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The Aggregate Approach to Partnerships -- (Almost) Always the Right Result?

On June 14, 2019, Treasury and the Internal Revenue Service ("IRS") released several sets of regulations, including final ("Final Regulations") and proposed regulations ("2019 Proposed Regulations") on "Global Intangible Low-Taxed Income" ("GILTI"). Both the Final Regulations and the 2019 Proposed Regulations contain an extensive discussion in applying the GILTI rules and subpart F rules to domestic partnerships that are shareholders of controlled foreign corporations ("CFCs").

In earlier proposed regulations on GILTI released on September 13, 2018, Treasury and the IRS addressed applying the GILTI rules to domestic partnerships that are shareholders of CFCs. The Code (Section 951A) did not contain any specific rules on domestic partnerships and their partners that directly or indirectly own stock of CFCs. Treasury and the IRS considered several different approaches. A pure aggregate approach to the treatment of domestic partnerships and their partners would treat the partnership as an aggregate of its partners, so that each partner would calculate its own GILTI inclusion amount taking into account its pro rata share of CFC items through the partnership. In contrast, under a pure entity approach, the domestic partnership would determine its own GILTI inclusion amount, and each partner would take into gross income its distributive share of such amount.

After considering both approaches, in the earlier proposed regulations, Treasury and the IRS initially utilized a hybrid approach -- one that incorporated both the aggregate and entity approaches. A domestic partnership is treated as an entity with respect to partners that are not US shareholders of any CFC owned by the partnership, but is treated as an aggregate for purposes of partners that are themselves US shareholders with respect to one or more CFCs owned by the partnership. As noted by Treasury and the IRS in the earlier proposed regulations, such a hybrid approach:

> [E]nsures that each non-US shareholder partner takes into income its distributive share of the domestic partnership's GILTI inclusion amount (similar to subpart F), while permitting a partner that is itself a US shareholder to determine a single GILTI inclusion amount by reference to all its CFCs, whether owned directly or through a partnership, as well as allowing a corporate US shareholder to calculate a foreign tax credit under section 960(d) with respect to each such CFC and to compute a section 250 deduction with respect to its GILTI inclusion amount determined by reference to each such CFC.

Upcoming Tax Events

Tax Planning and Transactions / Transfer Pricing Seminar

Boston
►July 25, 2019

20th Annual Tax and Trust Conference

New York
►September 24, 2019

20th Annual Tax and Trust Conference

Miami
►September 26, 2019

To review the complete Tax Events Calendar visit www.bakermckenzie.com/tax/event

In the Final Regulations, Treasury and the IRS, in response to comments, abandoned the hybrid approach and adopted, for the most part, the aggregate approach. As a result, a domestic partnership is treated as an aggregate of its partners for purposes of determining the level (partnership or partner) at which a GILTI inclusion amount is calculated and taken into gross income. Treasury and the IRS wrote:

> [A]n aggregate approach to domestic partnerships furthers the purposes of the GILTI regime. It is consistent with the general intent of the GILTI regime to determine tax liability at the US shareholder level on an aggregate basis rather than on a CFC-by-CFC basis.

The Final Regulations provide that the aggregate approach for domestic partnerships does not apply for purposes of determining whether a US person is a US shareholder, whether a US shareholder is a controlling domestic shareholder, or whether a foreign corporation is a CFC.

Since the enactment of subpart F in 1962, domestic partnerships generally have been treated as entities, rather than as aggregates of their partners, for purposes of determining whether US shareholders own more than 50 percent of the stock (by voting power or value) of a foreign corporation and whether a foreign corporation is a CFC. In addition, domestic partnerships generally have been treated as entities for purposes of being a US shareholder that has the subpart F income inclusion with respect to such CFC. As a result, each partner of the domestic partnership has a distributive share of the partnership's subpart F inclusion, regardless of whether the partner itself is a US shareholder. In contrast, foreign partnerships generally were treated as aggregates of their partners for purposes of subpart F.

In the 2019 Proposed Regulations, Treasury and the IRS extended the aggregate approach to domestic partnerships, which it adopted in the Final Regulations with respect to GILTI, to subpart F income inclusion. Specifically, a domestic partnership is treated as an aggregate of its partners in determining whether, and to what extent, its partners have inclusions of subpart F income. As a result, for partners' inclusions of subpart F income, a domestic partnership is treated in the same manner as a foreign partnership. In addition, such aggregate treatment is consistent with the treatment of domestic partnerships in determining whether, and to what extent, its partners have inclusions of GILTI.

Several other major provisions were enacted as part of the Tax Cuts and Jobs Act ("TCJA") in which a decision had to be made as to whether a partnership would be treated as an aggregate of its partners or as an entity. For example, Congress enacted the "Foreign-Derived Intangible Income" ("FDII") regime to complement the GILTI regime. Under the FDII regime, a domestic corporation is permitted a 37.5 percent deduction for its foreign-derived intangible income, which is generally income earned by the domestic corporation in accessing foreign markets. The Code (Section 250) does not provide specific rules for domestic corporations that are partners in a partnership with respect to FDII. In proposed regulations issued on March 4, 2019, Treasury adopted the aggregate approach for determining a domestic corporate partner's FDII attributable to the income and assets of a partnership.

Another example is the Base Erosion and Anti-abuse Tax ("BEAT"). The BEAT is a minimum tax on certain large US corporations that make deductible payments to foreign related parties ("base erosion payments"). The BEAT is designed to prevent these US corporations from using base erosion payments to strip or erode the US tax base. In proposed regulations issued on December 13, 2018, Treasury and the IRS adopted an aggregate approach for partnerships in applying the BEAT. So, for example, in determining whether payments to or payments from a partnership are base erosion payments, amounts paid or accrued by a partnership are treated as paid by each partner based on the partner's distributive share of items of deduction with respect to that amount, and any amounts received by or accrued to a partnership are treated as received by each partner based on the partner's distributive share of the income or gain with respect to that amount.

In drafting legislation, Congress also had to make additional decisions as to whether a partnership is treated as an aggregate or as an entity. Section 199A, enacted as part of TCJA, provides an individual a 20 percent deduction for qualified business income, generally income earned from a trade or business but not from performing services as an employee. During drafting, a decision was made that a partnership should be treated as an aggregate for purposes of the section 199A 20 percent deduction. Accordingly, the provision provides that section 199A is applied at the partner level and not at the partnership level. As a result, some partners may qualify for the deduction and others may be limited or prohibited from qualifying for the deduction.

Interestingly, Congress went in a different direction in drafting section 163(j), which limits the deduction for business interest expense for taxpayers with average annual gross receipts greater than $25 million. Specifically, the deduction for business interest expense is limited to the sum of a taxpayer's business interest income, 30 percent of adjusted taxable income and floor plan financing interest. During drafting, a decision was made that the limitation should apply at the partnership level -- in other words, an entity approach for the application of section 163(j). Large partnerships, those with gross receipts greater than $25 million, were viewed as being very comparable to large C corporations (also gross receipts greater than $25 million), and therefore section 163(j) should apply in a similar if not equal fashion -- at the entity level. Applying section 163(j) at the partnership level adds a tremendous amount of complexity to the provision, as evidenced by the statutory language contained in section 163(j) and the proposed regulations issued on November 26, 2018.

The New York State Bar Association Tax Section (the "Tax Section"), in its report on the proposed regulations under section 163(j), wrote that consideration should be given for a statutory amendment to section 163(j) so that it applies at the partner level and not at the partnership level. It notes the "inordinate complexity" of applying section 163(j) at the partnership level, the conflict with the more common approach of treating partnerships as aggregates of their partners, and the "inappropriate planning opportunities" for taxpayers. The Tax Section notes that the statutory purpose of section 163(j) will be better served by applying it at the partner level.

It appears that on substantive tax issues, as opposed to administrative or procedural issues (e.g., filing a return or making an election), the aggregate approach to partnerships generally should be adopted. In other words, treating a partnership as an aggregate of its partners generally better achieves the intent of a particular provision while also, in many cases, minimizing the complexity associated with the provision.

By: Christopher Hanna, Dallas

Key Developments Under the Taxpayer First Act

On July 1, 2019, President Trump signed H.R. 3151, the Taxpayer First Act of 2019 ("TFA") into law. The TFA was passed by Congress and signed by the President in under a month, but the impetus for the legislation goes back to early 2017, when Republicans made tax reform a key campaign policy issue.

The TFA makes a number of changes to the IRS's audit and administrative appeals process that are particularly important to large corporate taxpayers. This newsletter provides an overview of four key areas affecting large corporate taxpayers that are impacted by the TFA: (1) the codification of an independent administrative appeals process; (2) the modification of authority to issue designated summonses; (3) the limitation on third-party involvement in IRS examinations; and (4) the reorganization of the IRS's structure.

Codification of the IRS Independent Office of Appeals

The TFA codifies the IRS's internal procedural rules regarding its independent appeals function, and renames the IRS Office of Appeals the IRS Independent Office of Appeals ("Independent Appeals"). The TFA places Independent Appeals under the direction of a "Chief of Appeals" appointed by the Commissioner, and provides that its proceedings should be "generally available to all taxpayers." The TFA restricts attorneys in the IRS Office of Chief Counsel from assisting in Independent Appeals proceedings if those attorneys participated in the relevant examination, or if they will be involved in preparing the case for litigation.

The TFA also adds procedural safeguards for taxpayers seeking referral to Independent Appeals following receipt of a notice of deficiency. If the IRS denies a taxpayer's request for a "docketed" referral to Independent Appeals, the IRS *must* provide the taxpayer with "a detailed description of the facts involved, the basis for the decision to deny the request, and a detailed explanation of how the basis of such decision applies to the facts." These cases are referred to as "docketed" appeals because they are administrative appeals proceedings for cases concurrently docketed in the United States Tax Court. The Commissioner is instructed to prescribe procedures for the taxpayer to protest the IRS's decision to deny its request. These TFA provisions, in effect, overrule Rev. Proc. 2016-22, the IRS's prior procedures for docketed appeals. As an oversight mechanism, the Commissioner is also required to provide Congress with an annual report detailing the number of these cases it determined were not eligible for referral.

These provisions underscore Congress's emphasis on Independent Appeals as the appropriate forum to resolve most tax controversies and its desire to limit the number of taxpayers denied access to IRS appeals. It is unclear whether the IRS will extend these procedural protections to non-docketed cases (i.e., cases where the IRS has not yet issued a notice of deficiency), or to cases that are not preceded by a notice of deficiency (e.g., partnership cases). Nonetheless, the TFA should promote greater taxpayer access to Independent Appeals, even though individual outcomes at Independent Appeals may not change drastically.

These changes to IRS administrative appeals are effective immediately.

Modification of Authority to Issue Designated Summonses

A designated summons is an administrative summons issued to large corporate taxpayers relating to one or more tax years under examination that serves to suspend the running of the statutory limitations period beginning the day a summons enforcement proceeding is initiated in court and ending on the day of the final resolution.

In promulgating the TFA, Congress sought to reconcile taxpayers' and the IRS's opposing views regarding designated summonses. Congress acknowledged taxpayer apprehension that designated summonses, though rarely issued in the past, could become a more frequently-used IRS tool. Pete Sepp, *"IRS Reform: Resolving Taxpayer Disputes, National Taxpayers Union"* (Sept. 13, 2017) (testimony to the Committee on Ways and Means). Taxpayers suggested that the greater use of these summonses could lead to greater abuse, extending indefinitely statutory limitations periods that would otherwise close. However, Congress also appreciated the IRS's view that designated summonses are an important deterrent to taxpayer non-responsiveness and delay during lengthy and complicated examinations. H. Rep. No. 116-39, at 47 (2019). In an effort to balance these conflicting concerns, Congress retained designated summonses, but determined that IRS "approval and review" of such summonses should be "tightened." *Id.*

The TFA significantly enhances the review requirements for designated summonses, and places further safeguards against abuse of the IRS's authority. Requests to issue a designated summons must now be preceded by a personal review and written approval by both the Chief Counsel for the IRS and the Commissioner of the relevant IRS Operating Division that "states facts clearly establishing that the Secretary has made reasonable requests for the information that is the subject of the summons." The approval, including the relevant facts, must be attached to the summons. Moreover, the IRS will have burden to demonstrate, in any judicial proceeding to enforce the summons, that it made "reasonable requests" to obtain the information prior to issuing the summons. Future controversies regarding designated summonses will likely focus on this requirement.

These changes take effect on September 14, 2019 (45 days after the enactment of the TFA on July 1, 2019).

Third-Party Exam Involvement

The TFA also provides partial clarity on the involvement of third parties in examinations. The IRS previously sought to formally expand the scope of third-party involvement by issuing, in June 2014, Temp. Treas. Reg. § 301-7602-1T, which permitted the IRS to hire outside contractors, including private law firms, to participate fully in the interview of a witness summoned by the IRS to provide testimony under oath. On July 14, 2016, Treasury finalized Temp. Treas. Reg. § 301-7602-1T as Treas. Reg. § 301.7602-1(b)(3) with no material change. In a later issued Notice of Proposed Rulemaking, Treasury sought to limit the areas in which third-party attorneys could assist the IRS. 83 Fed. Reg. 13206, 13208 (Mar. 28, 2018).

In response to taxpayer concerns regarding the IRS's extension of its examination power to private parties, Congress placed provisions in the TFA that sharply proscribe the practice of bringing in outside assistance during audits. The TFA provides that "[n]o person other than an officer or employee of the [IRS] or [IRS Chief Counsel] may, on behalf of the Secretary, question a witness under oath" in an examination. Accordingly, Treas. Reg. § 301.7602-1(b)(3) has been effectively overruled.

The TFA's limitation of third-party involvement in examinations is, however, qualified. While third-party questioning of witnesses under oath is now prohibited, the TFA does not preclude third-party "experts" retained by the IRS from otherwise assisting in examinations.

The IRS Reorganization

The TFA directs the Treasury Secretary to submit a "comprehensive written plan" for reorganizing the IRS in its entirety, based on a customer service strategy, by September 30, 2020. The plan must:

1. ensure the successful implementation of the TFA;
2. prioritize services to ensure taxpayers can easily and readily receive assistance from the IRS;
3. streamline the structure of the IRS, which includes minimizing the duplication of services and responsibilities within the agency;
4. position the IRS to address cybersecurity and other threats to the IRS; and
5. address whether the Criminal Investigation Division of the IRS should report directly to the Commissioner.

Conclusion

The TFA effects important and needed changes in IRS infrastructure and establishes important taxpayer protections. If the TFA is implemented as Congress intended, large corporate taxpayers' interactions with the IRS should improve.

By: Erin Gladney and Brendan Sponheimer, New York, Daniel Wharton and Cameron Reilly, Chicago

D.C. Circuit Court of Appeals Pins IRS in *Grecian Magnesite Mining* Case, but a Hollow Victory for Taxpayers Prospectively

On June 11, 2019, the U.S. Court of Appeals for the D.C. Circuit in *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner,* 123 AFTR 2d 2019-2164 (D.C. Cir. June 11, 2019) affirmed the Tax Court's conclusion that a foreign partner is not generally taxable on the gain recognized upon redemption of its membership interest in a domestic partnership doing business in the United States (*See Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner* 149 T.C. No. 3 (2017)), with the one exception being the portion of the gain recognized that is attributable to US real property owned by the partnership. See prior *Tax News and Developments* article, *"Grecian Magnesite Mining: Tax Court Chimes in on Rev. Rul. 91-32, and It's Music to Taxpayers' Ears"* (October 2017).

As background, the case concerned the proper treatment of the gain recognized upon redemption of a foreign partner's membership interest in a US partnership. Grecian Magnesite Mining ("GMM") was a Greek corporation that had no office, employees, or business operation in the United States. Since 2001, GMM was a partner in a Delaware limited liability company ("Premier"), which was treated as a partnership for US federal income tax purposes. In 2008, GMM entered into an agreement for Premier to redeem GMM's interest in Premier for $10.6 million, realizing gain of $6.2 million. Of the total gain realized, $2.2 million was attributable to Premier's US real estate, and conceded as taxable under FIRPTA. The remaining $4 million was the amount in dispute.

In the Tax Court, the Commissioner raised two principal arguments: (1) the disposition of a partnership interest should be treated like a sale of the partner's distributive share of each of the partnership's underlying assets under the "aggregate theory" of partnerships (wherein partners are viewed as directly owning the partnership's assets); and (2) the disputed gain was attributable to GMM's US office (attributed through Premier) under the US office rule (as defined below), and therefore US source income, because all activities leading to the appreciation of the partnership share occurred in the United States through Premier's successful operations.

The Tax Court sided with GMM on both arguments, holding that: (1) GMM's interest in the partnership was a single, indivisible capital assets (i.e., the "entity theory" of partnerships); and (2) the income from the redemption was not attributable to the US office under the US office rule because the US office neither was a material factor in the redemption transaction nor regularly carried on activities of that type.

Appeals Court's Analysis

Since the Commissioner did not challenge the Tax Court's first holding on appeal (i.e., the "aggregate" versus "entity" theory of partnerships), the only question for the court to address on appeal is whether the disputed gain is attributable to a US office of GMM and as such, is sourced within the US (the "US office rule"). Under the US office rule, "if a nonresident maintains an office or other fixed place of business in the US, income from any sale of personal property (including inventory property) attributable to such office or other fixed place of business shall be sourced to the US." There are three prongs to the US office rule: (1) whether GMM has a US office or fixed place of business; (2) whether GMM's US office is a material factor in the production of such income, gain or loss; and (3) whether GMM's US office regularly carries on activities of the type from which such income, gain or loss is derived. All three prongs must be met in order for the income to be treated as US sourced. The court focused its analysis on the text, Treasury Regulations and legislative history of the US office rule, specifically as it relates to the third prong.

The Commissioner argued that the statutory language "attributable to such office or other fixed place of business shall be sourced to the US" modified the noun "income" and therefore the activity that generated the appreciation in Premier's value (i.e., the profitable operation of its magnesite mining business) is attributable to the US office. Whereas GMM applied the rule of last antecedent, which interprets a limiting phrase to modify the noun that it immediately follows, and argued that the language modified the noun "sale" and as a result the transaction itself (i.e., the redemption) should be attributable to the US office. The court agreed with GMM's interpretation of the statute and held that in general qualifying phrases attach to the terms that are nearest and in this case, the noun "sale" is modified.

To further support its decision that the rule was framed to apply to sales, opposed to income, the court analyzed the statute and corresponding Regulations as whole. Specifically, the court addressed the reference to section 864(c)(5), which provides that "income, gain or loss shall not be considered as attributable to an office or other fixed place of business within the US unless such office or fixed place of business is a material factor in the production of such income, gain or loss and such office or fixed place of business regularly carries on activities of the type from which such income, gain or loss is derived." The court held that the better approach is to read section 864(c)(5) at a "higher level of generality" and rejected the Commissioner's position that Premier regularly carried on redemption activities as a result of engaging in the business of managing transactions with its members. The court found that Premier was in the magnesite mining business and, as such, the redemption transaction was not within its ordinary course of its business.

Finally, the court reviewed the legislative history of the US office rule. Congress enacted the US office rule in response to an exception to the general rule that income is sourced according to a taxpayer's residence. The US office rule sought to address a situation in which a foreign resident engages in business operations through a US office or fixed place of business and avoids paying US tax on the income because its income is sourced to a foreign jurisdiction. The US office rule sourced income from sales occurring in US offices or fixed places of business according to the location of the activity giving rise to the sale, as opposed to the taxpayer's jurisdiction of residence. The court highlighted that the emphasis was on sales activities attributable to a US office or fixed place of business.

The court found that the US office rule was not satisfied because the third prong of the rule was not met, as Premier was not engaged in the business of partnership redemption but rather was in the business of magnesite mining. As a result, the disputed gain derived from the redemption was not US sourced.

Developments

The court's holding in *Grecian Magnesite* is a hollow victory for taxpayers, insofar as the Tax Cuts and Jobs Act ("TCJA") added section 864(c)(8) to provide that a foreign partner's gain or loss from the sale or exchange of an interest in a partnership is treated as effectively connected with the conduct of a trade or business in the United States to the extent that the partner would have had effectively connected income had the partnership sold all of its assets at fair market value on the date of disposition. In enacting section 864(c)(8) Congress adopted a modified version of the "aggregate theory" approach to partnership taxation, according to which partners are viewed as directly owning the partnership assets (which contrasts with the "entity theory" whereby a partner's interest in a partnership is treated as a capital asset). Section 864(c)(8) applies to sales, exchanges, or other dispositions occurring on or after November 27, 2017. To the extent the disposition of a partnership interest occurred prior to that date, the holding in *Grecian Magnesite* remains authoritative.

TCJA also includes a new section 1446(f) which requires a transferee to withhold 10% of the amount realized on the sale or exchange of a partnership interest by a non-US person if any portion of the seller's gain on the disposition would be effectively connected income under section 864(c). On May 7, 2019, the IRS released proposed regulations expanding on the transferee's withholding obligations and addressing potential exceptions under section 1446(f). See prior *Tax News and Developments* article, *"Proposed Regulations for Foreign Partner Effectively Connected Income and Withholding"* (June 2019).

By: Daniel Hudson and Chelsea Hunter, Miami, and Jacopo Crivellaro, Geneva

Ninth Circuit Upholds Validity of Cost-Sharing Regulations in Altera

On June 7, 2019, the Court of Appeals for the Ninth Circuit released its opinion in *Altera v. Commissioner*, Nos. 16-70496 and 16-70497. The Ninth Circuit, in a 2-1 split panel opinion, reversed the Tax Court's 15-0 court-reviewed opinion, 145 T.C. 91 (2015), issued on July 27, 2015.

Background

The *Altera* case involves a challenge by a subsidiary of Intel Corporation to the validity of Treas. Reg. § 1.482-7(d)(2), which requires US corporations to allocate some of their stock-based compensation expenses to foreign affiliates that are participants in a cost-sharing agreement to develop intangible property. In the Tax Court and in the Ninth Circuit, the taxpayer contended that Treas. Reg. § 1.482-7 was invalid because Treasury and the IRS did not engage in "reasoned decisionmaking" required by the Administrative Procedure Act ("APA") and by the Supreme Court in *Motor Vehicles Manufacturers Ass'n v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29 (1983) and *Chevron, U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). The Tax Court held that Treasury and the IRS had failed to: (i) connect Treas. Reg. § 1.482-7(d)(2) to evidence in the rulemaking record that unrelated parties do not share stock-based compensation expenses in arm's length transactions; (ii) respond to significant comments that the public had offered on this issue; and (iii) explain how a rule requiring related parties to share stock-based compensation was consistent with the arm's length standard in section 482 if unrelated parties would not share them.

The Ninth Circuit's First Opinion

On appeal, in a July 24, 2018 opinion, the Ninth Circuit held that Treasury and the IRS had complied with the APA and case law in promulgating Treas. Reg. § 1.482-7(d)(2). Further, the Ninth Circuit determined that the Tax Court erred in requiring the IRS to apply a purely external benchmark to determine what constitutes arm's length behavior. Instead, the Ninth Circuit ruled that the "commensurate with income" standard in section 482 permits the IRS to apply a purely internal benchmark to cost-sharing arrangements in the absence of comparable transactions between unrelated parties. Applying this standard, the Ninth Circuit, in a 2-1 panel decision, held that Treas. Reg. § 1.482-7(d)(2) was a permissible interpretation of section 482 that was entitled to deference under *Chevron*.

On August 14, 2018, the Ninth Circuit withdrew its July 24, 2018 opinion because one of the judges on the original panel had passed away before the opinion was issued. As a result, the Court ordered that oral argument would be held again to give the new judge an opportunity to hear the arguments.

The Ninth Circuit's Second Opinion

The Ninth Circuit heard oral re-argument on October 16, 2018 in front of the reconstituted panel. The Ninth Circuit issued a new opinion on June 7, 2019. The new opinion was largely consistent with the original opinion. Like the original opinion, the new opinion holds that Treas. Reg. § 1.482-7(d)(2) was both procedurally and substantively valid. Like the original opinion, the Ninth Circuit held that despite the lack of any evidence that unrelated parties dealing at arm's length share such expenses, the regulation was a valid and reasonable interpretation of section 482. And, as in the original opinion, one of the three panelists dissented. Below are a few highlights from the Court's reissued opinion.

Comparable Transaction Method Not Sole Reliable Means of Determining Arm's Length Pricing

In holding that the arm's length standard in section 482 does not require a comparison of a taxpayer's transactions to what unrelated parties would do, the majority stated that an analysis of comparable transactions is not the exclusive method for determining the appropriate costs to be shared in cost-sharing arrangements under section 482. In doing so, the majority emphasized that the IRS is not required to provide empirical evidence of comparable transactions in order to impose a rule regarding the costs to be shared in a cost-sharing arrangement.

The majority, while acknowledging that Treasury had determined during the notice-and-comment process there was substantial evidence that unrelated parties dealing at arm's length do not in fact view stock-based compensation as a cost to be shared when developing intangible assets, held that contrary evidence was not necessary. Accordingly, the Ninth Circuit held, as it did in its original opinion, that the regulation was not arbitrary and capricious in requiring stock-based compensation expenses to be allocated to foreign affiliates, even if unrelated parties would not do so.

Relation Between Chevron and State Farm Doctrines

As a clarification to its original opinion, the Ninth Circuit explained that a taxpayer's challenge to a regulation's validity under the standard set forth in *State Farm* is distinct from a challenge to a regulation's validity under the *Chevron* standard. Specifically, the Ninth Circuit noted that these two tests are "related but distinct." The Ninth Circuit described the *State Farm* test in procedural terms—"whether a rule is procedurally defective as a result of flaws in the agency's decisionmaking process." The court described the *Chevron* test in substantive terms—"whether the conclusion reached as a result of that process—an agency's interpretation of a statutory provision it administers—is reasonable." Ultimately, the Ninth Circuit applied a standard that functionally resembled both *State Farm* and *Chevron*, but it noted that a taxpayer could challenge Treasury Regulations under either test or both if it desired.

Commensurate-with-Income Standard

The new Ninth Circuit opinion held that the 1986 amendment to section 482, which added the "commensurate with income" standard, applied to the rulemaking at issue. The government argued that the commensurate-with-income standard, which applies to transfers of intangible property, is a modification of the "traditional" arm's length standard and can be applied separate from the arm's length standard. In contrast, the taxpayer argued that the commensurate-with-income standard is still subject to the arm's length standard as an outer limit and that the commensurate-with-income standard was inapplicable in this case because the cost-sharing arrangement did not involve the transfer of any intangible assets. Siding with the government, the majority interpreted the word "any" in "any transfer . . . of intangible property" as referring to any intangible property. Because a qualified cost-sharing arrangement involves transfers that will give rise to future developed intangibles, the arrangement, according to the majority, involved the transfer of intangible property "albeit intangibles that have yet to be developed." In contrast, the dissenting judge read "any" as meaning "any transfer," in other words referring to transfers of existing intangible property.

Third-Party Comparison Unnecessary for Commensurate with Income

The new Ninth Circuit majority opinion concludes that the commensurate-with-income standard is a "purely internal one, that is, internal to the entity being taxed." In reaching this determination, the court cited the legislative history to the 1986 amendment to section 482, attempting to tie the "purely internal" test to Congressional intent. Specifically, the court notes that:

> Congress expressed numerous concerns that pre-1986 allocation methods permitted entities to undervalue their tax liability by placing undue emphasis on "the concept of comparables" and basing allocations on industry norms, rather than on actual economic activity. Doing away with analysis of comparable transactions, and instead requiring an internal method of allocation, proves a reasonable method of alleviating these concerns.

According to the majority opinion, Congress's concern with taxpayers' overemphasis on strict comparability of transactions to what unrelated third parties would do necessitated the creation of a new purely internal transfer pricing measurement standard. On this basis, the Ninth Circuit held that the general arm's length standard in section 482 cannot be the outer limit in all cases for determining the appropriate pricing of an arrangement. Instead, the commensurate-with-income standard can operate independently of the arm's length standard and require that US corporations be compensated for providing stock-based compensation, even if unrelated parties would not do so.

Dissenting Opinion

Judge O'Malley, the dissenting judge, mostly devoted her new opinion to addressing the novel aspects of the majority opinion's reasoning. Generally, Judge O'Malley questioned the majority opinion's disregarding the arm's length standard in favor of the commensurate-with-income standard. Judge O'Malley also called attention to the long-standing history of the arm's length standard and observed that:

> Since the 1930s, Treasury regulations consistently have explained that, "in determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer."

Next Steps

After the Ninth Circuit's reissued opinion, the taxpayer has the option to seek rehearing en banc in the Ninth Circuit or to file a petition for certiorari in the Supreme Court.

By: Brandon King, Washington, D.C.

Section 956 Final Regulations Provide Two Modifications from Proposed Regulations

On May 22, 2019, the Treasury published final regulations (T.D. 9859) under section 956 (the "Final Regulations"). Similar to the proposed regulations published on November 5, 2018 (the "Proposed Regulations"), the Final Regulations exclude corporations that are US shareholders ("Corporate US Shareholders") from the application of section 956 to maintain symmetry between the taxation of actual repatriations and the taxation of effective repatriations after passage of the Tax Cuts and Jobs Act ("TCJA"). To achieve this result, the Final Regulations provide that the amount otherwise determined under section 956 (the "Tentative Section 956 Amount") with respect to a Corporate US Shareholder for a taxable year of a controlled foreign corporation ("CFC") is reduced to the extent that the Corporate US Shareholder would be allowed a deduction under section 245A if the Corporate US Shareholder received a distribution from the CFC in an amount equal to the Tentative section 956 Amount (the "Hypothetical Distribution"). In general, under section 245A and the Final Regulations, respectively, neither an actual dividend to a Corporate US Shareholder, nor such a shareholder's Tentative Section 956 Amount, will result in additional US tax.

Although the Final Regulations are substantially similar to the Proposed Regulations, which were discussed in more detail in the December 2018 NATPG newsletter, the Final Regulations provide two modifications to the Proposed Regulations. See prior *Tax News and Developments* article, *"Proposed Regulations Reduce Income Inclusions for CFC Shareholders"* (December 2018) First, the Final Regulations revise the ordering rule to attribute the Hypothetical Distribution exclusively to previously taxed income ("PTI") resulting from subpart F income and untaxed E&P. Second, the Final Regulations apply to US partnerships that are US Shareholders of a CFC.

In the first modification to the Proposed Regulations, the Final Regulations address concerns related to the application of the section 956 to prior year E&P. Published commentary raised concerns regarding the mechanical application of the Proposed Regulations because the Proposed Regulations, in conjunction with the section 959 ordering rule, could result in a Corporate US Shareholder continuing to have inclusions under Section 956 despite meeting the eligibility requirements for a Section 245A deduction. This result would have been at odds with the stated goal of the Final Regulations to maintain symmetry between the taxation of actual repatriations and effective repatriations post TCJA. To address this problem, the Final Regulations include an ordering rule to treat a Hypothetical Distribution as attributable first to E&P described in section 959(c)(2) (Subpart F PTI), then to E&P described in section 959(c)(3) (untaxed E&P) to ensure consistency with the allocation of an amount determined under section 956 pursuant to section 959(f)(1). This rule is illustrated in §1.956-1(a)(3)(iii); a new example in the Final Regulations.

The second modification to the Proposed Regulations, which included no provisions for the application of section 956 to US partnerships, provides rules for US partnerships that are US Shareholders of a CFC. The Final Regulations provide that the US partnership computes its Tentative section 956 Amount, then reduces that amount by the aggregate of the deductions that would be allowed to its domestic corporate partner under section 245A in a hypothetical distribution equal to the Tentative Section 956 Amount.

The Final Regulations apply to tax years of a CFC beginning on or after July 22, 2019, and to tax years of a Corporate US shareholder in which those tax years end. However, consistent with the reliance allowed for proposed regulations, taxpayers may apply the Final Regulations for Taxable years of a CFC beginning after December 31, 2017, provided the taxpayer consistently applies the Final Regulations with respect to all CFCs in which they are a Corporate US Shareholder for taxable years beginning after December 31, 2017.

By: Nick Serra, Chicago

Grasping for Simplicity, Beyond Arm's Length: OECD Releases its "BEPS 2.0" Work Program

On May 31, 2019, the OECD/G20 Inclusive Framework on BEPS released its *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy*. The "ambitious work program" was endorsed by G-20 leaders during the June 28-29 summit in Osaka, Japan.

The work program provides a roadmap for technical work proceeding under the January 23, 2019 Policy Note *Addressing the Tax Challenges of the Digitalisation of the Economy*, in which the Inclusive Framework agreed to examine and develop proposals on a "without prejudice basis" that fall into two pillars. "Pillar 1" addresses the tax challenges of digitalization through proposed changes to nexus standards designed to allocate additional taxing rights to market jurisdictions. "Pillar 2" contains a global minimum tax proposal. The OECD hopes these proposals will provide a basis for international consensus on a long-term solution for addressing the tax challenges of digitalization, and the work has been described as "nothing less than BEPS 2.0" by OECD Secretary-General Angel Gurría.

In order to keep pace with its challenging timeline that promises to deliver a ready-to-implement solution by the end of 2020, the work program contemplates that, over the coming six months, the OECD will simultaneously proceed with technical work under several Committee on Fiscal Affairs subsidiary bodies, including Working Party 1, 2, 6, and 11, as well as the Task Force on the Digital Economy and other subsidiary bodies, while also reaching political agreement on general architecture for a solution by January 2020.

After all, the global reallocation of taxing rights is by necessity a political negotiation, and the OECD must hammer a compromise that is palatable to the 130 countries of the Inclusive Framework from Andorra to Zaire. This emphasis on consensus among Inclusive Framework Members is new, as the original BEPS Project Actions were developed by OECD Member countries, and the Inclusive Framework was simply formed as a group of countries committed to implementing the four BEPS minimum conditions.

Reaching political agreement among such diverse stakeholders is a new challenge for the OECD, but the work program is explicitly intended to facilitate political agreement in a decidedly complex and high stakes area, with an eye to finding a simple, administrable solution for developed and developing countries alike. We describe key points from the work program at a high level below.

Pillar 1 - Profit Allocation and Nexus

All of the proposals under Pillar 1 are designed to allocate additional taxing rights, which the Program calls the "new taxing right" to "market jurisdictions," the jurisdiction of the customer and/or user. The proposals would operate alongside current profit allocation rules, but are expected to employ simplifying conventions that depart from the arm's length principle to reduce compliance costs. The three major building blocks of issues under this topic are:

(1) approaches to determine amount of profits subject to the new taxing right and allocating those profits among market jurisdictions;

(2) the design of a new nexus rule with a novel concept of business presence in a market jurisdiction not constrained by physical presence; and

(3) different instruments to ensure effective administration and resolution of tax disputes.

The work program describes three possible profit allocation approaches. The first, the modified residual profit split method ("MRPS") would allocate a portion of an multinational enterprise group's non-routine profit that reflects the value created in markets not recognized under existing profit allocation rules. While this method may be the approach with the least technical departure from arm's length concepts, the approach may prove too complex for global application.

Another option would be a fractional apportionment method, which would subject a portion of all MNE profits to the new taxing right. This approach would not distinguish between routine and non-routine profit, and appears consistent with the significant economic presence proposal, which has been advanced by India.

The work program also considers discusses distribution-based approaches as an option, a new proposal derived from business contributions at the OECD's Public Consultation held in Paris on March 13-14, 2019. One possibility would be to specify a baseline profit in the market jurisdiction for marketing, distribution, and user related activities, which could increase based on the MNE group's overall profitability. This mechanism would be used to reallocate a portion of non-routine profits to market jurisdictions. Another feature being considered in order to limit controversies would be that any profit allocated under such a method might be a final allocation—i.e., not one that taxpayers or tax authorities could re-evaluate and dispute under transfer pricing rules. The work program hints that distribution-based approaches may be the frontrunner in the profit allocation category, describing such approaches as "consistent with the strong demand for simplicity and administrability."

Chapter II discusses another material design feature of the new nexus/profit allocation approach—scoping. The work program recites the 2015 BEPS Action 1 Report conclusion that the economy as a whole is digitalizing, and, as a result, it would be difficult, if not impossible, to ring-fence the digital economy. Nevertheless, paragraph 37 of the work program states that scope limitations to the new taxing right may be appropriate, to the extent that the activities and assets within the scope of the new taxing right would not be undertaken or exploited by all businesses. The technical work will consider different possibilities for limiting the scope of the new taxing right by reference to the nature or size of a given business, and whether such limitations are legally possible or whether they might be inconsistent with international trade regulations.

Pillar 2 - Global Anti Base Erosion Proposal (GloBe)

Pillar 2 contains the global anti-base erosion ("GloBe") proposal, which Inclusive Framework Members have agreed to explore and which has been advanced primarily by France and Germany. This proposal is described as addressing remaining BEPS risk, and is framed within a narrative of preventing a "harmful race to the bottom … effectively undermining the tax sovereignty of nations."

The proposal would operate through two interrelated rules:

(1) an income inclusion rule that would tax the income of a foreign branch or controlled entity if its income was subject to an effective tax rate below a minimum rate; and

(2) tax on base eroding payments through the denial of deductions or imposition of source-based taxes such as withholding tax on certain payments, unless such payments are subject to tax at or above a minimum rate. The GloBe proposal would be implemented through domestic and treaty law changes, as well as possible co-ordination rules to address double taxation.

Interestingly, the work program specifically cites to the Action 1 Report and states that “the scope of the anti-base erosion proposal is not limited to highly digitalised businesses.” This direct statement under Pillar 2, absent from the Pillar 1 discussion, reinforces the impression that possible ring-fencing may still arise through the scoping exercise under Pillar 1.

From Here to 2020…

To meet its admittedly ambitious timeline, the OECD must set a furious pace for the political and technical work remaining, particularly the development of a unified approach under Pillar 1 and the key design elements of the GloBe proposal under Pillar 2.

A further report on the progress of the work is expected in December 2019, prior to the hoped-for agreement on the general architecture of a consensus solution by January 2020. Chapter IV of the work program also describes a phased impact assessment, with further Secretariat-led analysis to be delivered to the Inclusive Framework by the end of 2019. Impact assessment work is expected to continue in 2020 to help evaluate the impacts of the proposals. An Inclusive Framework consensus-based implementation-ready solution is targeted for the end of 2020.

While the debates are undeniably high stakes, early July comments from OECD Director Pascal Saint-Amans bode well, indicating that there is strong political will among countries to reach a common solution as quickly as possible and that “things are moving fast.”

By: Grace Meador, San Francisco

IRS Issues Proposed Regulations on Section 3405 Withholding

On May 31, 2019, the IRS issued proposed regulations under section 3405 clarifying income tax withholding on certain payments from commercial annuities, individual retirement plans, and employer deferred compensation plans (“Proposed Regulations”). The IRS reaffirmed most of its earlier guidance under Notice 87-7, which was issued in 1987, and added rules in respect of payments to military personnel and payments delivered outside of the United States and its possessions.

Section 3405 requires the payor of certain periodic and nonperiodic payments to withhold income tax from the payments. A periodic payment is defined as any designated distribution that is an annuity or similar periodic payment. A nonperiodic distribution is defined as any designated distribution that is not a periodic payment. Under section 3405(e), a designated distribution generally includes any distribution or payment from an employer deferred compensation plan (i.e., pension, annuity, profit sharing, or stock bonus plan or other plan deferring the receipt of compensation), an individual retirement plan, or a commercial annuity (i.e., an annuity, endowment, or life insurance contract issued by an insurance company licensed to do business under the laws of any state).

Under the statutory framework, an individual may elect to have withholding under section 3405 not apply. However, pursuant to sections 3405(e)(13)(A) and (B), no election can be made with respect to any payment delivered outside of the United States and its possessions unless the recipient certifies to the payor that the recipient is not (i) a United States citizen or a resident alien of the United States, or (ii) an individual to whom section 877 applies.

In Notice 87-7, the IRS identifies three categories of payees:

1. Payees who have provided payors with a residence address outside of the United States;
2. Payees who have provided payors with a residence address within the United States; and
3. Payees who have not provided payors with a residence address.

Under Notice 87-7, the payor is required to withhold income tax from payments to payees from the first and third categories. A payee who has provided the payor with an address for the payee's nominee, trustee, or agent without also providing the payee's residence address is deemed to be included in the third category. With respect to the payees in the second category, Notice 87-7 provides that the payor is required to withhold income tax from payments to the payee unless the payee has elected to not have withholding apply.

In the Preamble to the Proposed Regulations, the IRS concluded that Notice 87-7 generally provides "an administrable standard with respect to withholding under section 3405 that is consistent with the purposes of the statute" and bases the Proposed Regulations on the guidance provided in Notice 87-7. In addition, the Proposed Regulations clarify the application of section 3405 and Notice 87-7 in the following situations:

- If a payee provides the payor with an Army Post Office ("APO"), Fleet Post Office ("FPO"), or Diplomatic Post Office ("DPO") address, the Proposed Regulations treat an APO, FPO, or DPO address as an address located within the United States. In the Preamble to the Proposed Regulations, the IRS noted that section 3405(e)(13) (relating to disallowing an election not to withhold) was enacted with the intent to increase compliance of US persons residing abroad. Congress was concerned, based on data gathered by the General Accounting Office (GAO), that "the percentage of taxpayers who fail to file returns is substantially higher among Americans living abroad than it is among those resident in the United States..." However, the GAO data referred to in the legislative history of section 3405(e)(13) "does not include United States military personnel and their families as taxpayers who are living abroad." The IRS observed that the enforcement of compliance by individuals receiving mail at an APO, FPO, or DPO address generally does not involve the same challenges as the IRS faces when enforcing compliance by other taxpayers living abroad. Taxpayers with an APO, FPO, or DPO address commonly maintain an employment or contractor relationship with the United States federal government. In addition, APO, FPO, or DPO addresses are generally treated as ‘‘domestic’’ by the United States Postal Service. Accordingly, under the Proposed Regulations, APO, FPO, and DPO addresses are treated as addresses located within the United States.

- The Proposed Regulations impose mandatory withholding requirements on payors when a payee provides a residence address located within the United States but requests that the funds be delivered outside of the United States or delivered within the United States with further instructions to forward outside the United States. Notice 87-7 does not mandate withholding in this scenario and allows an election not to withhold. The IRS revisited the language of section 3405(e)(13)(A), which prohibits an election with respect to ‘‘any periodic payment or nonperiodic distribution which is to be delivered outside of the United States,’’ and concluded that the new withholding requirement is consistent with the text and purpose of section 3405(e)(13)(A).

- The Proposed Regulations require withholding under section 3405 if a payee provides a residence address outside of the United States or does not provide any address, regardless of delivery instructions. Under these rules, the payor is required to withhold even if a payee requests that payment be delivered to a financial institution located within the United States. In this regard, the IRS observed that the funds deposited with a financial institution in the United States can be easily withdrawn by a person located outside the United States and therefore “the payee’s residence address is more likely to be indicative of the place the distribution is ultimately to be delivered than the location of the financial institution.” The IRS stated that these rules are consistent with Notice 87-7, which uses the residence address to determine whether the payee may elect not to have withholding apply.

The Proposed Regulations confirmed that section 3405 withholding does not apply to payments that are subject to withholding under subchapter A of Chapter 3 of the Code (e.g.., withholding under section 1441 on payments to non-resident aliens) or would be so subject but for a tax treaty.

Taxpayers may continue to rely on Notice 87-7 until the Proposed Regulations are finalized, or, in the alternative, taxpayers may rely on the Proposed Regulations until the applicability date of the final regulations. Thus, advisors should ensure that clients understand that regardless of whether they supply a US or foreign address, mandatory withholding may apply to payments to be delivered outside of the United States even before the Proposed Regulations are finalized.

By: Olga Sanders, New York

Clarification Only: IRS Finalizes Regulations Regarding Properties Transferred to REITs Following a Section 355 Distribution with Minimal Change

On June 7, 2019, Treasury and the IRS finalized proposed regulations under section 337, which imposes a corporate-level tax on certain transfers of property by a C corporation to a real estate investment trust ("REIT") following a section 355 "spin-off" transaction. In large part, these final regulations adopt the proposed regulations issued on March 26, 2019 without material changes. But Treasury and the IRS did clarify certain aspects of the proposed regulations, specifically relating to the term "converted property" and the final regulations' interaction with section 856(c)(8).

Background

Before discussing the 2019 final regulations, it is important to understand the development of the rules as context. The key case is *General Utilities v. Helvering*, 296 U.S. 200 (1935) in which the U.S. Supreme Court held that corporations generally could distribute appreciated property to their shareholders without the recognition of corporate-level gain. Congress explicitly repealed the so-called "General Utilities Doctrine" by, among other changes to the Code, enacting section 336 in 1986. Section 336 overrides the General Utilities Doctrine by providing that a property distribution by a corporation in complete liquidation is a taxable transaction as if such property was sold to the distributee at its fair market value. In doing so, and via section 337(d), Congress provided Treasury and the IRS with the authority to prescribe regulations as may be necessary, including regulations to ensure that gain recognition may not be circumvented through the use of a regulated investment company ("RIC"), REIT, or tax-exempt entity. Under this authority, final regulations were issued in 2003 which generally treat appreciated assets of a C corporation acquired by a RIC or REIT in a "conversion transaction" (either a transfer from a C corporation to a RIC or REIT or a C corporation's election of RIC or REIT status) in accordance with section 1374. This means that if the RIC or REIT disposes of the assets within a set "recognition period," the RIC or REIT must recognize the built-in gain in the assets attributable to the period in which the assets were held by a C corporation.

Prior to 2015, a number of taxpayers were able to structure a section 355 distribution involving a REIT whereby the corporations would separate REIT-qualifying assets from non-REIT-qualifying assets in a tax-deferred manner. Effectively, taxpayers were able to avoid corporate-level tax on the built-in gain held by such REIT as long as the assets were held during the recognition period. In response, in 2015, Congress enacted section 856(c)(8) and section 355(h) which provide that if a corporation was either the distributing or the controlled corporation in a section 355 distribution, the corporation (or its successor) is not eligible to elect to be a REIT for any tax year beginning before the end of the 10-year period beginning on the date of the section 355 distribution.

Development of Regulations under Section 337

In 2016, Treasury and the IRS issued temporary and proposed regulations under section 337, which imposed several restrictions on conversion transactions occurring within ten years of a section 355 distribution. In relevant part, under the 2016 proposed regulations, if a C corporation is the distributing corporation or the controlled corporation in a related section 355 distribution, and the C corporation or its successor engages in a conversion transaction involving a REIT, the C corporation or its successor will be treated as making a "deemed sale election," thus requiring the C corporation to recognize all built-in gain in property transferred to the REIT.

In July 2017, the IRS issued Notice 2017-38 listing the section 337 regulations as one of the eight regulations that should be reviewed for either imposing an undue financial burden on US taxpayers or adding undue complexity to the US federal tax laws. The IRS acknowledged that the rules "could result in over-inclusion of gain in some cases, particularly where a large corporation acquires a small corporation that engaged in a section 355 spinoff and the large corporation subsequently makes a REIT election." *See* Notice 2017-38, Section III.2.

In March 2019, to address the potential over-inclusion of gain, the IRS issued revised proposed regulations and partially withdrew the 2016 proposed regulations. Broadly speaking, under the 2019 proposed regulations, when a C corporation engages in a section 355 distribution and later in a conversion transaction, it must recognize gain only to the extent of the built-in gain on property that is traceable to the earlier section 355 distribution.

2019 Final Regulations

The 2019 final regulations became effective June 7, 2019, without a 30-day delay in the effective date. Accordingly, the 2019 final regulations apply to (A) conversion transactions occurring on or after June 7, 2019 and to (B) conversion transaction and related section 355 distributions for which the conversion transaction occurs before June 7, 2019, and the related section 355 distribution occurs on or after June 7, 2019.

Although commentators made various suggestions to the 2019 proposed regulations—many of which could have been taxpayer favorable—Treasury and the IRS did not make material changes to the 2019 proposed regulations. Instead, Treasury and the IRS clarified two items.

First, the 2019 proposed regulations would have defined the term "converted property" as "property owned by a C corporation that becomes the property of a RIC or a REIT and *any other property* the basis of which is determined, directly or indirectly, in whole or in part, by reference to the basis of the property owned by a C corporation that becomes the property of a RIC or a REIT." 81 Fed. Reg.

36816. A commentator requested that the definition be clarified to confirm that the phrase “any other property” refers only to property of a RIC or a REIT. Treasury and the IRS agreed and revised the definition accordingly. *See* Treas. Reg. § 1.337(d)-7(a)(2)(vii).

Second, a commentator inquired whether Treasury and the IRS intended the 2019 proposed regulations to override section 856(c)(8), which provide that if a corporation was either the distributing or the controlled corporation in a section 355 distribution, the corporation (or its successor) is not eligible to elect to be a REIT for ten years. Treasury and the IRS confirmed that they did not intend to do so. Thus, if section 856(c)(8) would prevent a distributing corporation or a controlled corporation from electing REIT status, no gain would be recognized, absent further action (for example, a merger of the distributing corporation or the controlled corporation into a REIT).

Conclusion

Treasury and the IRS have maintained their stance on effecting the repeal of the General Utilities Doctrine as applied to certain transfers of property to RICs and REITs and have rejected various commentator suggestions based on this position. For example, a commentator suggested reducing the 20-year period application of the automatic deemed sale rule to ten years, but Treasury and the IRS rejected this comment by citing the need to “ensure the continuing integrity of General Utilities repeal.” Another commentator suggested that the section 337 regulations should not apply to a member of the separate affiliated group of the distributing corporation or the controlled corporation. Likewise, Treasury and the IRS declined to adopt this suggestion as they have determined that this requirement “would further the intent of Congress to prevent avoidance of General Utilities repeal.” Considering that Treasury and the IRS are maintaining their position and several aspects of the section 337 regulations are now clarified, REITs should take special care when acquiring property from a C corporation to ensure that the possible application of the section 337 regulations is not overlooked.

By: Mary Yoo* and *David Gong, Chicago

Canada Revenue Agency Releases a Notice to Tax Professionals on Hybrid Financing into Canada

The Canada Revenue Agency (“CRA”) has been attacking inbound to Canada hybrid financing structures for several years now. These transactions typically involve the use of forward subscription agreements - and are meant to be respected as debt for Canadian income tax purposes, but treated as equity for US income tax purposes.

Earlier this month, the CRA published a “Notice to tax professionals” in which it stated that it has “resolved a file regarding a hybrid mismatch arrangement involving the deduction of non-arm's length interest in a series of transactions that included a forward subscription agreement … on the basis that paragraphs

247(2)(b) and (d) of the Income Tax Act and transfer pricing penalties applied." Paragraphs 247(2)(b) and (d) are the Canadian transfer pricing rules that may apply where transactions are entered into that: (i) would not have been entered into by parties dealing at arm's length; and (ii) are undertaken primarily to obtain tax benefits. Where these conditions are met, amounts may be adjusted in quantum or nature to reflect transactions that would have been entered into between persons dealing at arm's length.

It has been known for some time that the CRA has been considering the possibility of the application of paragraphs 247(b) and (d) against hybrid financing arrangements into Canada. Canadian tax practitioners have been, on balance, skeptical of the CRA's chances of success with approach. We will continue to monitor developments in this area.

By: Alex Pankratz, Toronto

IRS Concedes Position on Creditability of French Social Charges

According to a joint status report filed with the US Tax Court by the IRS and the taxpayers in the case, the IRS is set to withdraw its position that certain French social charges are covered by the Social Security Totalization Agreement between France and the United States and, therefore, not creditable foreign incomes taxes. The result would be that US taxpayers resident in France and subject to these social charges should be able to claim additional foreign tax credits for the amounts contributed going forward and may be able to amended previously filed tax returns to claim such credits as well.

For a more detailed discussion, please see the Baker McKenzie Client Alert, *"IRS Concedes Position on Creditability of French Social Charges,"* distributed on June 25, 2019.

By: Elliot Murray, Geneva

Treasury and IRS Release Temporary Regulations Under Sections 245A and 954(c)(6)

The Treasury and IRS released temporary regulations under sections 245A and 954(c)(6) on June 14, 2019. The temporary regulations partially deny the section 245A dividends-received deduction to repatriated earnings that were generated by dispositions of property from a specified foreign corporation to a related person during the period after December 31, 2017, but before the effective date of the section 951A GILTI regime for fiscal year taxpayers. As applicable to both fiscal year and calendar year taxpayers, the regulations also wholly or partially deny the dividends-received deduction to dividends arising from a reduction of a controlling US shareholder's ownership in a controlled foreign corporation that could result in a reduction of subpart F or GILTI inclusions. The temporary regulations additionally extend such provisions to dividends from a lower-tier controlled foreign corporation to an upper-tier controlled foreign corporation by limiting the exception to subpart F under section 954(c)(6).

The temporary regulations apply to dividends received after December 31, 2017. For a more detailed discussion, please see the Baker McKenzie Client Alert, "*Treasury and IRS Release Temporary Regulations Under Sections 245A and 954(c)(6)*," distributed on July 2, 2019.

By: Elizabeth Lieb, Palo Alto

Treasury and IRS Release Final and Proposed Regulations on GILTI

On June 14, 2019, the Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") released final regulations related to "Global Intangible Low-Taxed Income" ("GILTI"), as reflected in new section 951A of the Code (the "Final Regulations"). Additionally and concurrently, Treasury and the IRS released proposed regulations to the GILTI and Subpart F regimes related to (1) domestic partnership ownership treatment and (2) "high taxed" income otherwise taxed under GILTI (the "2019 Proposed Regulations").

The Final Regulations largely follow the 2018 Proposed Regulations, but made several changes to Subpart F income and GILTI inclusion rules, including (i) a revision to the anti-abuse rule for specified tangible property held temporarily, (ii) a revision to the pro rata share anti-abuse rule, (ii) an adjustment to the inclusion period rules, (iii) technical changes to the cumulative preferred stock rule and (iv) a rule barring reductions in both Subpart F income and GILTI tested income as a result of dividend distributions.

The Final Regulations generally adopt an aggregate approach for domestic partnerships for purposes of applying section 951A, including any related provision that applies by reference, such as sections 959 (providing for "previously taxed earnings and profits"), 960 (providing for "deemed paid" foreign tax credits) and 961 (providing for basis adjustments). Importantly, the Final Regulations do not adopt the "hybrid aggregate-entity" approach from the 2018 Proposed Regulations. Similarly, the 2019 Proposed Regulations modify the Subpart F regime to generally extend the aggregate approach for controlled foreign corporation ("CFC") investments made by domestic partnerships.

Treasury and the IRS finalized a "high tax" exception to GILTI, but only for CFC income otherwise subject to Subpart F and excepted under the "high tax" regime of section 954(b)(4). This limitation means that, to be eligible for the exception, the income would have to be considered foreign base company income ("FBCI") under section 954(a) or insurance income under section 953. Many taxpayers have been engaged in attempts to convert CFC income to FBCI to enjoy foreign tax credits with no haircut and timing constraints or enjoy the "high tax" exception.

However, the 2019 Proposed Regulations introduced an expanded "high tax" exception to GILTI for CFC income subject to a rate of tax similar to section 954(b)(4), that is greater than 90 percent of the U.S. statutory corporate tax rate of 21 percent (or greater than 18.9 percent). The 2019 Proposed Regulations are intended to be prospective only, although Treasury has encouraged

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comments to the newly proposed "high tax" exception to GILTI and hinted that it would consider making the final regulations retroactive by election. It would be applied on a qualified business unit ("QBU") by QBU basis and would be elective for all commonly controlled U.S. shareholders of the CFC. While the election may be revoked, upon revocation, it generally cannot be made again for another 60 months.

For a more detailed discussion, please see the Baker McKenzie Client Alert, "*Treasury and IRS Release Final and Proposed Regulations on GILTI and the States Have Now Weighed In*," distributed on July 16, 2019.

By: Lawrence Zlatkin, New York

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