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CLIENT ALERT

Treasury and IRS Issue Additional Guidance on Securities and Sections 965, 1446(f) and 163(j)

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On Monday, April 2, 2018 the Internal Revenue Service ("IRS") and Treasury Department issued three notices addressing forthcoming guidance on three new provisions enacted as part of "an Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," otherwise known as the Tax Cuts and Jobs Act ("TCJA"). This memorandum provides a high-level review of those notices.

Notice 2018-26

Notice 2018-26 announces forthcoming guidance with respect to Section 965 of the Internal Revenue Code of 1986, as amended (the "Code"). Section 965 imposes a "transition tax" on U.S. shareholders who own 10% or more of certain specified foreign corporations ("SFCs"). The tax is levied on the untaxed foreign earnings of the SFCs and is generally taxed at a 15.5% rate for earnings held in cash and cash equivalents and an 8% rate for other retained earnings. Somewhat higher effective rates apply to non-corporate U.S. shareholders. The transition tax can generally be paid in installments over eight years.

The main portion of the notice (Section 3) announces the IRS and Treasury's intent to issue regulations as follows:

- To limit the application of the "downward attribution" rules to cause a foreign corporation to be an SFC for purposes of Section 965. The Notice provides that for purposes of Section 965, stock of a foreign corporation owned by a partner in a partnership will not be considered as being owned by the partnership if such partner owns less than 5% of the interests in the partnership's capital and profits;

- Guidance regarding cash measurement dates when an SFC ceases to exist in between cash measurement dates or when stock of an SFC is acquired or sold by a U.S. shareholder in between those dates;

- An exception to the general rule for computing post-1986 earnings and profits for certain foreign income taxes that accrue between measurement dates;

- A new broad anti-abuse rule which would invalidate, for purposes of Section 965, the effect of transactions occurring on or after November 2, 2017 if such transaction is undertaken with a principal purpose of reducing the transition tax liability of a U.S. shareholder and such transaction would in fact reduce such tax liability. In addition, any change in accounting method or entity classification election made on or after November 2, 2017 is ignored for purposes of Section 965 without regard to its principal purpose if it has the effect of reducing a U.S. shareholder's transition tax; and

- Certain procedural matters, including documentation of cash positions, clarifying the application of Section 965 and certain elections thereunder with respect to domestic pass-through owners, the effect of a Section 965(n) election on NOL computations, filing and payment due dates for U.S. individuals living abroad and clarifying that a Section 965(c) deduction is not treated as an itemized deduction.

The remaining portions of the notice announce:

- The intent to issue regulations providing that the terms "accounts receivable" and "accounts payable" referred to in Notice 2018-13 will include only receivables or payables with a term of less than one year (Section 4).

- The intent to issue regulations clarifying that an individual owner of a domestic pass-through entity of an SFC may make a Section 962 election only if the owner is a U.S. shareholder of the SFC and clarifying that the Section 965(c) deduction will apply for purposes of the tax calculation arising from the Section 962 election (Section 5).

- Relief from certain penalties (Section 6).

- Effective dates – generally the Notice's provisions are effective beginning for the first taxable year of a foreign corporation to which Section 965 applies (Section 7).

Notice 2018-29

Notice 2018-29 announces rules that modify or suspend the requirement to withhold 10% of the amount realized by a non-U.S. person on the sale, exchange or other disposition of an interest in a partnership that is engaged in the conduct of a U.S. trade or business.

The TCJA added Section 864(c)(8) to the Code, which treats a non-U.S. person's gain or loss from the sale, exchange, or other disposition of a partnership interest on or after November 27, 2017 as "effectively connected income" ("ECI") to the extent that the person would have had ECI had the partnership sold all of its assets at fair market value. The substantive liability of a non-U.S. person to pay tax on such ECI is policed by Section 1446(f), which requires the transferee to withhold 10% of the amount realized.

The notice provides rules for dispositions of partnership interests that are not publicly traded and supplements Notice 2018-08, issued late last year, which suspended the withholding requirement for dispositions of publicly traded interests in publicly traded partnerships. These changes to the withholding rules, however, do not affect a non-U.S. partner's substantive tax liability.

Notice 2018-29 announces the IRS and Treasury's intent to issue regulations as follows:

- To report and deposit withheld taxes, transferees will generally use the forms that apply under the "FIRPTA" rules to gain from the sale of United States real property interests, which is also treated as ECI. Taxpayers complying with these provisions on or before May 31, 2018 will not be subject to penalties or interest.

- No withholding is required if the transferor certifies that it is not a foreign person. An affidavit meeting the requirements of the FIRPTA rules or an IRS Form W-9 will suffice.

- No withholding is required if the transferor certifies that the disposition will not result in gain (*e.g.*, the selling partner has a loss) or that a non-recognition provision applies.

- No withholding is required if (1) the transferor certifies that less than 25% of its income from the partnership during the last 3 years was ECI or (2) the partnership certifies that less than 25% of the gain from a deemed asset sale would be ECI.

- The amount realized includes a reduction in the selling partner's share of partnership liabilities. To determine the amount of liabilities, the transferee may generally rely on the transferor's most recent Schedule K-1 or on a certification from the partnership.

- A partnership can be required to withhold if it makes a distribution to a non-U.S. partner in excess of that partner's basis in its partnership interest. The partnership may generally rely on its books and records, or on a certification from the distributee partner, to determine whether the distribution exceeds the partner's basis.
- In general, if withholding is required under both the new rules and the FIRPTA rules, the FIRPTA rules will apply.
- The requirement that the partnership must withhold on distributions to the transferee to the extent the transferee is required, but fails, to withhold on the transfer will not apply until regulations are issued.
- Gain on the transfer of an interest in an upper-tier partnership can be treated as ECI because of the deemed sale of an interest in a lower-tier partnership. Regulations will require lower-tier partnerships to furnish information so that their partners can perform these calculations.

Notice 2018-28

The TCJA amended Section 163(j) to limit the deduction for business interest expense to the sum of (i) business interest income and (ii) 30% of adjusted taxable income. Adjusted taxable income is taxable income before interest, net operating loss deduction, and, for years before 2022, any deduction for depreciation, amortization or depletion. Any business interest deduction disallowed pursuant to Section 163(j) may be carried forward indefinitely. Prior to the TCJA, Section 163(j) imposed limitations on deduction interest paid to certain related or tax-exempt parties. As in the current version of Section 163(j) disallowed interest deductions were able to be carried forward.

Notice 2018-28 announces the IRS and Treasury's intent to issue regulations as follows:

- The business interest deduction will be calculated at the consolidated group level, rather than at the level of each corporation within a consolidated group. Intercompany obligations of the consolidated group will be disregarded.
  - The regulations will be issued to address the interaction of Section 163(j) and the carryforward of interest deduction and the consolidated return regulations, such as when a member enters or leaves the group. No indication was given as to how these matters will be addressed.
- Earnings and profits calculations will not be impacted by the rules of Section 163(j). Business interest will reduce earnings and profits without regard to whether the deduction for such business interest is disallowed.
- All interest paid or accrued by a C corporation will be business interest for purposes of Section 163(j), and all interest that is includable in the gross income of a C corporation will be treated as business interest.

  - The regulations will also address the extent to which interest paid, accrued, or includible in gross income by a non-corporate entity, such as a partnership, in which a C corporation holds an interest will be treated as business interest. The Notice does not indicate what these rules will provide.

- Where a partnership has more business interest income than business interest expense, the excess will not increase the partners' capacity to deduct business interest on their tax returns.

- The TCJA includes new Section 59A (commonly referred to as the "BEAT"), which imposes an excise tax on certain payments to foreign related parties. The regulations will provide that any interest that was disallowed under the prior version of Section 163(j), and is carried forward to a tax year beginning after December 31, 2017, will be subject to Section 59A in the same manner as interest paid or accrued during such tax year. This regulation will effectively apply the BEAT to interest disallowed under prior Section 163(j), but deducted following the enactment of the BEAT. This provision is controversial because it effectively imposes an excise tax on payments made prior to enactment of the BEAT.

If you have any questions regarding this client alert, please contact the following attorneys or the attorney with whom you regularly work.

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