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IRS news

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 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 dividend 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 from 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 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 Reg. 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).

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. While their finalization is unsurprising, there are some important implications for taxpayers.

Importance for taxable income and Section 951A determinations

As noted in prior *Dispatches*, all owners of Section 987 QBUs should be currently calculating Section 987 gain or loss on an annual basis. For US owners of Section 987 QBUs, Section 987 determinations can directly affect taxable income, and thus, may be relevant for other US tax reform provisions, including the so-called BEAT (base erosion anti-abuse tax) provisions of Section 59A, the foreign-derived intangible income (GILTI) deduction in Section 250(a), the interest limitation rules of Section 163(j), and the Section 904(d) foreign branch income basket rules.

Similarly, for controlled foreign corporation (CFC) owners of Section 987 QBUs, Section 987 determinations can directly affect the tested income or tested loss of a CFC under Section 951A (the GILTI provisions). In making such determinations, all owners of Section 987 QBUs should be considering the deferral and outbound loss event rules of Reg. Section 1.987-12, which currently apply.

Taxpayers should also continue to monitor the status of the other final Section 987 regulations, which continue to be delayed until 1 January 2020, for in-scope, calendar-year taxpayers under the provisions of Notice 2018-57. In addition, as first indicated in Notice 2017-57, there may be amendments to the final regulations, as "Proposed modification of regulations under [IRC Section] 987 on income and currency gain or loss with respect to a [IRC Section] 987 qualified business unit" is on Treasury's 2018–2019 Priority Guidance Plan. As of now, however, the final regulations (and the required foreign exchange exposure pool method) are generally effective 1 January 2020, for calendar-year taxpayers.

Importance for taxpayers that have engaged in deferral or outbound-loss-event transactions

Reg. Section 1.987-12(i) currently retains the fresh start coordination rules from *former* Reg. Section 1.987-12T(i). Consequently, all owners of Section 987 QBUs that have engaged in deferral or outbound-loss-event transactions should consider the potential consequences of the fresh start transition method for any deferred Section 987(3) gain or loss and related stock basis adjustments.

Under Notice 2018-57, fresh start transition has been delayed until 1 January 2020, for in-scope, calendar years unless a taxpayer elected to early apply the final Section 987 regulations under Reg. Section 1.987-11(b).

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. Comments on the proposed regulations, as well as requests for a public hearing, are due by 12 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, however, are completely redacted, which makes interpreting the ILM particularly 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 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.

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."

Treasury and the IRS issued proposed regulations under Section 250 in early March 2019, providing guidance for calculating the deduction allowed to a domestic corporation for its FDII and Global Intangible Low-taxed Income (GILTI). The proposed regulations primarily provide guidance for calculating a domestic corporation's FDII.

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 has been updated to indicate that local filing will not be required in India.

Digital Taxation

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

A senior US Treasury official again 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 is in active discussions with various countries to dissuade them from taking further action.

The official was quoted as saying there is particular concern over French and UK DST proposals that would be effective next year, with the US Government "arguing very strongly that any such taxes should be deferred until after 2020" to give the Organisation for Economic Co-operation and Development (OECD) the opportunity to come up with a multilateral solution.

He criticized DST proposals that impose tax on gross revenue rather than economic profit, and which he said disproportionately target US companies.

The official added that the United States supports increasing market countries' taxing authority by utilizing a marketing intangibles approach. According to a press report, he predicted that the scope of the changes will not be substantial considering the need for broad consensus.

Puerto Rico enacts tax incentives law for investments in opportunity zones

On 14 May 2019, Puerto Rico enacted the Law for the Development of Opportunity Zones and the Economic Development of Puerto Rico of 2019, which establishes various tax incentives in Puerto Rico for investments in qualified opportunity zones within Puerto Rico. The tax incentives include preferential tax rates, transferable tax credits, and partial exemptions of property and municipal taxes.

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 must be filed on or before 30 June. 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.

In a related development, the Council of the European Union on 17 May held a meeting where they discussed digital taxation as well as the European Union (EU) list of non-cooperative jurisdictions for tax purposes.

In relation to digital taxation, the Council discussed current international tax reforms with a view to preparing for the upcoming OECD and G20 leaders' meetings. The Council also 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.

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