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Treasury and IRS news

IRS issues final and proposed interest expense limitation regulations

Treasury and the IRS on 28 July 2020, released final regulations (TD 9905) and proposed regulations (REG-107911-18) on the business interest expense limitation under Section 163(j) (the Section 163(j) Limitation). The Section 163(j) Limitation was modified in December 2017 by the *Tax Cuts and Jobs Act* (TCJA), and in March 2020 by the *Coronavirus Aid, Relief, and Economic Security Act* (CARES Act).

At the same time, the IRS issued Notice 2020-59, which creates a safe harbor allowing taxpayers that manage or operate qualified residential living facilities to be treated as a real property trade or business solely for purposes of qualifying as an electing real property trade or business. The government also released FAQs on the aggregation rules that apply for purposes of the gross receipts test and determining whether a taxpayer is a small business exempt from the Section 163(j) deduction.

The eagerly-anticipated final regulations provide guidance on:

- Items treated as interest expense and interest income for purposes of Section 163(j)
- The exclusion of certain small taxpayers and trades or business from the Section 163(j) Limitation
- The application of the Section 163(j) Limitation to consolidated groups, partnerships, foreign corporations, trusts and other taxpayers (such as REITs)
- The interaction of Section 163(j) with other deferral, disallowance and capitalization rules
- Ordering rules for taking into account previously disallowed interest expense
- Elections for excepted trades or businesses and how to allocate interest expense, interest income and other items
- Coordination of the final regulations with the provisions of the CARES Act

There are significant changes in the final regulations, as compared to the former proposed regulations, including:

- Narrowing the proposed scope of the items treated as interest income and expense to exclude commitment fees, debt issuance costs, and gains/losses from certain hedging transactions, except in cases of abuse
- Permitting taxpayers to add depreciation, amortization or depletion allowances that are capitalized into inventory under Section 263A to "tentative taxable income" when calculating adjusted taxable income (ATI) for tax years beginning before 1 January 2022
- Precluding intercompany transactions and asset transfers to an acquiring corporation in a Section 381(a) transfer from being treated as a "sale or other disposition"

The final regulations apply to the first tax year beginning 60 days after the final regulations are published in the Federal Register (i.e., 1 January 2021, for calendar-year taxpayers). An anti-avoidance rule applies to transactions entered on or after the date the final regulations are published in the Federal Register. Taxpayers may apply the final regulations to tax years beginning after 31 December 2017, so long as they consistently apply all of the final regulations.

The Section 163(j) proposed regulations:

- Include a substantially modified set of rules for applying the Section 163(j) Limitation to controlled foreign corporations (CFCs), including CFCs that are members of a "CFC group"
- Clarify the application of Section 163(j) to different partnership structures
- Provide guidance under the CARES Act on excess business interest expense allocated to a partner in a partnership in a 2019 tax year, and the election to use ATI from the last tax year beginning in 2019 to determine a taxpayer's Section 163(j) limitation for a 2020 tax year
- Provide rules for applying the Section 163(j) Limitation to foreign persons with effectively connected income

The proposed regulations generally are not retroactive, though taxpayers may choose to apply them to tax years beginning after 31 December 2017.

Final and proposed GILTI regulations deliver few benefits and more than a few surprises

Treasury and the IRS issued final regulations (TD 9902) and proposed regulations (REG-127732-19) on 20 July 2020 (published in the Federal Register on 23 July 2020), addressing the application of the high-tax exclusions from Global Intangible Low-Taxed Income (GILTI) under Section 951A(c)(2)(A)(i)(II) (the GILTI high-tax exclusion) and from subpart F income under Section 954(b)(4) (the proposed subpart F high-tax exception), respectively.

The elective GILTI high-tax exclusion allows taxpayers to exclude from their GILTI inclusion items of a controlled foreign corporation's (CFC) gross tested income subject to a high effective rate of foreign tax.

This exclusion applies at the level of each "tested unit" of a CFC, which will lower the amount of gross tested income excluded from a taxpayer's GILTI inclusion.

The proposed subpart F income high-tax exception would conform that exception to the final GILTI high-tax exclusion. When finalized, a single election would be available to apply both the GILTI high-tax exclusion and the subpart F income high-tax exception.

More specifically, the final GILTI high-tax exclusion:

- Excludes from a CFC's gross tested income under Section 951A income items subject to an effective foreign tax rate over 18.9% (i.e., 90% of the highest corporate rate based on the current 21% corporate tax rate)
- Applies regardless of whether the CFC has tested income or a tested loss
- Applies at the level of each "tested unit" of a CFC, substantially eliminating blending of income subject to different rates of foreign tax
- Applies to every CFC in which a taxpayer holds, or is treated as holding, a majority equity interest (a CFC group)
- May be elected on an annual basis
- Applies generally for tax years beginning on or after 23 July 2020
- Permits taxpayers to apply the election retroactively to any CFC tax year beginning after 31 December 2017, if they apply the final regulations consistently to each year for which the election is made

The proposed regulations would conform the existing subpart F income high-tax exception to the GILTI high-tax exclusion and would apply a single unified election to both provisions (or neither) for a tax year. That is, the proposed regulations generally would:

- Incorporate the tested unit principles of the GILTI high-tax exclusion into the subpart F income high-tax exclusion
- Combine the GILTI high-tax election and the subpart F income high-tax election into a single election, requiring the election to apply simultaneously to *both* the GILTI and the subpart F income high-tax "exceptions," or to *neither*
- Conform generally to the rules governing the elections (including the requirement to apply the unified election to every CFC in a CFC group)

Many taxpayers will find the high effective foreign tax rate threshold adopted by the final regulations difficult to meet, especially as it applies to each tested unit of a CFC. Whether and the extent to which the exclusion reduces a taxpayer's GILTI inclusion, however, will require careful modeling – for current year (tax year 2019), future years, and also for previously filed tax years beginning after 2017.

The proposed regulations would replace the existing subpart F income high-tax exception and the newly-finalized GILTI high-tax exclusion with a unified high-tax exception. Many aspects of the proposed regulations were foreseeable (for example, the CFC group consistency rules and the tested unit standard). Yet the combination of the subpart F income high-tax exception and GILTI high-tax exclusion into a unified high-tax exception may surprise many taxpayers -particularly those that have applied the current high-tax exception in recent years.

Taxpayers should soon evaluate whether the unified high-tax exception is likely to be available, and advantageous, under the proposed regulations.

Final FDII regulations retain proposed regulations' structure, but reduce documentation burden, defer effective date and make important substantive changes to computation of Section 250 deduction

Treasury and the IRS on 9 July 2020 released final regulations under Section 250 (TD 9901) for calculating the deduction allowed to a domestic corporation for its Foreign-derived Intangible Income (FDII) and Global Intangible Low-Taxed Income (GILTI).

As background, Section 250 generally allows a domestic corporation an annual deduction in respect of its GILTI and FDII. For tax years beginning after 31 December 2017, but on or before 31 December 2025, the Section 250 deduction generally is the sum of: (i) 50% of the corporation's GILTI inclusion amount (and Section 78 "gross-up" for associated deemed-paid foreign income taxes) and (ii) 37.5% of its FDII. If the sum of the taxpayer's GILTI and FDII amounts exceeds the taxpayer's taxable income, however, the Section 250 deduction is reduced, proportionately to those two amounts.

The final Section 250 regulations generally reflect a structure that is similar to the proposed regulations released in March 2019. Nevertheless, the final regulations contain a number of significant, and mostly taxpayer-favorable, changes. For example, the final regulations:

- Delay the effective date of the final regulations until tax years beginning in 2021
- Eliminate or relax, in response to taxpayer concerns, some of the more burdensome "documentation requirements" for "establishing" facts necessary to secure an FDII benefit
- Presume other necessary facts (e.g., foreign person, foreign use) in certain circumstances
- Allow taxpayers to use any "reasonable" method to coordinate Section 250 with other sections with taxable income limitations (e.g., Sections 163(j) and 172)
- Require taxpayers to ignore carryover deductions under those sections when identifying deductions to be apportioned to gross deduction eligible income (DEI) and gross foreign-derived deduction eligible income (FDDEI)
- Relax certain provisions that defer an FDII benefit for a related-party sale that is followed by an unrelated-party sale
- Introduce new provisions applicable to narrower categories of taxpayers (e.g., "digital content" and SaaS providers, providers of advertising services, *Arms Export Control Act* sellers and renderers, and taxpayers engaging in hedging transactions)

Most taxpayers will find the final Section 250 regulations — as compared to the proposed regulations — to be quite favorable. In particular, the final regulations adopt sensible rules for taxpayers to document their FDDEI sales and services.

The final regulations are more accommodating in other respects as well. Most importantly, the effective date of the final regulations has been postponed to tax years beginning on or after 1 January 2021, giving taxpayers more time to develop systems or other procedures to meet the substantiation requirement; for tax years before that effective date, taxpayers may apply, at their option, the final or the proposed regulations (subject to consistency requirements).

Taxpayers should also consider whether a desired position for a pre-2021 tax year may be taken based solely on a reasonable interpretation of Section 250 itself.

Nearly every taxpayer should now react swiftly to the final regulations. For tax years beginning before 1 January 2021, taxpayers should consider which set of regulations would be more favorable — or less burdensome — to them. Looking forward, taxpayers ought to model the effect of various reasonable methods to coordinate the taxable income limitations of Sections 250(a)(2), 163(j), 172 and others.

Moreover, taxpayers should evaluate the new documentation requirements and substantive provisions against their facts and begin the process of reassessing their operating models, intercompany flows, and pricing policies and consider whether changes should be made to take full advantage of the benefits under Section 250.

IRS notes more multilateral APA requests

The Director of the IRS Advance Pricing and Mutual Agreement program in July 2020 was quoted as saying there has been an uptick in multilateral advance pricing agreement (APA) requests. The official also said that multilateral APAs are representing a broader range of transactions and not limited to specific global financial transactions as in the past. The APMA Director noted that the IRS is seeing more multilateral APA requests that include a "sandwiched" foreign-owned US entity involving related transactions with the foreign parent and other foreign subsidiaries.

Proposed PTEP regulations coming before year-end

An IRS official in mid-July 2020 was quoted as saying that the Government expects to release proposed regulations on previously taxed earnings and profits (PTEP) before the end of the year. The official said she expected the timeline – which has been pushed back several times – to hold despite "this year's very unique circumstances."

IRS releases new draft partnership Schedules K-2 and K-3 for international tax reporting

The IRS in July 2020 released for comment new draft Schedules K-2 and K-3 for the 2021 tax year IRS Form 1065, *U.S. Return of Partnership Income*. The new IRS schedules and accompanying instructions are designed to help partnerships report certain US international tax information to their partners in a standardized format. This information should assist partners in computing and reporting their corresponding US income tax liability, including under the new US international tax regimes enacted as part of the *Tax Cuts and Jobs Act of 2017*.

The new draft 2021 tax year IRS Schedules and instructions include:

- Schedule K-2 (Form 1065), *Partners' Distributive Share Items – International*
- Schedule K-3 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc. – International*
- Partnership Instructions for Schedule K-2 (Form 1065) and Schedule K-3 (Form 1065)
- Partner's Instructions for Schedule K-3 (Form 1065)

Partnerships must complete the new schedules beginning in tax year 2021 (filing season 2022) if they (1) must file a US partnership tax return (IRS Form 1065) and (2) have items of US international tax relevance (in general, certain specified non-US activities or non-US person partners). The new draft schedules do not affect partnerships with no US international tax items to report.

Partnerships and other affected stakeholders may review the proposed changes and submit comments. The IRS will consider comments submitted through 14 September 2020. The IRS plans to finalize the forms later in 2020.

The IRS plans similar revisions to the 2021 IRS Forms 1120-S, *U.S. Income Tax Return for an S Corporation*, and 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*, and invites comments on changes to these forms.

OECD news

G20 Finance Ministers and Central Bank Governors' meeting communiqué reiterates commitment to address digitalization tax challenges

On 18 July 2020, the G20 Finance Ministers and Central Bank Governors met via videoconference. At the conclusion of the meeting, a joint communiqué (the communiqué) stressed the importance of continuing to advance the work on addressing the tax challenges of the digitalization of the economy and reaffirmed the G20's commitment to reaching a global, consensus-based solution.

In advance of the meeting, the OECD and other multilateral bodies issued several tax-related documents for the G20 Finance Ministers' and Central Bank Governors' consideration. Among these documents is the annual OECD Secretary-General Tax Report to the G20 on progress on the international tax agenda.

The G20 communiqué confirmed the OECD's current plan to develop blueprints for both Pillar One on new nexus and profit allocation rules and Pillar Two on new global minimum tax rules. The blueprints will be discussed by the member jurisdictions of the Inclusive Framework on BEPS at its early October meeting, and subsequently reported on to the G20 Finance Ministers and Central Bank Governors before their meeting on 15-16 October.

US announces action against France's DST

The US Trade Representative (USTR) announced on 10 July 2020 that the United States would take action against France's Digital Services Tax (DST) in the form of an additional 25% ad valorem duty on specified French-origin goods. The tariffs are scheduled to take effect on 6 January 2021, 180 days after the determination of action. The list covers 21 tariff subheadings, with an estimated trade value for calendar year 2019 of approximately $1.3 billion.

The announcement came after the US withdrew from negotiations regarding DSTs at the OECD level in June.

OECD releases new corporate tax statistics including anonymized and aggregated Country-by-Country report statistics

On 8 July 2020, the OECD released the second edition of the annual Corporate Tax Statistics publication (the report) together with an updated database. The database is intended to assist in the study of corporate tax policy and expand the quality and range of data available for the analysis of base erosion and profit shifting (BEPS) activity.

For the first time, the database includes anonymized and aggregated Country-by-Country (CbC) reporting statistics, reflecting information for 2016 provided by 26 member jurisdictions of the Inclusive Framework on BEPS and covering about 4,000 multinational enterprise (MNE) groups that operate across more than 100 jurisdictions worldwide. The OECD also published a list of Frequently Asked Questions on the anonymized and aggregated CbC reporting data.

As highlighted in the press release accompanying the release of the report and the database, the OECD views the new statistics as suggesting some preliminary insights that, despite the data limitations, are indicative of the existence of BEPS behavior.

This second edition of the database also includes, for the first time, information on controlled foreign company (CFC) rules and on interest limitation rules, which the OECD indicates can assist in understanding progress related to the implementation of BEPS Actions 3 and 4.

OECD releases model rules for data reporting by platform operators for sellers in the sharing economy

On 3 July 2020, the OECD released *Model Rules for Reporting by Platform Operators with respect to Sellers in the Sharing and Gig Economy* (Model Rules as approved by the OECD/G20 Inclusive Framework on BEPS on 29 June 2020). The Model Rules lay out a system for requiring digital platforms to collect information on the income realized by those offering accommodation, transport and personal services through platforms and to report the information to tax authorities.

The press release accompanying the release of the Model Rules includes a comment from Pascal Saint-Amans, Director of the OECD Centre for Tax Policy and Administration, that "The approval of the [Model Rules] by the G20/OECD Inclusive Framework on BEPS proves that multilateral solutions to address tax challenges in the digital economy are possible and that they are to the benefit of tax administrations, taxpayers and businesses alike."

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