Building a better working world

Washington Dispatch

June 2019, Volume 23, Issue 6

NEW! EY Tax News Update: Global Edition

EY's new Tax News Update: Global Edition is a free, personalized email subscription service that allows you to receive EY Global Tax Alerts, newsletters, events, and thought leadership published across all areas of tax. Access more information about the tool and registration here.

Additionally, EY's weekly and monthly US international tax podcasts are available on iTunes and ey.com:

- Subscribe to iTunes
- Listen on ey.com

In this issue

Treasury and IRS news

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

2. US government issues final and proposed GILTI and subpart F regulations, include favorable and unfavorable provisions for taxpayers

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

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

Transfer pricing news

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

5. IRS LB&I withdraws CSA directive

Treaty news

5. US Senate Foreign Relations Committee reports out tax protocols to treaties with Japan, Luxembourg, Spain and Switzerland

OECD news

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

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

Treasury and IRS news

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).

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.

US government 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. The new 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.

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 (CFCs) ending on or after the date Treasury publishes the proposed regulations in final form (and to the tax years of "United States shareholders" in which or with which those tax years end).

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 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 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 (FPHCI, a component of subpart F income) for certain rents earned by the CFC.

As part of the *Tax Cuts and Jobs Act* (TCJA), Congress repealed former Section 958(b)(4). 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).

When effective, the proposed regulations could cause amounts that a taxpayer had not treated as subpart F income to qualify as subpart F income (and vice versa). With the TCJA's enactment of the GILTI regime (Section 951A), classifying an amount as subpart F income generally no longer undermines the indefinite deferral of US federal income tax on that amount. Now, most CFC earnings are subject to current taxation as a subpart F income or GILTI inclusion — but subject to different rates (for corporate United States shareholders) and different rules (e.g., foreign tax credit carryovers).

The proposed regulations would also affect provisions that incorporate the Section 954(d)(3) definition of related person. Accordingly, they would be relevant for purposes of applying (among several others) Sections 267A, 1297(b)(2), and 1471(e)(2). Taxpayers should consider whether the proposed regulations could affect their positions under the subpart F and GILTI regimes and these other provisions.

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.

Transfer pricing news

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

On 7 June 2019, in a 2-1 ruling, a Ninth Circuit 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."

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 Internal Revenue 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.

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 has 45 days to apply for either or both a panel rehearing or a rehearing "en banc" by the full Ninth Circuit Court of Appeals. Alternatively, the taxpayer has 90 days to apply for a writ of certiorari to the Supreme Court. If the Ninth Circuit denies the rehearing requests, then the 90-day window for the taxpayer to apply for certiorari to the US Supreme Court resets from the date the Ninth Circuit publicly rejects the taxpayer's rehearing request.

IRS LB&I withdraws CSA directive

The IRS Large Business and International (LB&I) Division recently 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 in regard to 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."

US, Cyprus negotiating CbC exchange agreement

The IRS in June 2019 indicated that the US and Cyprus are negotiating a competent authority agreement to exchange Country-by-Country (CbC) reports. The arrangement would be based on the exchange of information provision in the 1984 Cyprus-US tax treaty.

Treaty news

US Senate Foreign Relations Committee reports out tax protocols to treaties with Japan, Luxembourg, Spain and Switzerland

The US Senate Foreign Relations Committee voted out of committee protocols amending US tax treaties with Japan, Luxembourg, Spain, and Switzerland during a business meeting on 25 June 2019.

The tax protocols have been awaiting action in the Senate for years and were held up over Committee member Rand Paul's (R-KY) concerns regarding information sharing provisions. Foreign Relations Committee Chairman Jim Risch (R-ID) earlier said the plan was to move rapidly on the protocols and that Senate floor time may be allocated to advance them.

The Committee did not address new US tax treaties with Chile, Hungary, and Poland. Foreign Relations Ranking Member Robert Menendez (D-NJ) wrote to Treasury on 11 June regarding his concerns about possible reservations for the Section 59A Base Erosion and Anti-abuse Tax (BEAT) – enacted by the *Tax Cuts and Jobs Act* – that may be necessary for the Chile, Hungary, and Poland treaties. The issue could require more work to sort out and the proposed treaties could be scheduled for Committee action at a later date.

OECD news

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 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 ministerial meeting in Fukuoka, Japan (see following article).

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.

The proposals addressed in the Workplan will have implications 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 currently operate. It is therefore important for businesses to follow these developments closely as they unfold in the coming months.

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.

EY Member Firm US Tax Desks

Australia	Scott Hes, *Sydney*	scott.hes@au.ey.com
Canada	George Guedikian, *Toronto*	george.b.guedikian@ca.ey.com
	Emad Zabaneh, *Toronto*	emad.m.zabaneh@ca.ey.com
	Asif Rajwani, *Toronto*	asif.rajwani@ca.ey.com
	Ryan Coupland, *Calgary*	ryan.coupland@ca.ey.com
	George Tsitouras, *Montreal*	george.tsitouras@ca.ey.com
	Denis Rousseau, *Montreal*	denis.rousseau@ca.ey.com
	Nelson Brooks, *Vancouver*	nelson.brooks@ca.ey.com
China	Aaron Topol, *Hong Kong*	aaron.topol@hk.ey.com
	Lipeng He, *Shanghai*	lipeng.he@cn.ey.com
France	Diane Juzaitis, *Paris*	diane.juzaitis@ey-avocats.com
Germany	Tom Day, *Munich*	thomas.day@de.ey.com
	Andrew Brown, *Munich*	andrew.brown@de.ey.com
Israel	Amir Chenchinski, *Tel Aviv*	amir.chenchinski@il.ey.com
	Tal Levy, *Tel Aviv*	tal.levy@il.ey.com
	Itai Ran, *Tel Aviv*	itai.ran@il.ey.com
Japan	Takayuki Ohta, *Tokyo*	takayuki.ohta@jp.ey.com
Mexico	Alberto Lopez, *Mexico City*	alberto.r.lopez@mx.ey.com
	Manuel Solano, *Mexico City*	manuel.solano@ey.com
Singapore	Garrett Davidson, *Singapore*	garrett.davidson@sg.ey.com
Switzerland	Michael Parets, *Zurich*	michael.parets@ch.ey.com
United Kingdom	Joseph Kledis, *Hong Kong*	joe.kledis1@uk.ey.com
	Leif Jorgensen, *London*	ljorgensen@uk.ey.com
	Joseph Toce, *London*	jtoce@uk.ey.com

EY | Assurance | Tax | Transactions | Advisory

About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

About Ernst & Young's International Tax services practices

Our dedicated international tax professionals assist our clients with their cross-border tax structuring, planning, reporting and risk management. We work with you to build proactive and truly integrated global tax strategies that address the tax risks of today's businesses and achieve sustainable growth. It's how Ernst & Young makes a difference.

The Washington Dispatch is a monthly communication prepared by Ernst & Young LLP's Washington International Tax Services summarizing recent developments and "inside-the-beltway" news pertinent to multinational companies. For additional information, please contact your local international Tax professional.

© 2019 EYGM Limited.
All Rights Reserved.

EYG no. 003078-19Gbl

1508-1600216 NY
ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com