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International Tax ADVISORY ▪

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Trickle Down Guidance: Interim Notices Tackle Key International Reforms

On April 2, in quick succession, the IRS and Treasury announced notices addressing two provisions added by the Tax Cuts and Jobs Act (TCJA): the repatriation tax under Section 965 and withholding on non-publicly traded partnerships under Section 1446(f). Given the statutory provisions' immediate impact – and in the case of Section 965, retroactive effect – official guidance and transitional relief cannot reach taxpayers fast enough.

Notice 2018-26 – Repatriation Tax

To transition to the participation exemption regime of the TCJA, Section 965 requires U.S. shareholders, as defined in Section 951(a)(1), to include as Subpart F income their share of the accumulated post-1986 deferred foreign earnings of all "deferred foreign income corporations" (DFICs). A DFIC's Subpart F income is increased by the greater of its accumulated post-1986 deferred foreign earnings as of November 2, 2017, or December 31, 2017 ("cash measurement dates").

DFIC means a "specified foreign corporation" (SFC) that has deferred foreign income. SFC means a controlled foreign corporation (CFC) or a foreign corporation that has at least one corporate U.S. shareholder. Deferred foreign income includes all post-1986 earnings other than effectively connected income (ECI) or, in the case of a CFC, earnings that, if distributed, would be excluded from a U.S. shareholder's income as previously taxed income.

The U.S. shareholder's inclusion occurs in the last tax year of a DFIC beginning before January 1, 2018. Due to the Section 965(c) deduction, generally a 15.5% rate applies to earnings held in liquid assets and an 8% rate to earnings held in illiquid assets. Taxpayers may elect to pay the Section 965 tax liability in eight installments.

The IRS and Treasury already issued two notices and a revenue procedure under Section 965: Notice 2018-07, Notice 2018-13, and Revenue Procedure 2018-17. The IRS also released Publication 5292 to assist taxpayers with their Section 965 computations.

Notice 2018-26

The latest notice gives taxpayers direction not only on computational issues but also the scope of Section 965. For example, the IRS and Treasury plan to issue regulations to address some of the compliance headaches raised by the repeal of Section 958(b)(4). For the purpose of determining whether a corporation is an SFC (other than a CFC), stock owned directly or indirectly by a "tested partner" will not be considered owned by a partnership under Sections 958(b) and 318(a)(3)(A) if the tested partner owns less than 5% of the partnership's capital and profits. The notice's exception to downward attribution is not unlimited, however, as the tested partner will be treated as owning another partner's partnership interest under Sections 958(b) and 318, as if the partnership interest were stock.

Future regulations would also provide rules to determine cash measurement dates in cases where an SFC ceased to exist before November 2, 2017, or a U.S. shareholder acquired or disposed of SFC stock between measurement dates. An SFC that ceased to exist before November 2, 2017, could have a measurement date as early as November 2, 2015. A U.S. shareholder must take into account its share of an SFC's cash position as of any measurement date on which the shareholder is a U.S. shareholder, whether or not the shareholder is a U.S. shareholder on any other measurement date.

Generally, an SFC's earnings and profits (E&P) or deficit in E&P is determined under rules similar to those for domestic corporations. Notice 2018-13 announced exceptions to this general rule to ease compliance. The latest notice offers another limited exception that enables taxpayers to allocate foreign income taxes that accrue on or before December 31, 2017, and between measurement dates.

Under anti-avoidance rules described in the notice, a transaction will be disregarded for Section 965 purposes if it (1) occurs, in whole or in part, on or after November 2, 2017; (2) has a principal purpose of reducing Section 965 tax liability; and (3) would, absent the anti-avoidance rules, reduce the Section 965 tax liability of a U.S. shareholder (by reducing the inclusion amount or aggregate cash position or increasing certain foreign taxes). In addition to describing presumed and per se avoidance transactions, the notice states that certain changes in accounting method (unless requested before November 2, 2017) and entity classification elections filed after November 2, 2017 (including retroactive elections) will be disregarded for Section 965 purposes – whether or not there was a principal purpose to avoid Section 965 tax.

The notice states that regulations will clarify that individual U.S. shareholders who make a Section 962 election (to be taxed as a corporation on Subpart F income) will be allowed to take the Section 965(c) deduction against Section 11 corporate tax. The deduction will not be treated as a miscellaneous itemized deduction subject to the 2% floor of Section 67 or disallowance under the alternative minimum tax.

A particularly welcome aspect of the notice is relief from underpayment and estimated tax penalties, so long as a taxpayer timely pays their Section 965 tax liability, either in the inclusion year or in elective annual installments. A taxpayer's estimated tax payments do not need to account for amounts attributable to Section 965 tax liability or liability otherwise attributable to Section 965 and the repeal of Section 958(b)(4).

Taxpayers may rely on the operative and procedural provisions of the notice, including the anti-avoidance rules, before regulations are issued. The IRS and Treasury continue to seek comments on Section 965 computation issues in anticipation of releasing further guidance.

Notice 2018-29 – Foreign Partner Withholding

Under new Section 864(c)(8), gain or loss from a foreign partner's sale or disposition of a partnership interest will be ECI to the extent the foreign partner would have had ECI had the partnership sold all of its assets at fair market value. This provision, added by the TCJA, specifically overrides a 2017 Tax Court decision *(Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner)* and applies to dispositions on or after November 27, 2017.

Relatedly, Section 1446(f)(1) requires a transferee to withhold 10% of the amount realized if any gain on disposition of a partnership interest would be ECI. An exception to withholding applies if the transferor certifies that it is not a foreign person. Under Section 1446(f)(4), if the transferee fails to withhold, the partnership is required to deduct and withhold from distributions to the transferee tax equal to the amount the transferee failed to withhold (plus interest). Section 1446(f) generally applies to dispositions after December 31, 2017.

On December 29, 2017, the IRS and Treasury released Notice 2018-08, which suspended the requirement to withhold on dispositions of certain interests in publicly traded partnerships (PTPs). This prior notice had also sought comments on whether a temporary suspension should apply for non-PTPs.

Notice 2018-29

Despite comments requesting a general suspension of Section 1446(f) withholding for non-PTP interests until specific guidance can be issued, Notice 2018-29 boldly presses forward with guidance for "an effective and orderly implementation" while allowing several limited exceptions. The notice effectively directs transferees of partnership interests to consult and use the forms and procedures under Section 1445, relating to withholding on dispositions of U.S. real property interests, for purposes of Section 1446(f). No penalties or interest will apply if repurposed forms are filed and correctly withheld amounts are paid over to the IRS on or before May 31, 2018.

Withholding is not required if the transferee receives a certification of non-foreign status, including a Form W-9 meeting certain requirements. Forthcoming regulations would also provide exceptions to withholding if the transferee receives a certification that (1) the transferor will not realize gain on the disposition of its partnership interest; (2) the transferor's allocable share of ECI was less than 25% of its total distributive share for each of the transferor's three most recent prior tax years; (3) satisfies the notice of nonrecognition requirements under Section 1.1445-2(d); or (4) if the partnership sold its assets at fair market value, the amount of gain that would be ECI would be less than 25% of the total gain. Transferors would furnish the first three types of certifications, while the partnership would furnish the last type.

The notice offers guidance on the amount of partnership liabilities to be included in the amount realized for purposes of Section 1446(f) withholding. A transferor that is not a controlling partner can provide a certification to the transferee showing the transferor's share of partnership liabilities based on a sufficiently recent Schedule K-1 and certifying that the transferor does not have actual knowledge of events after the Schedule K-1's issuance that would significantly change the share of liabilities. A transferor is a controlling person if it and related persons own a 50% or greater interest in capital, profits, deductions, or losses in the 12 months pre-disposition. Alternatively, a partnership can issue a certification stating the transferor's share of liabilities and certifying that the partnership does not have actual knowledge of events after its determination that would significantly change the share of liabilities. A difference of 25% or less of the transferor's share of liabilities is not significant.

Future regulations would limit the amount of withholding under Section 1446(f) by a transferee (other than the partnership or a person related to the transferor) if the amount otherwise required to be withheld would exceed the amount realized less the decrease in the transferor's share of partnership liabilities. Rules would also permit a partnership to rely on its books and records or a partner's certification to determine whether a distribution exceeds the partner's basis in its partnership interest, such that gain would be realized and subject to withholding. The IRS and Treasury also plan to issue rules coordinating Sections 1445 and 1446(f) and clarifying look-through treatment in the case of tiered partnerships.

The notice graciously postpones withholding by a partnership under Section 1446(f)(4) (i.e., when a transferee fails to withhold) until regulations or other guidance is issued under that provision. Transferees can rely on the notice's provisions until more definitive guidance is released. In the meantime, the notice also solicits further comments on PTP and non-PTP withholding under Section 1446(f).

For more information, please contact Edward Tanenbaum at 212.210.9425 or Heather Ripley at 212.210.9549.

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