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Treasury and IRS news

Treasury and IRS finalize DRD anti-abuse regulations with few changes

On 21 August 2020, Treasury and the IRS released final regulations under Section 245A (TD 9909) providing anti-abuse rules for "extraordinary dispositions" and "extraordinary reductions." The regulations finalize proposed regulations and replace temporary regulations that were issued in June 2019.

The final regulations continue to deny the Section 245A dividends received deduction (DRD) for 50% of the dividends paid by specified 10%-owned foreign corporations (SFCs) to the extent attributable to earnings and profits (E&P) from extraordinary dispositions. Similarly, the final regulations continue to deny 100% of the Section 245A DRD for certain dividends paid in a tax year in which an extraordinary reduction occurs.

The final regulations are substantially similar to the proposed and temporary regulations, with a limited number of generally taxpayer-favorable changes at the margin. While the substantive rules did not change much, taxpayers should pay close attention to new examples illustrating anti-abuse rules. Several new examples illustrate the anti-abuse rules, and one of them would extend the application of the extraordinary-disposition rules beyond "dispositions."

At the same time, Treasury and the IRS released new proposed regulations that would coordinate the final regulations with certain rules under Section 951A that effectively deny deductions arising from "disqualified basis" that is generated during the GILTI gap period, as defined later. (A separate discussion on the proposed regulations follows this article.)

The final regulations apply to tax periods ending on or after 14 June 2019, while Temp. Reg. Section 1.245A-5T continues to apply to distributions made after 31 December 2017, to which the final regulations do not apply. Taxpayers may apply the final regulations retroactively, provided that they and all related parties apply them consistently.

Treasury and the IRS propose complex, taxpayer-favorable regulations to reduce possibility of double taxation caused by anti-abuse rules on GILTI gap period

Treasury and the IRS on 21 August 2020, released taxpayer-favorable proposed regulations under Sections 245A and 951A (REG-124737-19) to coordinate two independent sets of anti-abuse rules that apply to extraordinary dispositions and disqualified transfers (together, EDs). Both rules apply to certain transactions of a controlled foreign corporation (CFC) occurring during the so-called GILTI gap period. Absent the proposed regulations, gain recognized in an ED effectively could be taxed twice:

- Once, in the form of a taxable dividend distributed by a CFC (because the dividend is deemed to be attributable to the ED)
- Twice, either as increased subpart F income or GILTI inclusions from a CFC (because deductions attributable to basis acquired in the ED may not reduce subpart F income or tested income) or as increased gain from transactions in CFC stock (because those deductions generally still reduce earnings and profits)

The proposed regulations contain numerous and complex rules, conditions, and exceptions. The regulations, which would not be elective, would coordinate the two sets of anti-abuse rules so that one set generally would not apply to the extent that the other set resulted in taxable income. Taxpayers may apply the proposed regulations before they are finalized, including retroactively to past tax years of foreign corporations.

Taxpayers that engaged in an ED should consider immediately how the proposed regulations apply to their circumstances. The regulations are complex and will entail significant compliance costs. In particular, a taxpayer in either of the following circumstances might benefit from taking action sooner than later:

- The ED rules have already applied to a dividend, such that the taxpayer has included marginal amounts in taxable income. The taxpayer might obtain a refund or credit upon amending past tax returns to apply the proposed regulations.
- The taxpayer intends, in the near future, to cause a specified foreign corporation to distribute a dividend to which the ED rules would apply. The taxpayer might accelerate that dividend so the disqualified basis anti-abuse rules' (DQB) reduction rule can increase CFC deductions in an earlier tax year, and those deductions are not otherwise lost forever.

Taxpayers should consider not merely the extent to which application of the proposed regulations would reduce, based on past tax years, their ED account balances and disqualified basis. They should also evaluate whether the proposed regulations create opportunities to manage those ED account balances and disqualified basis efficiently in future tax years. In so doing, taxpayers should take into account foreign tax credits and other attributes, projections for future income and taxes, repatriation strategies, mergers and acquisitions, and numerous other unique considerations.

The proposed regulations would apply to tax years of foreign corporations beginning on or after the proposed regulations' finalization, and to tax years of a United States person in which or with which those tax years end. For tax years beginning before the proposed regulations are finalized, however, taxpayers may apply the proposed regulations, provided they and all related parties apply the proposed regulations consistently to all such tax years.

Tax treaty news

US, Swiss competent authorities reach agreement on treaty arbitration process

The IRS in Announcement 2020-13 disclosed that the US and Swiss competent authorities entered into an agreement establishing a competent authority arrangement regarding implementation of the arbitration process in Article 25, paragraphs 6 and 7, of the US-Switzerland income tax treaty.

According to the treaty, arbitration will be available where, pursuant to the Article 25 mutual agreement procedure, the competent authorities are unable to reach a complete agreement. In addition, an unresolved competent authority request that originated in a bilateral Advance Pricing Agreement request will be subject to arbitration procedures. Certain cases described in the competent authority arrangement are not eligible for arbitration.

Digital Taxation

UN tax committee issues proposal for taxing digital services income

A group of United Nations (UN) Tax Committee members from developing countries issued a proposal regarding the taxing of digital services income. The proposal differs significantly from the OECD Pillar 1 proposal, both in its scope and allocation methods.

The proposal on new article 12B – Income from Automated Digital Services – will be considered during the Committee's meetings in October and November and could be added to the UN Model Tax Convention. The proposal is in the early stages of development and will be subject to further discussions and likely revisions.

IRS officials confirm draft Partnership Schedules K-2 and K-3 for 2021 IRS Form 1065 guided by need for standardization

IRS officials in August 2020 reiterated that the recently released draft Schedules K-2 and K-3 for the 2021 tax year IRS Form 1065, *U.S. Return of Partnership Income* were guided by the need to standardize format, rather than to request additional information. One official was quoted as saying that the information was already being reported to partners in various formats and added that the changes were necessitated by amendments to the international tax regime by the *Tax Cuts and Jobs Act*.

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