a pro forma profit (loss) split. APMA will compare the pro forma profit split results to the results achieved under the transfer pricing method proposed in a taxpayer's APA request.

APMA assured taxpayers that it will use the FCD Model in limited circumstances, only for diagnostic purposes, and its application does not imply that the residual profit split is necessarily the "most appropriate method" under the OECD Guidelines for the covered transactions, (see box below).

Although APMA stated it intends to use the FCD Model in a manner consistent with the revised OECD Guidelines for both inbound and outbound cases, stressing concepts such as important functions and control, it is not clear how this relates to concepts and principles already embedded in the Section 482 regulations. For example, it is unclear how the FCD Model will relate to principles such as respecting contractual arrangements (including allocation of risks) that have substance, and the appropriate return to risky financing of investments.

The FCD Model approach is another example of pressures on transfer pricing policies in which risks are separated from functions. If a taxpayer's covered transactions involve more than routine functions and risks, the IRS will ask the taxpayer to complete this model to see if the residual profit split method or another method is more appropriate than the taxpayer's proposed method to provide arm's-length results. This will involve more due diligence on the part of taxpayers, including a viewpoint toward system-wide profit that may not be readily available. While the results of the FCD Model could substantially agree with the results of the taxpayer's original method results, the analysis will have to be completed to make that determination.

IRS LB&I requiring transfer pricing teams to consult with APMA

The IRS Large Business & International Division issued a memorandum (LB&I-04-0219-001) at the end of February 2019, that requires transfer pricing issue teams to consult with the Advance Pricing and Mutual Agreement (APMA) office on issues involving transfer pricing transactions between US taxpayers and related parties in US tax treaty countries that may result in adjustments for which competent authority assistance may be required.

The new requirement applies whether or not the taxpayer currently has a mutual agreement procedure (MAP) or advance pricing agreement (APA) case in APMA or whether APMA has an active relationship with the treaty partner.

IRS may use APMA FCD Model in some exams

The IRS may use the new Advance Pricing and Mutual Agreement Program (APMA) Functional Cost Diagnostic (FCD) Model released in February 2019, in examinations in appropriate cases, according to an IRS official quoted in the tax press. The IRS earlier had indicated that the excel-based financial model was developed for use when reviewing certain Advance Pricing Agreement (APA) requests and was not intended as an examination tool. The official noted, however, that there is no link between the APMA diagnostic tool and recent IRS interim guidance requiring transfer pricing issue teams to consult with APMA before making adjustments involving a related party in a treaty country. (See article above, *IRS LB&I requiring transfer pricing teams to consult with APMA*.)

Withholding

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.

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 2019, 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.

French President comments on new Digital Services Tax

At the conclusion of a three-day G-7 Summit meeting in Biarritz, France, French President Emmanuel Macron commented on the future of France's Digital Services Tax (DST), which entered into force on 25 July 2019. Speaking at the post-Summit press conference with President Trump on 26 August 2019, President Macron said that the French DST would be eliminated, and any DST amounts that are paid by multinational companies would be reimbursed in some way, if a new international tax system with respect to digital services is put in place through the OECD process.

The French DST was enacted in July 2019 with retroactive effect to 1 January 2019. The United States charged that the proposed 3% tax targeted certain US multinationals and launched a probe under Section 301 of the *Trade Act of 1974*. President Trump also threatened retaliatory action on certain French imports, including wine. US officials did not comment at the time on the French statements that the DST will be eliminated and some form of reimbursement provided when new international tax rules covering digital services are in place.

The US Trade Representative held a public hearing on 19 August 2019, on its Section 301 investigation of the DST. According to press reports, the representatives of various US technology companies testifying at the hearing were unanimous in opposing France's DST, noting it could result in double taxation and calling it discriminatory and against tax treaty practice. (See above article on the US trade investigation findings.)

As noted earlier, 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 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.

IRS issues proposed regulations addressing cloud-based and other digital transactions

On 9 August 2019, Treasury and the IRS released proposed regulations (REG-130700-14, Prop. Reg. Section 1.861-19) addressing cloud-based transactions and other transactions involving digital content, such as gaming and social media. Treasury also proposed regulations that would amend current Reg. Section 1.861-18, which provides rules governing transactions involving computer programs.

These proposed rules represent Treasury's first significant attempt to grapple with cloud computing and related digital tax issues. The proposed regulations reflect an incremental approach by Treasury to create a flexible and coherent framework to resolve a host of complex and dynamic tax issues raised by cloud computing transactions and the digital economy. The proposed regulations identify several critical gating issues regarding the classification of cloud computing and other digital transactions, such as characterizing cloud transactions as either the provision of a service or the lease of tangible or intangible property.

The proposed regulations would modernize and expand the software regulations under Reg. Section 1.861-18 to cover "digital content." They would also clarify certain open questions, such as the source of income for transactions involving sales of copyrighted articles and the scope of the rights to publicly display or make a public performance.

With respect to the service or lease characterization determination addressed by Prop. Reg. 1.861-19, the approach in the proposed regulations is generally consistent with how many taxpayers analyze transactions involving digital content and cloud computing transactions. Specifically, the cloud regulations expand on Section 7701(e), which provides factors that distinguish between services and leasing transactions, and common law authorities. Thus, the proposed regulations, if finalized in current form, are unlikely to cause significant disruption or rethinking of reporting positions on income characterization.

The new sourcing rule for sales of digital content through an electronic medium (copyrighted article transaction), however, is a departure from the existing rules for sourcing of inventory products (generally where right, title and interest transfer from seller to buyer). The proposed regulations primary approach for sourcing such income – i.e., the location where users download the digital content – is likely to be burdensome and difficult for taxpayers to track, forcing some taxpayers to effectively rely on the secondary rule (customer location based on sales data) to determine source.

Prop. Reg. Section 1.861-18 would apply to transactions entered into in tax years beginning on or after the date of publication of the Treasury Decision adopting the regulations as final. Prop. Reg. Section 1.861-19 would also apply to cloud transactions entered into in tax years beginning on or after the date of publication of the Treasury Decision adopting the regulations as final.

US reiterates opposition to unilateral digital proposals, EU consensus proves elusive

A senior US Treasury official warned of the dangers of unilateral digital services taxes (DSTs) being enacted around the world, telling an American Bar Association Tax Section meeting in May 2019, that the US government was in active discussions with various countries to dissuade them from taking further action.

The official was quoted as saying that the US government is "arguing very strongly that any such taxes should be deferred until after 2020" to give the OECD the opportunity to come up with a multilateral solution. He criticized DST proposals that impose tax on gross revenue rather than economic profit, which he said disproportionately target US companies. He added that the United States supports increasing market countries' taxing authority by utilizing a marketing intangibles approach.

In a related development, the Council of the European Union on 17 May 2019, held a meeting where they discussed digital taxation as well as the European Union (EU) list of non-cooperative jurisdictions for tax purposes. The Council clarified that if, by the end of 2020, it appears that OECD-level agreement is expected to take additional time, the Council could revert to discussing a possible EU approach to digital taxation. EU consensus on a community-wide approach to digital taxation has proved elusive.

Congressional tax writers concerned over unilateral digital taxation proposals

A bipartisan group of Congressional tax leaders on 10 April 2019, released a statement urging countries to abandon unilateral measures to adopt digital tax measures, and instead "to focus on and engage productively in the OECD dialogue in order to reach measured and comprehensive solutions ... ."

The statement was issued by Senate Finance Committee Chairman Chuck Grassley (R-IA) and Committee ranking member Ron Wyden (D-OR) and House Ways and Means Committee Chairman Richard Neal (D-MA) and Committee ranking member Kevin Brady (R-TX). The statement's release coincided with a meeting of G-20 Finance Ministers in Washington, DC.

On 3 April 2019, Republican House Ways and Means Committee members had written to President Trump to voice their concerns over France's proposed digital services tax. The 16 committee members characterized the French proposal as "designed and explicitly intended to target US companies." The letter, which also referenced the United Kingdom's proposed DST, argued that such taxes act as "a 'de facto' tariff on US exports" and threaten the US tax base. The group urged the Administration to "engage forcefully on these issues, including addressing them as a trade barrier."

Later in April 2019, two US government officials offered their insights on the ongoing global digital taxation debate.

A senior Treasury official was quoted as saying that certain exporting and headquarters jurisdictions might need to accept a modest reallocation of taxing rights to market jurisdictions to achieve global consensus. He indicated that a certain loss of revenue by some countries may be the price for reaching a coordinated, coherent solution to the digital taxation conundrum.

The official cautioned that absent an agreed-upon global solution, unilateral measures will lead to more complexity and "enormous risks of double taxation." He also said that he expected the arm's-length standard would continue to apply in the great majority of transfer pricing cases, but that other approaches might be necessary in some instances.

Foreign Account Tax Compliance Act (FATCA)

GAO issues report on FATCA implementation

The US government Accountability Office (GAO) in early April 2019, released a critical report on implementation of the *Foreign Account Tax Compliance Act* (FATCA), concluding that FATCA data limitations and a lack of a comprehensive strategy had hampered IRS efforts to increase compliance. The GAO recommended specific actions that should be taken to enhance compliance efforts, eliminate overlapping requirements, and mitigate the burdens on US persons abroad.

Among its recommendations, the GAO urged the IRS to develop a "comprehensive plan for managing efforts to leverage FATCA data in agency compliance efforts." The IRS responded that the resources needed to develop such a plan "would be better spent on enforcement activities."

IRS releases final FATCA regulations covering compliance and verification procedures

The IRS issued final *Foreign Account Tax Compliance Act* (FATCA) regulations (TD 9852) under Chapter 4 (Sections 1471 through 1474) on 21 March 2019, that provide compliance requirements and verification procedures for: (1) sponsoring entities of foreign financial institutions (FFIs); (2) certain non-financial foreign entities (NFFEs); (3) trustees of certain trustee-documented trusts; (4) registered deemed-compliant FFIs; and (5) financial institutions that implement consolidated compliance programs (compliance FIs). The regulations are effective 25 March 2019.

Among other things, to follow industry practice, the final regulations expand the definition of the term "responsible person" with respect to a sponsoring entity to include "an officer of an entity that establishes and maintains policies and procedures for, and has general oversight over, the sponsoring entity, provided such individual has sufficient authority to fulfill the duties of a responsible officer."

The final rules also provide that a sponsorship agreement is not required "to be a standalone agreement, and that a sponsorship agreement between a sponsoring entity and a sponsored FFI can refer generally to the obligations of the parties under FATCA."

The preamble to the regulations enforces the 31 March 2019 due date for the sponsoring entity certifications of compliance.

IRS updates FATCA FAQs

The IRS in March 2019, updated FATCA frequently asked question (FAQ) FAQ Q23, extending penalty relief for the 2018 calendar year under certain circumstances. It also published new FAQ Q24, addressing 2018 tax year withholding and reporting requirements for certain partnerships and trusts.

IRS names new IRS Associate Chief Counsel (International)

On 25 April 2019, the IRS's Chief Counsel announced the appointment of Peter Blessing to the position of Associate Chief Counsel (International), which was previously held by Marjorie Rollinson, who left the IRS to join EY as Deputy National Tax Leader.

IRS issues revised FATCA Publication 5188

The IRS in August 2019, released a revised version of Publication 5188 on reporting FATCA (*Foreign Account Tax Compliance Act*) data. The International Data Exchange Services (IDES) user guide provides information for financial institutions, direct reporting non-financial foreign entities, sponsoring entities, non-global intermediary identification number filers, and Host Country Tax Authorities who transmit data through the IDES.

IRS forms

IRS releases final Form 8990 and instructions

The IRS on 31 December 2018, posted the final version of Form 8990, "Limitation on Business Interest Expense Under Section 163(j)." Instructions to the form were posted on the IRS website on 3 January 2019. The government released proposed regulations (REG-106089-18) under Section 163(j) on 26 November 2018, which was modified by the *Tax Cuts and Jobs Act*.

Miscellaneous

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.

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

The IRS in December 2019 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.

Treasury issues final regulations removing Section 385 documentation requirements, issues notice of proposed rulemaking for treating some interests as debt

On 31 October 2019, the Treasury Department issued final regulations (TD 9880) under Section 385 removing the minimum documentation requirements that must be satisfied to treat certain financial arrangements among related parties as indebtedness for federal tax purposes. The final regulations adopt the proposed regulations (REG-130244-17) without any change.

At the same time, Treasury issued an advance notice of proposed rulemaking (ANPR) (REG-123112-19) that would modify the so-called Distribution Regulations, which may treat an issuance of a debt instrument in a distribution (or similar) transaction as stock. The Distribution Regulations include a funding rule that treats as stock a debt instrument that is issued as part of a series of transactions that achieves a similar result.

The most noteworthy proposed modification would remove the funding rule's per-se 72-month period for a more "facts and circumstances" test. According to the ANPR, when issued the proposed regulations would treat the debt as stock only if its issuance has sufficient factual connection to a distribution to a member of the taxpayer's expanded group or an economically similar transaction.

While determining that the Distribution Regulations remain necessary, Treasury intends that the proposed regulations make the regulations "more streamlined and targeted." Treasury further intends the proposed regulations to apply to tax years beginning on or after the date of publication of adopting those rules as final regulations in the Federal Register.

OMB announces new IRS final reg project on rules for domestic shareholders' accounting method changes for foreign corporations

The Office of Management and Budget's Office of Information and Regulatory Affairs on 20 November 2019, released its fall 2019 unified agenda. One new project that was not included in the IRS's 2019/2020 priority guidance plan concerns final regulations that would clarify the application of Reg. Section 1.964-1 relating to the rules for controlling domestic shareholders to adopt or change a method of accounting on behalf of foreign corporations. Proposed regulations date from November 2011.

IRS announces taxpayers can still rely on expired temporary Section 385 recharacterization rules

In Notice 2019-58, released 11 October 2019, the IRS announced that taxpayers may continue to rely on the October 2016 proposed regulations on characterizing certain corporate interests as stock or debt under Section 385, even though the related temporary regulations expired on 13 October 2019.

The expiration of a significant portion of the overall regulatory framework is expected to raise numerous questions regarding ongoing taxpayer compliance with the regulations that remain in place.

As background, the 2016 proposed regulations consisted of a cross-reference to the temporary regulations issued at the same time as the final Section 385 regulations (TD 9790).

The final and temporary regulations (i) established extensive documentation requirements that must be satisfied for a debt instrument to constitute indebtedness for US federal tax purposes (Reg. Section 1.385-2); and (ii) recharacterized a debt instrument issued after 4 April 2016, as stock if the instrument was issued as part of a transaction listed in Reg. Section 1.385-3 and Reg. Section 1.385-3T. Proposed regulations were subsequently issued proposing to revoke the documentation rules and were finalized on 31 October (see previous story for details).

The October 2016 proposed regulations were to apply to tax years ending on or after 19 January 2017, and do not expire. Notice 2019-58 made clear that taxpayers may rely on the October 2016 proposed regulations for periods after the temporary regulations expire until further notice is given, provided taxpayers consistently apply the proposed rules in their entirety.

Significant portions of Reg. Section 1.385-3 that were final, including the essential recharacterization rules of Reg. Section 1.385-3(b), are not affected by Notice 2019-58.

Those portions of the Section 385 regulations that have expired (for which the October 2016 proposed regulations remain in place) generally define the "qualified short-term debt" exception and address the treatment of controlled partnerships.

In addition, Reg. Section 1.385-4T, which provided special rules for consolidated return groups, also expired. Thus, these subject areas are likely to be most affected by the expiration of the temporary regulations.

European General Court rules Netherlands did not grant illegal State aid to Starbucks

On 24 September 2019, the European General Court annulled the decision of the European Commission that the Netherlands granted illegal State aid to Starbucks. This implies that – according to the General Court – the Dutch government did not give Starbucks an advantage as compared to other Dutch taxpayers which operated under similar facts and circumstances, by concluding an Advance Pricing Agreement (APA). The General Court ruled that the European Commission did not demonstrate the existence of a selective advantage giving rise to illegal State aid within the meaning of the of the Treaty on the Functioning of the European Union. Therefore, the General Court annulled the final State aid decision by the European Commission against Starbucks.

The European Commission in October 2015 had rendered its final decision in the State aid investigation regarding an APA that had been concluded by Starbucks Manufacturing EMEA BV with the Dutch tax authorities in 2008. The APA confirmed the arm's-length remuneration of Starbucks Manufacturing EMEA BV's intragroup production and distribution activities, as well as the determination of the royalty payment to its parent company for the use of Starbucks' roasting Intellectual property.

IRS reconsidering Form 1120-F nonfilers compliance campaign

In mid-September 2019, the IRS reportedly was considering ending its compliance campaign on nonfilers of Form 1120-F, "U.S. Income Tax Return of a Foreign Corporation." The campaign, one of the first compliance campaigns to be promulgated by the agency in 2017, had come under criticism by the Treasury Inspector General for Tax Administration (TIGTA). The TIGTA found "low examination referral and proposed assessment rates" resulting from the campaign. According to a TIGTA report released on 16 September 2019, the IRS would evaluate whether the campaign should be amended or suspended entirely.

Proposed Section 382(h) regulations would eliminate 338 safe harbor and modify built-in gain or loss calculations

The IRS issued proposed regulations (REG-125710-18) on 10 September 2019, on the items of income and deductions that are included in calculating built-in gains and losses under Section 382(h), and reflecting changes made to the Code by the *Tax Cuts and Jobs Act* (TCJA). The proposed regulations would eliminate the so-called "338 approach," a safe harbor method as set forth in Notice 2003-65. The proposed regulations would adopt as mandatory another safe harbor method in Notice 2003-65, the "1374 approach," with certain modifications, particularly for cancellation of indebtedness (COD) income and deductions for the payment of contingent liabilities. Other significant changes in the package include the rules related to consolidated groups and the rules related to some international tax provisions, including Sections 951A and 1248.

If finalized in their current form, these proposed regulations would significantly change current practice for utilizing built-in gains or losses that are subject to the Section 382 limitation. The proposed approach would generally offer less taxpayer-favorable determinations of recognized built-in gain (RBIG), because the 338 approach – proposed to be eliminated – is favored by corporations with built-in gains, given their ability to treat "forgone" depreciation and amortization as RBIG, notwithstanding the lack of an actual item of income or gain.

In addition, the proposed changes with respect to the COD income would likely change the status of many loss corporations from a net unrealized built-in gain (NUBIG) to a net unrealized built-in loss (NUBIL) position. Unlike the approach taken by Notice 2003-65, built-in COD income on recourse debt would now only be reflected NUBIG/NUBIL to the extent income from the cancellation of debt is ultimately recognized. In addition, the treatment of contingent liabilities as recognized built-in loss (RBIL) would also significantly expand the treatment of items that constitute RBIL.

For multinational US groups, the proposed regulations would deny RBIG treatment for all dividends from a controlled foreign corporation (CFC), regardless of whether a dividend received deduction is claimed for such dividend under Section 245A (the proposed rule would apply to all dividends under Section 61(a)(7), not just to dividends from CFCs). But the proposed regulations do not address other issues relating to the ownership of CFCs, in which built-in income inside a CFC owned by the loss corporation is not reflected in NUBIG or RBIG, because the asset of the loss corporation is the CFC stock, not the CFC's assets.

Consolidated return groups should keep in mind that Treasury is considering changes to the end-of-day rule and next-day rule of Reg. Section 1.1502-76(b). Taxpayers will need to evaluate such changes, when published, in conjunction with these proposed regulations to evaluate the treatment of loss corporations. Treasury had issued proposed changes to the end-of-day rule and next-day rule of Reg. Section 1.1502-76(b) in part to address a perceived abuse – taxpayers applying the next-day rule purportedly to avoid Section 382. The proposed Section 382(h) regulations appear to address Treasury's concern in this regard by treating the items to which the next-day rule applies as RBIG/RBIL.

DC Circuit affirms *Grecian Magnesite Mining*

The Circuit Court of Appeals for the District of Columbia on 11 June 2019, affirmed the US Tax Court's decision in *Grecian Magnesite Mining, Industrial & Shipping Co. SA v. Commissioner*, and rejected the government's appeal. New Code Section 864(c)(8), enacted by the *Tax Cuts and Jobs Act* effectively overruled the holding in *Grecian*.

Section 864(c)(8) treats the portion of gain (or loss) from the sale or exchange of an interest in a partnership that is engaged in a US trade or business as effectively connected income (ECI), to the extent the gain (or loss) from the sale or exchange of the underlying assets held by the partnership would be treated as ECI allocable to such partner.

JCT releases Blue Book for 115th Congress; TCJA covered by earlier release

The Congressional Joint Committee on Taxation staff released the *General Explanation of Certain Tax Legislation Enacted in the 115th Congress* (JCS-2-19) on 31 October 2019. Colloquially known as the Blue Book (2019 JTC Blue Book), the publication includes a description of all tax legislation enacted in the 115th Congress, with the exception of the *2017 Tax Cuts and Jobs Act* (Public Law 115-97), which was covered in a separate General Explanation released in December 2018.

New LB&I compliance campaigns focus on transfer pricing and information reporting

On 16 April 2019, the IRS announced three new Large Business and International (LB&I) compliance campaigns. The new campaigns concern: (1) transfer pricing between US multinational companies and their foreign captive service providers; (2) income tax and information reporting requirements for offshore bank accounts; and (3) correctly filing Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*.

Campaigns are designed to select returns with identified potential compliance risks. According to the announcement, LB&I identified the campaigns through its data analysis and suggestions from IRS compliance employees. LB&I's stated goal for its campaigns is to "improve return selection, identify issues representing a risk of non-compliance and make the greatest use of limited resources."

The IRS continues to analyze tax return and other information to identify campaigns for audit. The addition of these three new campaigns demonstrates LB&I's continued efforts to move toward an issue-based examination program in which selection of tax returns for audits will be based on identified campaign issues.

Taxpayers that may be affected by a campaign should consider developing strategies to effectively respond to any formal or informal inquiries from the IRS (i.e., issue-based examinations or soft letters).

Puerto Rico

Puerto Rico's new transfer pricing study option could allow full deduction of related-party expenses

Taxpayers may be able to fully deduct related-party expenses in Puerto Rico if they submit a transfer pricing study with their income tax returns.

Although the PR Internal Revenue Code generally disallows an income tax deduction for 51% of the expenses a taxpayer incurs from related persons not engaged in a trade or business in Puerto Rico, a change in the law eliminated this disallowance for tax years commencing in 2019 and later — as long as the taxpayer submits, along with its income tax return, a transfer pricing study that covers the operations carried out within Puerto Rico. Entities interested in submitting transfer pricing studies with their Puerto Rico returns should be sure to take into consideration the time required to have a study completed.

Because no regulations or administrative guidance has been issued by the Puerto Rico Treasury Department (PRTD) at this time, there are unanswered questions and aspects of this new rule that remain unclear. Unofficial statements made by PRTD tax policy officials in public forums have alluded that, in the absence of administrative guidance, a transfer pricing study complying with IRC Section 482 should be sufficient to support full deductibility of related-party expenses under the Code. Nonetheless, this matter should be monitored closely since the PRTD reserves the right to issue an official interpretation on the application of the new transfer pricing option at any time.

Puerto Rico's new Incentives Code includes various tax incentives for investments in opportunity zones

On 1 July 2019, the Governor of Puerto Rico signed into law *Act 60*, also known as the Puerto Rico Tax Incentives Code (Incentives Code), which consolidated dozens of tax decrees, incentives, subsidies and tax benefits in a single statute, including *Act No. 21* of 14 May 2019, also known as the "*Development of Opportunity Zones of Economic Development Act of Puerto Rico of 2019*" (the Act). Through the enactment of the Incentives Code, the Act was repealed. However, most of the provisions of the Act establishing various tax incentives in Puerto Rico for investments in qualified opportunity zones were codified in the Incentives Code.

Approximately 95% of the territory of Puerto Rico is considered a qualified opportunity zone under the parameters established by the US federal government. The opportunity zone provisions under the Incentives Code are intended to align local tax statutes with the benefits afforded under the US *Tax Cuts and Jobs Act of 2017*. In addition to the preferential income tax treatment, the local statute provides for reductions in other local taxes and a transferable tax credit of up to 25% of cash contributed. These provisions, among other benefits such as the expedited permitting process, are intended to make Puerto Rico's market more appealing for investors looking to take advantage of opportunity zones.

Puerto Rico's Treasury Department issues guidance for mandatory electronic filing of CIT returns for 2018 tax year

The Puerto Rico Treasury Department (PRTD) issued guidance (Circular Letter (CL) 19-08) for the electronic filing of corporate income tax returns for tax year 2018.

As background, domestic and foreign corporations that are engaged in a trade or business in Puerto Rico generally must file a corporate income tax return no later than the 15th day of the fourth month following the close of the tax year. For tax year 2018, the corporate income tax return for calendar-year taxpayers had to be filed no later than 15 April 2019; and for fiscal-year taxpayers, by no later than the 15th day of the fourth month following the close of the tax year. Foreign corporations that do not have an office or place of business in Puerto Rico must file their corporate income tax returns no later than the 15th day of the sixth month following the close of the tax year.

For tax year 2018, corporations and limited liability companies taxed as corporations will be required to electronically file their Puerto Rico corporate income tax returns (Form 480.20) through a program certified by the PRTD. Certified programs can be accessed on the PRTD's website under Corporate Returns 2018 under the "Hacienda Virtual" link.

Tax return specialists using a private program to prepare corporate income tax returns for their corporate clients may also use the private program to electronically file these returns. To complete the electronic filing, the tax specialists must be registered with the PRTD and use their social security number or employer identification number and the password provided by the PRTD through email.

The PRTD will not consider a return timely filed if a taxpayer fails to comply with the mandatory electronic filing requirement. Corporations and limited liability companies that file Puerto Rico corporate income tax returns should take notice of the changes so they comply with their filing obligations.

Other corporations (e.g., exempt businesses under the Puerto Rico Incentives Programs filing Form 480.30II, and life insurance companies filing Form 480.40D or Form 480.40F) and conduit entities (e.g., partnerships, LLCs with election or statutorily required to be partnerships) will continue to file their income tax returns on paper.

Puerto Rico announces qualified retirement plan limits for 2019; affects plan sponsors and record-keepers

In Circular Letter 18-21, Puerto Rico's Treasury Department announced the benefits and contribution limits for qualified retirement plans under Section 1081.01(a) of the Puerto Rico Internal Revenue Code of 2011, as amended (the PR Code), for tax years beginning on or after 1 January 2019. Section 1081.01(h) of the PR Code requires the PRTD to report the applicable limits that are announced by the United States IRS and will apply to plans qualified under the PR Code.

The dollar limitations for qualified retirement and certain non-qualified plans that became effective 1 January 2019, were released by the IRS in Notice 2018-83.

Plan sponsors and/or record-keepers of dual qualified plans and Puerto Rico-only qualified plans need to be aware of these limits to timely reflect the appropriate limitations in their systems for tax years beginning on or after 1 January 2019, and to properly assess and comply with applicable withholding and reporting obligations resulting from distributions from those plans.

USVI launches new online platform for companies to file annual reports

The US Virgin Islands (USVI) Office of the Lieutenant Governor launched a new online platform for businesses (Catalyst), which all corporations conducting business in the USVI must use to register and submit their corporate annual reports and franchise tax annual reports beginning with the 2018 tax year.

These reports are due annually and had to be filed on or before 30 June 2019. The Office of the Lieutenant Governor will only accept paper filed annual reports for exempt limited liability companies and any 2017 outstanding annual reports. Existing corporations previously registered with the Division of Corporations and Trademarks are also required to create an online account through the portal.

OECD

The following covers OECD BEPS-related developments over the period 1 January - 31 December 2019.

Digital taxation

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 2019, 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.

OECD releases beneficial ownership toolkit

The OECD on 20 March 2019, released a new beneficial ownership toolkit, the purpose of which is to help governments implement the *Global Forum on Transparency and Exchange of Information for Tax Purposes* standards. The toolkit is meant to ensure that tax administrations have access to reliable information on a company's or other legal entity's ultimate beneficial owners. The toolkit is particularly aimed at developing countries.

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.

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, *US releases trade investigation findings regarding France's Digital Services Tax; proposes imposition of tariffs*, on page 28.)

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.

OECD holds public consultation on Pillar One of BEPS 2.0

The OECD held a public consultation in Paris on 21-22 November 2019 on the proposal from the OECD Secretariat for a "unified approach" under Pillar One of the ongoing project titled "Addressing the Tax Challenges of the Digitalisation of the Economy." The OECD released the Pillar One consultation document on 9 October 2019. Regarding the public consultation meetings, the tax press reported that "several commentators voiced concerns about the lack of clarity of some of the concepts introduced under Pillar One at this stage of the work."

Separate from the public consultation, an OECD official confirmed that digital taxation will be addressed through a multilateral solution agreed to through the OECD framework by the end of 2020. The official was quoted as saying that unilaterally-imposed digital services taxes are incompatible with a BEPS 2.0 Pillar solution. He indicated that a multilateral, consensus-based solution agreed to by the Inclusive Framework is the only way to address the issue.

One key issue to be resolved will be some form of dispute resolution, according to another OECD official. The official was quoted as saying that while "some countries will not agree to binding arbitration" – an idea that the US government has strongly supported – the OECD is exploring other ways to getting to binding dispute resolution without arbitration.

EY submits comment letter on OECD Pillar One

On 12 November 2019, EY submitted a comment letter to the OECD on the public consultation document, Secretariat Proposal for a "Unified Approach" Under Pillar One. The EY submission provides a comprehensive review of the strategic issues involving Pillar 1, as well as key implementation issues that must be resolved.

OECD issues consultation document on technical design aspects of Pillar Two

On 8 November 2019, the OECD released the highly-anticipated public consultation document on the Global Anti-Base Erosion (GloBE) proposal under Pillar Two of the ongoing project titled, "Addressing the Tax Challenges of the Digitalisation of the Economy" (the Consultation Document).

The design proposals were prepared by the OECD Secretariat and do not represent the consensus view of the countries participating in the project as members of the Inclusive Framework.

The GloBe proposal

Pillar Two of the Workplan seeks to develop an integrated set of global minimum tax rules to ensure that the profits of internationally operating businesses are subject to at least a minimum rate of tax. The OECD has indicated that the level at which the minimum tax rate will be set is to be discussed by the participating jurisdictions once other key design elements of the proposal are fully developed.

The four components of the GloBE proposal set out in the Programme of Work include:

a. An income inclusion rule that would tax the income of a foreign branch or a controlled entity if that income was subject to tax at an effective rate that is below a minimum rate.

b. An undertaxed payments rule that would operate by way of a denial of a deduction or the imposition of source-based taxation (including through a withholding tax) for a payment to a related party if that payment was not subject to tax at or above a minimum rate.

c. A switch-over rule to be introduced into tax treaties that would permit a residence jurisdiction to switch from an exemption method to a credit method where the profits attributable to a permanent establishment (PE) or derived from immovable property (which is not part of a PE) are subject to an effective tax rate that is below the minimum rate.

d. A subject to tax rule that would complement the undertaxed payment rule by subjecting a payment to withholding or other taxes at source and adjusting eligibility for a treaty.

The GloBE proposal would also incorporate an ordering rule to avoid the risk of double taxation.

The Consultation Document invites comments on all aspects of the Workplan on Pillar Two, but irequests input on the following three specific aspects of the GloBE proposal:

- Tax base determination: considering the implications of using financial accounts as a possible simplification for determining the tax base and approaches to neutralizing differences between financial accounts and taxable income.

- Blending: considering the extent to which low-tax and high-tax income within the same entity or across different entities within the same group should be combined for purposes of determining the effective tax rate.
- Carve-outs and thresholds: considering possible approaches for restricting the application of the GloBE proposal.

The Consultation Document also includes an annex that sets out several simplified examples illustrating the approaches for addressing temporary differences in the measurement of income for tax and accounting purposes. The facts of the examples are based on the potential application of the income inclusion rule. However, the Consultation Document indicates these approaches might also be suitable for addressing temporary differences in the context of other elements of the GloBE proposal.

As noted earlier, the Consultation Document does not represent the consensus views of the jurisdictions participating in the Inclusive Framework. However, the OECD Secretariat prepared the Consultation Document to focus on specific technical issues in respect of the GloBE proposal where input from stakeholders would be valuable in continuing the work on the project.

There are additional technical and design aspects of the GloBE proposal that depend on policy choices that will need to be agreed within the Inclusive Framework, including, for example, the minimum tax rate, the mechanics and operation of the undertaxed payment rule, and the nature and scope of the subject to tax rule.

As the Consultation Document expressly states, the proposals under Pillar Two represent a substantial change to the tax architecture and go well beyond digital businesses or digital business models. These proposals could lead to significant changes to the overall international tax rules under which multinational businesses operate.

It is important for businesses to follow these developments closely in the coming months as work continues on key technical, design, and policy aspects of the GloBE proposal. Businesses should also consider engaging with the OECD and policymakers at both the national and multilateral levels on the business implications of these proposals. They should also begin to evaluate the potential impact of these changes on their business models.

G20 affirms OECD two-pillar approach; OECD official offers timeline

G20 Finance Ministers and Central Bank Governors issued a press release on 18 October 2019, following their Washington, DC meeting, expressing support for the OECD's two-pillar approach and ongoing progress on the tax challenges arising from the digitalization of the economy. The group affirmed their support for a consensus-based solution and stressed the importance of the Inclusive Framework on BEPS, agreeing to the outlines of the architecture by January 2020, with a final report to be delivered by the end of 2020.

In mid-October, Pascal Saint-Amans, Director of the OECD's Centre for Tax Policy and Administration, elaborated on the timeline. He was quoted as saying the organization hopes to cement the details of its digital tax proposal in January, with a political agreement reached in June 2020. If agreement can be reached in summer 2020, Saint-Amans said the implementation phase would begin. Saint-Amans added, "Then the question is, what will be the instrument to implement it and how much time to develop [rules]? But the goal is to move as fast as possible if we have political agreement. For the time being we are focusing on political agreement."

OECD takes next step on BEPS 2.0 – Pillar One 'unified approach' released

On 9 October 2019, the OECD released a public consultation document outlining a proposal from the OECD Secretariat for a "Unified Approach" under Pillar One (Secretariat Proposal) of the ongoing project titled, *Addressing the Tax Challenges of the Digitalisaton of the Economy* (the Consultation Document).

The Secretariat Proposal does not represent the consensus view of countries that are members of the Inclusive Framework on Base Erosion and Profit Shifting (BEPS). The Secretariat Proposal provides high-level suggestions on the scope of the new rules being developed under Pillar One, an approach to the new nexus concept, and an approach for new and revised profit allocation rules. It is intended to facilitate negotiations among the countries, with the aim of achieving the objective of a political agreement among the Inclusive Framework jurisdictions by the first half of 2020.

The Secretariat Proposal suggests that a "unified approach" under Pillar One should focus on large consumer-facing businesses. This would cover highly digitalized business models as well as businesses interacting with final customers. The Secretariat Proposal broadly defines large consumer-facing businesses as businesses that generate revenue from supplying consumer products or providing digital services that have a consumer-facing element. In this regard, the Secretariat Proposal notes that further work is needed to articulate the scope of the "unified approach," including how to define a consumer-facing business and how to deal with the supply of goods and services through intermediaries, the supply of component products and the use of franchise arrangements.

Moreover, the Secretariat Proposal indicates that some sectors should be carved out, citing extractive industries and commodities in particular. It also notes that there should be further consideration of whether other sectors (e.g., financial services) should be carved out. In addition, it indicates that consideration should be given to a size-base limitation (e.g., using the BEPS Action 13 country-by-country reporting €750 million revenue threshold).

The Secretariat Proposal includes a new nexus concept that is not dependent on physical presence and is largely based on sales. This new nexus is proposed to be separate from the existing permanent establishment concept, and it would operate regardless of whether taxpayers have an in-country marketing or distribution presence or sell through related or unrelated distributors.

Once it is determined that a jurisdiction has the right to tax profits of a nonresident enterprise under the new nexus approach, the next question would be how much profit should be allocated to that jurisdiction. The Secretariat Proposal describes a new profit allocation rule that is applicable to taxpayers within the scope of the "unified approach" and that would operate regardless of whether taxpayers have an in-country marketing or distribution presence (a permanent establishment or a subsidiary) or sell through unrelated distributors.

The proposal suggests that the new and revised profit allocation rules, taken together with existing transfer pricing rules, will need to be simple, avoid double taxation, and significantly improve tax certainty relative to the current position. The rules should be applicable to both profits and losses in order to avoid distortions. The Secretariat Proposal provides for a three-tier mechanism for allocating profits.

The three-tier mechanism would include a formulary approach if there is no nexus under existing principles. Revised profit allocation rules would apply where there is already a nexus in the market jurisdiction under existing rules.

The Secretariat Proposal acknowledges that further technical work is required and includes an annex with a series of specific questions for public comment on significant policy, technical and administrability issues.

G7 Finance Ministers support OECD two-pillar project to develop new rules for taxing multinational businesses

On 18 July 2019, at the conclusion of a two-day meeting in Chantilly, France of the G7 Finance Ministers and Central Bank Governors group, France issued a Chair's Summary of the discussion at the meeting.

The Chair's Summary included a section on international taxation, which focused on the OECD/G20 Inclusive Framework project to address the tax challenges of the digitalization of the economy through revisions to existing profit allocation and nexus rules (Pillar 1) and development of new global minimum tax rules (Pillar 2).

The Chair's Summary indicated that the G7 Finance Ministers agreed that addressing these challenges is urgent and supported a two-pillar solution to be developed through the OECD workplan. The Chair's Summary noted that the new rules to be developed should be administrable and simple and that mandatory arbitration must be a component of this global solution.

With respect to the Pillar 1 work on revising profit allocation and nexus rules, the Chair's Summary reflected the G7 group's discussion aimed at bridging the gap between the US "marketing intangibles" proposal and the "user participation" proposal favored by many European countries, including, in particular, the UK and France.

The potential unification of these alternative proposals is reflected in the G7 group's agreement that the OECD should work on an approach under which the new taxing rights under Pillar 1 would be determined "by reference to criteria reflecting the level of businesses' active participation in a customers' or users' jurisdiction, such as valuable intangibles or employment of a highly digitalized model." The concept of highly digitalized business models is referenced twice in the Chair's Summary, underscoring the importance of this aspect of the project to some European countries.

The Chair's Summary also stated that the new rules for profit allocation and nexus should be administrable and simple, further noting that the G7 group agreed that, "in order to avoid double taxation and ensure the stability of the international tax system, robust and effective tax dispute resolution through mandatory arbitration must be a component of this global solution."

With respect to the Pillar 2 work on new global minimum tax rules, the Chair's Summary stated that the G7 group agreed that a minimum level of effective taxation – "such as for example the U.S. Global Intangible Low-taxed Income (GILTI) regime" – would contribute to ensuring that companies pay their fair share of tax. The Chair's Summary further noted that "the tax level to be set would depend on concrete design features of the rules."

G20 Finance Ministers and Central Bank Governors welcome progress on addressing tax challenges from digitalization, reiterate commitment to final solution by 2020

The G20 Finance Ministers and Central Bank Governors meeting in Fukuoka, Japan on 8-9 June 2019, concluded with the issuance of a communiqué on key topics discussed at the meeting.

With respect to the current OECD project on digitalization, the communiqué said the group welcomed "the recent progress on addressing the tax challenges arising from digitalization" and endorsed the Workplan that was agreed to by the Inclusive Framework on BEPS and released by the OECD on 31 May 2019. In addition, the communiqué stated that the G20 countries plan to "redouble" efforts for a consensus-based solution with a final report by 2020.

OECD workplan envisions global agreement on new rules for taxing multinational enterprises

On 31 May 2019, the OECD released its document *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy* (the Workplan).

The Workplan describes the planned approach for addressing the tax challenges of the digitalization of the economy that has been agreed upon by the 129 jurisdictions participating in the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS). The Workplan was approved at the 28-29 May 2019 plenary meeting of the BEPS Inclusive Framework. The Workplan was presented by OECD Secretary-General Angel Gurría to G20 Finance Ministers for endorsement during their 8-9 June 2019 ministerial meeting in Fukuoka, Japan.

Under the Workplan, an outline of the architecture of a long-term solution to address the challenges of the digitalization of the economy is to be submitted to the Inclusive Framework for agreement in January 2020. Work will continue to flesh out the policy and technical details of the solution throughout 2020 to deliver consensus agreement on new international tax rules by the end of 2020.

The Workplan acknowledges that this is an extremely ambitious timeline due to what it describes as "the need to revisit fundamental aspects of the international tax system." The Workplan states that this reflects the "political imperative" that the participating jurisdictions attach to timely resolution of the issues at stake.

OECD holds consultation on tax challenges of digitalization with aggressive 2020 timeline for consensus

The OECD on 13-14 March 2019, held its eagerly-anticipated public consultation on preliminary proposals for addressing the global tax challenges of digitalization. The groundwork for the meeting was the OECD consultation document, *Addressing the Tax Challenges of the Digitalisation of the Economy*, that was released in February 2019.

OECD officials at the time emphasized that the effort is in the early stages, with plenty of future opportunities for public input. EY submitted a comment letter and a global team of EY representatives participated in the consultation.

The OECD received over 200 comment submissions on the consultation document that was issued in February 2019.

During the meeting, dozens of stakeholders urged caution in the development of the details of what potentially are sweeping changes to long-standing rules for determining taxing jurisdiction over business profits and broad new anti-base erosion rules that go well beyond the 2015 Base Erosion and Profit Shifting (BEPS) project recommendations. Many stakeholders also expressed the view that some changes to the international tax system are inevitable to better align the taxing rules with the new global economy. Because the consultation was intended as an opportunity to hear from stakeholders, the government representatives who attended were largely in listen mode and did not share their views during the sessions.

OECD opens public consultation on addressing tax challenges arising from digitalization of the economy

On 13 February 2019, the OECD issued a public consultation document seeking public comments on possible solutions identified to address the tax challenges arising from the digitalization of the economy.

The publication of the consultation document was discussed in the 29 January 2019 Policy Note, published by the Inclusive Framework on BEPS (BEPS IF), following the agreement by the 128-strong members of the BEPS IF to examine proposals involving two pillars. Pillar One includes proposals for revised nexus and profit allocation rules and Pillar Two considers a global anti-base erosion proposal.

The OECD notes that the proposals included in the consultation do not represent the consensus views of the BEPS IF, the OECD's Committee on Fiscal Affairs (CFA) or their subsidiary bodies.

The consultation document described the proposals discussed by the BEPS IF at a high level, and sought comments from the public on a number of policy issues and technical aspects.

The 32-page consultation document is divided into three key sections:

- **Section 1: Introduction**: provides detailed background, reviewing the OECD's work in this area to date
- **Section 2: Revised profit allocation and nexus rules**: provides detailed examination of three key proposals under debate
- **Section 3: Global anti-base erosion proposal**: sets out proposals to address the continued risk of profit shifting to entities subject to no or very low taxation

The discussion on revising the profit allocation and nexus rules focuses primarily on two proposals: user participation and marketing intangibles. The user participation proposal addresses digital business and the value created by digitalized businesses through "developing an active and engaged user base, and soliciting data and content contributions from them." That value is most significant in business models such as social media, search engines, and online marketplaces. The proposal seeks to revise profit allocation rules to accommodate such value-creating activities, and to revise nexus rules so that user jurisdictions would have the right to tax the additional profit allocable to them.

A marketing intangibles approach would change the profit allocation and nexus rules for a broader set of businesses (beyond digital) that enter a jurisdiction to develop a user/customer base and other marketing intangibles. The document acknowledges "an intrinsic functional link between marketing intangibles and the market jurisdiction."

Current transfer pricing and tax treaty rules would have to be modified under the proposal, to require marketing intangibles and risks associated with such intangibles to be allocated to the market jurisdiction, which would be entitled to tax some or all of the associated income. A "significant economic presence" proposal is also discussed.

The consultation paper's second pillar addresses the remaining BEPS challenges of risk and profit shifting to entities that are subject to no or very low taxation, through a global anti-base erosion proposal: this includes two interlocking rules – an income inclusion or minimum tax, and a tax on base eroding payments. The income inclusion rule would operate as a minimum tax by requiring a shareholder in a foreign branch or controlled entity to bring into account a proportionate share of income if that income was subject to a low effective tax rate in the jurisdiction, applied on a per jurisdiction basis.

The proposal for a tax on base eroding payments would include both an "undertaxed payments rule" that would deny a deduction for a payment to a related party if the payment was not subject to tax at a minimum rate, and a "subject to tax rule" to deny treaty benefits if the item of income is insufficiently taxed in the other jurisdiction.

OECD releases policy note addressing tax challenges of digitalization

The OECD on 29 January 2019, released a press release and Policy Note in relation to its work on *Addressing the Tax Challenges of the Digitalisation of the Economy*. The policy note confirmed that a two-pillar approach would be pursued in developing comprehensive changes to international tax policy.

The policy note stated that there was agreement among the 127-jurisdiction strong Inclusive Framework on BEPS to examine proposals involving two pillars which could form the basis for consensus. The first pillar would address the broader challenges of the digitalized economy and focused on the allocation of taxing rights among countries, including nexus issues.

The second pillar would address remaining BEPS issues. The OECD believes that a two-pillar approach would be effective in recognizing that the digitalization of the economy is pervasive, raises broader issues, and is most evident in, but not limited to, highly digitalized businesses.

OECD BIAC issues tax principles for digital economy

The Business and Industry Advisory Committee to the OECD (BIAC) on 21 January 2019, released 11 principles to guide tax reform for the digital economy. According to the BIAC, the recommendations are to ensure that "reforms to existing tax principles are coherent, pro-growth, and do not inhibit the innovation and digitalization that is transforming our world." The BIAC underscored that the OECD BEPS project itself recognized that it would be "difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes," which is one of the BIAC's recommendations.

Among the positions taken, the BIAC says that any tax reform in the context of the digital economy should be based on "well-founded underlying principles of international taxation including taxation of net income, nexus, permanent establishment, and transfer pricing based on the arm's length standard." They add that any revised framework should apply to all digitalizing business and be flexible enough to address future business models. Among other things, the BIAC took a strong stand against countries taking unilateral action, suggesting that the OECD is the only forum that can garner global support and point to the agreed-to international timeline of reaching consensus by 2020.

Country-by-Country Reporting (CbCR)

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 additional guidance on CbC Reporting, summary of common errors made by MNE groups in preparing reports

On 5 November 2019, the OECD released additional guidance to give greater certainty to tax administrations and multinational enterprise (MNE) groups on the implementation and operation of BEPS Action 13 Country-by-Country Reporting (CbCR).

The existing guidance on the implementation of CbCR consequently has been updated to include questions and answers on, among other topics, treatment of dividends, the deemed listing provision, accounting periods other than 12 months, the requirements for and operation of local filing, the use of rounded amounts and the information that must be provided with respect to the sources of data used.

The OECD also published a summary of common errors made by MNE groups in preparing CbC reports (the Summary). The release of this Summary aims at helping MNE groups to avoid these errors and tax administrations in detecting them when they occur.

The guidance marks the ninth release by the OECD regarding practical questions that have arisen concerning the implementation and operation of CbCR. The guidance will continue to be updated with any further guidance that may be agreed by the inclusive Framework on BEPS.

India ratifies US-India CbC exchange agreement

The Indian Government announced that on 25 April 2019, it ratified the pending US-India agreement on the automatic exchange of country-by-country (CbC) reports. The new agreement, signed on 27 March 2019, will enable both countries to exchange CbC reports filed by ultimate parent entities of international groups in the respective jurisdictions, for financial years beginning on or after 1 January 2016. Therefore, Indian constituent entities of US headquartered international groups that have already filed CbC reports in the United States would not be required to file CbC reports locally in India. Consistent with this, the IRS website was updated to indicate that local filing will not be required in India.

Mutual Agreement Procedure (MAP)

OECD holds first Tax Certainty Day and releases 2018 Mutual Agreement Procedure statistics

On 16 September 2019, the OECD held its first OECD Tax Certainty Day at the OECD headquarters in Paris. The event was organized by the OECD Forum on Tax Administration (FTA). Over 200 tax policymakers, tax administration officials, business representatives (including EY professionals) and other stakeholders from over 50 jurisdictions participated. The discussion focused on the state of the tax certainty agenda and ways to make further improvements to both dispute prevention and dispute resolution.

During the event, the OECD published a report on the 2018 Mutual Agreement Procedure (MAP) statistics. For 2018, the report includes statistics from all OECD and G20 members and the members of the OECD Inclusive Framework on BEPS that joined the Inclusive Framework prior to 2019 – for a total of 89 jurisdictions, covering almost all MAP cases worldwide.

For the first time, the 2018 MAP statistics compare the reporting jurisdictions' performance with respect to key indicators for each type of case through an interactive tool.

Transparency

OECD releases database to provide insights on global profiles of individual multinational enterprises

The OECD has developed a new database — the Analytical Database on Individual Multinationals and Affiliates (ADIMA) — which provides information on individual multinational enterprises (MNEs) and their global presence. The ADIMA database contains public information on the physical and digital locations of the MNE, detailed financial and quantitative data (including revenue, profit, income tax and number of employees), and an indication of "events" such as large company restructurings.

The database currently contains 100 of the largest publicly traded, non-state-owned MNEs (by sales) in the world, with both more companies and data points expected to be added in future releases. The MNEs in aggregate generated nearly US$10 trillion in revenues (almost 20% of the global gross domestic product), earned $730 billion in profits and paid $185 billion in taxes.

The purpose of the database is to a provide a "whole view" of MNEs, including where they are located, how they operate and where they pay taxes. The OECD used several open big data sources to collect public information on individual MNEs and their global footprint. The creation of the ADIMA, with its detailed and individualized data, is an important development in global transparency.

Companies should be aware of the information about them that is included in the database and how this information aligns with the information that is required to be provided to the tax authorities (e.g., transfer pricing documentation and country-by-country reporting).

Exchange of Information

OECD releases additional guidance on spontaneous exchange of information by no or only nominal tax jurisdictions

On 31 October 2019, the OECD released new guidance titled "Substantial Activities in No or Only Nominal Tax Jurisdictions: Guidance for the Spontaneous Exchange of Information."

The guidance addresses the practical modalities regarding the exchange of information requirements of the "substantial activities requirement" for "no or only nominal tax" jurisdictions (the Standard) that was agreed to by the Inclusive Framework on BEPS in 2018. It provides guidance on the timelines for the exchanges, the international legal framework under which they may occur and clarifications on the key definitions, to ensure that spontaneous exchanges take place in a coordinated and efficient manner.

The guidance also contains a standardized IT format for the spontaneous exchanges, the No or only nominal Tax Jurisdictions (NTJ) XML Schema and the related user guide.

It is expected that exchanges pursuant to the standard will commence in 2020.

Tax administration

OECD's FTA publishes 7 reports on tax administration, including joint audits

The OECD Forum on Tax Administration (FTA) held its 12th plenary meeting in Santiago, Chile, on 26-28 March 2019. At this year's plenary, the FTA focused on four priorities:

- Delivering on base erosion and profit shifting (BEPS) and tax certainty
- Improving tax cooperation
- Supporting the continued digitalization of tax administrations
- Building capacity for developing countries

FTA members also welcomed publication of seven reports that provided tax administrations with direct, practical assistance on the four priorities.

Joint Audit Report

Among the released reports was "Joint Audit 2019 – enhancing tax co-operation and improving tax certainty." The report identifies both the benefits that may arise from the greater use of joint audits, as well as the challenges that must be overcome to ensure that those benefits can be realized as effectively and efficiently as possible, for both tax administrations and taxpayers.

The report is divided into seven chapters. The first chapter outlines the approach of the FTA Joint Audits Project, the second chapter illustrates the role that joint audits can play in enhancing tax certainty, and the third chapter provides an overview of the key benefits and the cost associated with the conduct of joint audits. The fourth chapter describes the current international landscape from the perspective of the exchange of taxpayer information in connection with joint audits, and the fifth chapter addresses the role of the taxpayer during the joint audit. The sixth Chapter deals with building capacity, relationships and trust in a dedicated network for international cooperation in joint audits.

The report concludes with a summary of the joint audit process and includes practical guidance and best practices for conducting joint audits.

OECD FTA announces ICAP 2.0

The OECD's Forum on Tax Administration (FTA) announced a second pilot of the International Compliance Assurance Program (ICAP 2.0). A new handbook that will guide the second pilot was also endorsed and published by the FTA. ICAP is a voluntary risk assessment and assurance program designed to facilitate open and cooperative multilateral engagement between multinational enterprise (MNE) groups willing to engage actively and transparently and tax administrations in jurisdictions where the MNEs have business activities.

The first ICAP pilot program was launched in January 2018, with the participation of eight FTA member jurisdictions (Australia, Canada, Italy, Japan, the Netherlands, Spain, the UK and the US). ICAP 2.0 includes nine additional participating tax administrations: Austria, Belgium, Denmark, Finland, Germany, Ireland, Luxembourg, Norway, and Poland.

Peer reviews

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 releases sixth batch of peer review reports on Action 14

On 24 October 2019, the OECD released the sixth batch of peer review reports relating to the implementation by Argentina, Chile, Colombia, Croatia, India, Latvia, Lithuania and South Africa of the BEPS minimum standard on Action 14 (*Making Dispute Resolution Mechanisms More Effective*). Colombia, Latvia and Lithuania had also requested that the OECD provide feedback concerning their adoption of the Action 14 best practices, and the OECD also therefore released three accompanying best practices reports.

Overall, the reports conclude that five of the eight assessed jurisdictions meet the majority or most of the elements of the Action 14 minimum standard. Latvia meets slightly more than half of the elements of the Action 14 minimum standard, and India meets half of the elements. Colombia meets fewer than half of the elements of the Action 14 minimum standard. In the next stage of the peer review process, each jurisdiction's efforts to address any shortcomings identified in its Stage 1 peer review report will be monitored.

OECD releases outcomes of second phase of peer reviews on BEPS Action 13, announces public consultation

On 3 September 2019, the OECD released the compilation of outcomes of the second phase of peer reviews of the minimum standard on Action 13 *(Transfer Pricing Documentation and Country-by-Country Reporting)* of the BEPS project.

According to the compilation, over 80 jurisdictions have already introduced legislation to impose a filing obligation for Country-by-Country (CbC) Reporting on multinational enterprise (MNE) groups, covering almost all MNE groups with consolidated group revenue equal to or exceeding €750 million. Where legislation is in place, the implementation of CbC Reporting has been found to be largely consistent with the Action 13 minimum standard. However, 41 jurisdictions have received a general recommendation to either put in place or finalize their domestic legal or administrative framework, and 17 jurisdictions received one or more recommendations to make improvements to specific areas of their framework.

In addition, the OECD updated its website on country-specific information on CbC Reporting. The updated website includes an enhanced table providing high-level information on jurisdictions' implementation of CbC Reporting.

OECD releases United States Stage 2 peer review report on implementation of Action 14 minimum standard

On 13 August 2019, the OECD released the Stage 2 peer review report for the United States relating to the BEPS minimum standard under Action 14 on improving tax dispute resolution mechanisms.

The US was among the six assessed jurisdictions included in the first batch for which the OECD has released Stage 2 peer review reports. (The other Stage 2 peer review reports covered Belgium, Canada, Netherlands, Switzerland, and the United Kingdom.) Overall, the report concludes that the US addressed most of the shortcomings identified in its Stage 1 peer review report. The report noted that although US tax treaties contain a provision relating to mutual agreement procedures, not all US treaties are consistent with the requirements of the Action 14 minimum standard.

In addition to the peer review report, the OECD released an accompanying document addressing the implementation of best practices.

OECD releases update on peer review of preferential tax regimes and no-or-only-nominal tax jurisdictions

On 23 July 2019, the OECD released an update on the results of the peer reviews of jurisdictions' domestic laws under BEPS Action 5.

The updated results cover 56 regimes, bringing the number of regimes that have been reviewed, or are under review, to 287. The assessments were undertaken by the OECD Forum on Harmful Tax Practices (FHTP). The update is an indication of the extent of the ongoing work aimed at ending harmful tax practices, through the requirement that all preferential regimes require adequate levels of substance. The peer review results will continue to be updated from time to time, as approved by the Inclusive Framework on BEPS.

OECD publishes full version of Model Tax Treaty

The OECD on 25 April 2019, published the 10th edition of the full version of the OECD Model Tax Treaty. The full version includes the full text of the Model Treaty as it read on 21 November 2017. It further includes articles, commentaries, non-OECD member positions, recommendations of the OECD Council and historical notes and background reports.

Additionally, the OECD released the results of the review of the substantial activities factor for no-or-only-nominal tax jurisdictions. Twelve jurisdictions had been identified by the FHTP as being a no-or-only-nominal-tax jurisdiction.

The releases underscore the swift and geographically comprehensive progress being made on the implementation of BEPS Action 5 on harmful tax practices.

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

On 14 February 2019, the OECD released the fifth batch of peer review reports relating to the implementation by Estonia, Greece, Hungary, Iceland, Romania, Slovak Republic, Slovenia, and Turkey of the BEPS minimum standard on Action 14, (*Making Dispute Resolution Mechanisms More Effective*). The reports conclude that the majority of these jurisdictions meet most or almost all of the elements of the Action 14 minimum standard. Iceland meets more than half of the elements of the Action 14 minimum standard, and Romania meets less than half of these elements. In the next stage of the peer review process, each jurisdiction's efforts to address any shortcomings identified in its Stage 1 peer review report will be monitored. The Stage 2 peer review of the fifth batch was scheduled to commence in October 2019.

OECD releases first annual peer review report on BEPS Action 6

On 14 February 2019, the OECD released the first peer review report relating to the compliance by members of the Inclusive Framework on BEPS (IF on BEPS) with the minimum standard on BEPS Action 6 for prevention of treaty abuse. The report covers 116 jurisdictions; it reflects information available as of 30 June 2018 (cut-off date).

Overall, the report concludes that a large majority of the IF on BEPS members have begun to translate their commitment on treaty shopping into actions and are now in the process of modifying their treaty network. According to the report, the peer review shows the efficiency of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI) in implementing the treaty-related BEPS measures. The MLI is by far the preferred tool of the IF on BEPS members for implementing the minimum standard.

By the cut-off date, 82 jurisdictions had some agreements that were already compliant with the minimum standard or were subject to a complying instrument. Once the complying instrument (i.e., the MLI or a protocol/treaty) takes effect, the agreements will come into compliance with the minimum standard.

The progress of the jurisdictions assessed will be reflected in peer review reports in subsequent years.

According to the report, the ultimate aim of the BEPS work on Action 6 is to put an end to treaty shopping. In this respect, the report mentions that the work on Action 11 (*BEPS data analysis*) will help in the monitoring of the impact of the implementation of the minimum standard on treaty shopping and in the interpretation of the aggregate and jurisdictional data in future peer review reports.

Most treaty changes to implement the minimum standard under BEPS Action 6 will be effective from 2020. Any conflicts that might occur from these treaty changes will have to be resolved through Mutual Agreement Procedures.

Preferential regimes

OECD issues 2018 progress report on preferential regimes

The OECD on 29 January 2019, released *Harmful Tax Practices – 2018 Progress Report on Preferential Regimes* (2018 Progress Report). The purpose of the report is to provide an update to the 2017 Progress Report and to report the results of the review of identified preferential tax regimes of Inclusive Framework members.

United Nations (UN)

UN updates tax treaty negotiation manual

The 2019 United Nations (UN) tax treaty negotiation manual was updated to reflect changes in the 2017 UN Model Treaty to include changes that resulted from the OECD's Base Erosion and Profit-Shifting Project. The *Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries* which covers entitlement to treaty benefits was finalized and adopted during the 18th session of the UN Committee of Experts on International Cooperation in Tax Matters in New York, on 23-26 April 2019.

UN subcommittee issues paper on digital taxation

The United Nations Subcommittee on Tax Challenges Related to the Digitalization of the Economy prepared a paper for the Committee of Experts on International Cooperation in Tax Matters for its 18th Session on 23-26 April 2019. The Subcommittee noted that its work is independent of ongoing work in other forums, most notably the OECD. The report, which proposes a general workplan and guiding principles, addresses tax treaty issues, domestic law, and value added tax issues.

The Subcommittee identified the tax challenges of the digitalization of the global economy as fundamentally about the inability of the "source jurisdiction" under the physical presence criteria of tax treaties "to tax business profits of certain *new* business models not requiring a *physical* presence in the market to derive such profits." The paper describes possible approaches for addressing these challenges, particularly in respect of developing countries.

The paper was guided by the following principles: avoiding both double taxation and non-taxation; a preference for taxing income on a net basis where practicable; and simplicity and administrability.

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