KPMG

# Tax Reform – Tax Administrative Guidance in the First Year Following Enactment

**Supplement to KPMG Report on New Tax Law**

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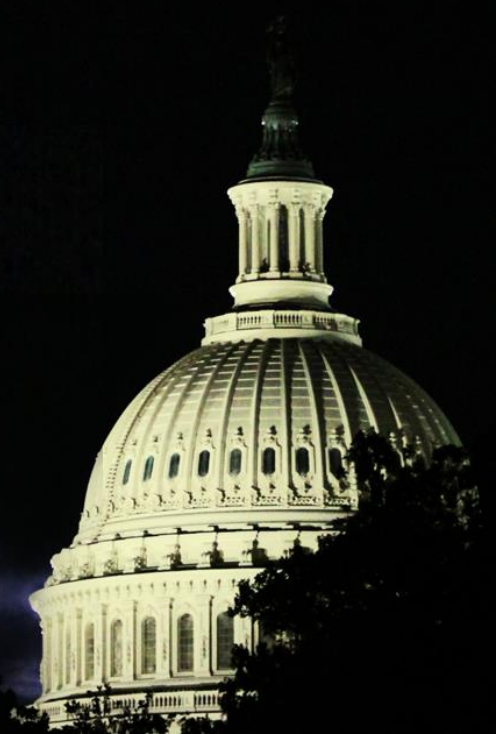
**NOTE: Reflects developments through December 31, 2018. For more recent developments, see *TaxNewsFlash-Tax Reform*.**



# Introduction

On December 22, 2017, the president signed into law legislation originally known as the Tax Cuts and Jobs Act. Shortly after enactment of the new law (Public Law No. 115-97), KPMG LLP ("KPMG") released an **over 200-page report** [PDF 10 MB] ("KPMG Book") with discussion, analysis, and observations regarding the new law.

This report serves as a supplement to the KPMG Book. Since the enactment of the new law, the Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") have been working to implement the new law through issuing significant guidance on many issues.[1] This report summarizes federal administrative tax guidance issued in the first year following the law's enactment, as well as federal tax legislation enacted in that year, with respect to provisions of the new law.[2] The report also includes excerpts from select articles and other reports that KPMG professionals have prepared on the new law. Articles and reports by KPMG professionals reflect the views of those professionals only and do not necessarily reflect the views or advice of KPMG.

Note that this supplement only addresses legislative changes to the extent those changes were enacted and modify provisions of the new law.[3] For example, this supplement covers a legislative change to the new law's treatment of cooperatives made by the Consolidated Appropriations Act, 2018 (Pub. L. No. 115-141, enacted on March 23, 2018), as well as modifications made to a few new law provisions by the Bipartisan Budget Act of 2018 (Pub L. No. 115-123, enacted on February 9, 2018). The supplement, however, does not cover other changes made by Pub. L. No. 115-123—including the enactment of some provisions that had been dropped from the legislation as it moved through the legislative process in 2017.[4]

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1 The IRS also has made available a tax reform **webpage** that includes sections highlighting how the new law may affect individuals, businesses (including international businesses), tax-exempt organizations, retirement plans, tax-advantaged bonds, and government entities. These webpage sections summarize some of the key changes made with respect to various issues and list relevant resources with respect to those issues. In addition, Treasury's **2018-2019 priority guidance plan** [PDF 123 KB] released on November 9, 2018, lists 62 guidance projects relating to the new law—including just under 30 proposed regulations, IRS notices, and other items that already had been issued by that date. The plan may continue to be updated throughout the plan year.

2 In most cases, this supplement refers to the date the IRS and Treasury released advance versions of guidance as the date of issuance of such guidance. Also, except to the extent specified otherwise, references to "sections" are to sections of the Internal Revenue Code of 1986, as amended, or to Treasury regulations promulgated thereunder.

3 Note that, on August 16, 2018, the U.S. Senate Finance Committee released a letter that then-Chairman Orrin Hatch (R-UT) and 12 other Republican members of the committee sent to the Treasury and IRS, identifying some issues in the new law that require technical corrections legislation or regulatory guidance. The **letter** [PDF 3.5 MB] focused on three provisions—depreciation of qualified improvement property, the effective date of net operating loss (NOL) deduction changes, and the deduction of legal fees in connection with sexual misconduct settlements. In addition, then-House Ways and Means Committee Chairman Kevin Brady (R0TX) included several technical corrections as amendments to a bill (H.R. 88) that the House passed in December 2018 but that did not become law during the 115th Congress. He also released a "discussion draft" of technical corrections legislation in January of 2019. Read ***TaxNewsFlash***. Because technical corrections legislation with respect to the new law has not yet been enacted, it is not addressed further in this supplement.

4 Provisions that were dropped as the new law moved through the legislative process but that were enacted as part of Pub. L. No. 115-123 include provisions relating to modifications to user fee requirements for installment agreements, deduction for attorney fees and court costs to whistleblowers, and broadened scope of collected proceeds eligible for awards to whistleblowers.

This supplement also does not address the **General Explanation of Public Law 115-97** prepared by the staff of the Joint Committee on Taxation (JCS-1-18), which was issued on December 20, 2018. Nonetheless, this so-called "blue book" can be helpful to taxpayers in better understanding the new law, as well as to Treasury and the IRS as they continue to implement the law. In addition, the blue book indicates in footnotes areas in which technical corrections may be necessary to carry out Congressional intent. However, although a blue book can be relevant in interpreting a law, courts have found that it does not constitute official legislative history.[5]

This supplement only addresses U.S. federal tax matters. Further it only **reflects developments through December 31, 2018**. Please see ***TaxNewsFlash-Tax Reform*** for coverage of significant developments occurring after the issuance of this supplement.

Finally, it is important to note that the summaries of developments in this supplement are drawn from *TaxNewsFlash* articles that were issued shortly after developments occurred. These summaries generally have not been updated to take into account developments that occurred after the underlying *TaxNewsFlash* articles were issued.

**Additional resources**

A host of additional resources relating to the new law are available on KPMG's website (**read.kpmg.us/tax-reform**), including links to summaries and detailed reports, industry views, webcasts, insights on technical and practical business issues, and information about modeling and business impact analysis.

5 See, e.g., *United States v Woods,* 134 S.Ct. 557 (2013).

# Contents

# Business – General

## Corporate income tax rate and corporate AMT

Under the new law, the rate of corporate income tax was reduced to a flat rate of 21%, effective for tax years beginning after December 31, 2017. The new law also repealed the corporate alternative minimum tax (AMT) imposed under section 55, effective for tax years beginning after December 31, 2017.

### Blended income tax rate for fiscal year C corporations: Notice 2018-38 and IR-2018-99

On April 16, 2018, the IRS issued **Notice 2018-38** [PDF 22 KB], regarding federal income tax rates for fiscal year corporate taxpayers under the new law. The IRS noted that many U.S. corporations that use a fiscal year (rather than a calendar year) for federal income tax purposes will pay a "blended" rate of federal income tax as provided by section 15 for the fiscal year that includes January 1, 2018.

Notice 2018-38 addresses the corporate income tax rate under section 11(b), the corporate AMT under section 55, and the application of section 15, in determining the federal income tax (including the AMT) of a corporation with a fiscal or tax year that began before January 1, 2018, and ends after December 31, 2017. The notice explains that a corporation with a tax year that includes but does not start on January 1, 2018 must apply section 15(a) to determine the amount of federal income tax imposed under section 11 for that tax year. The notice further explains that certain taxpayers—e.g., life insurance companies and regulated investment companies—that are not subject to the tax imposed under section 11(a) but are taxed under other Code provisions that use the rates of tax set forth in section 11(b) apply section 15 in the same manner. Examples are provided in the IRS notice to illustrate application of these measures.

A related IRS release—**IR-2018-99**—notes that, with the new law, fiscal year corporate taxpayers determine their federal regular income tax for fiscal years that include January 1, 2018, by:

- First, calculating their income tax for the entire tax year using the tax rates in effect before the new law
- Second, calculating their tax using the new 21% rate
- Next, prorating each tax amount based on the number of days in the tax year during which the different rates were in effect.
- Finally, adding the sum of these two amounts to determine the corporation's federal income tax for the fiscal year that includes January 1, 2018.

The release states that fiscal year taxpayers that already filed their federal income tax returns for the tax year that includes January 1, 2018, but did not show the blended rate, may want to consider filing amended returns.

The release also notes that the federal sequester law remains in effect for the 2018 fiscal year, and reminds corporations to consider how these rules may affect their tax credits and refunds. Read an **IRS posting** on the effect of sequestration on the AMT credit for corporations.

## Modified net operating loss deduction

### New 80% limitation: KPMG article

Read an article by Becky Sager and Maury Passman of KPMG on the changes to the net operating loss rules in the new law, ***Does NOL Stand for Net Operating Loss or Non Obstante Lamentum? A Discussion of Amendments to Section 172 by H.R. 1*** [PDF 203 KB], published in the July/August 2018 edition of Corporate Taxation Journal.

The article examines the new rules for the treatment of losses, analyzes alternative interpretations of how the new 80% limitation could apply when pre-effective-date and post-effective-date losses are in the mix, and identifies the interpretation of the 80% limitation that seems to make the most sense in light of the uncertainty at the time the article was written.

## Cost recovery

### Modification of rules for expensing depreciable assets

*"Qualified real property" expensing and alternative depreciation: Rev. Proc. 2019-08*

On December 21, 2018, the IRS released **Rev. Proc. 2019-08** [PDF 70 KB] regarding expense deductions and depreciation measures related to real property that were enacted by the new law.

As background, the new law amended:

- Section 179, by modifying the definition of "qualified real property" that may be eligible as section 179 property under section 179(d)(1)

- Section 168, by (1) requiring certain property held by an electing real property trade or business (defined by section 163(j)(7)(B)) to be depreciated under the alternative depreciation system in section 168(g)) and (2) reducing the recovery period under the alternative depreciation system from 40 to 30 years for residential rental property

- Section 168, by requiring certain property held by an electing farming business (defined by section 163(j)(7)(C)), to be depreciated under the alternative depreciation system

As explained in a related IRS release—**IR-2018-257**—Rev. Proc. 2019-08 provides guidance on deducting expenses under section 179(a) and on deducting depreciation under section 168(g), generally for tax years beginning after 2017, as follows:

- Section 179 allows taxpayers to deduct the cost of certain property as an expense when the property is placed in service. For tax years beginning after 2017, the maximum amount of the expense deduction under section 179 was increased from $500,000 to $1 million. The phase-out limit increased from $2 million to $2.5 million. These amounts are indexed for inflation for tax years beginning after 2018. The deduction under section 179 applies to tangible personal property—such as machinery and equipment purchased for use in a trade or business—and if the taxpayer elects, qualified real property. The new law amended the definition of qualified real property to mean qualified improvement property and some improvements to nonresidential real property—including roofs; heating, ventilation and air-conditioning property; fire protection and alarm systems; and security systems. Rev. Proc. 2019-08 explains how taxpayers can elect to treat qualified real property as section 179 property.

- The category of businesses that must use the alternative depreciation system (ADS) under section 168(g) has been expanded. A farming business can elect out of the interest deduction limit of section 163(j). If it does, the business must use the ADS for property with a recovery period of 10 years or more. A real property trade or business can also elect out of the section 163(j) limit. If it does, the business must use the ADS for nonresidential real property, residential rental property, and qualified improvement property. Rev. Proc. 2019-08 explains how electing real property trades or businesses or farming businesses change to the ADS for property placed in service before 2018, and provides that this is not a change in accounting method.

- The ADS recovery period of residential rental property has been revised, so that for property placed in service after 2017, the recovery period is 30 years. Previously, it was 40 years. Rev. Proc. 2019-08 provides an optional depreciation table for residential rental property depreciated under the ADS with a 30-year recovery period.

### *Proposed bonus depreciation regulations*

The Treasury and IRS on August 8, 2018, released for publication in the Federal Register **proposed regulations** [PDF 321 KB] (REG-104397-18) implementing changes to the additional first-year depreciation deduction ("bonus depreciation") enacted as part of the new law.

The regulations are proposed to be effective for property placed in service during or after the tax year the proposed regulations are finalized, but taxpayers can rely on them now.

As such, taxpayers that have or would like to take positions on their 2017 federal income tax returns that may differ from the proposed regulations may do so, but they should consider reviewing those positions in light of the proposed regulations.

Under the new law, qualified property is generally eligible for 100% bonus depreciation if it is acquired and placed in service after September 27, 2017, and before 2023 (with certain long-lived property, transportation property, and aircraft eligible through 2023). Bonus depreciation phases out after 2022 on a set schedule. Under the new law, both new and used property are generally eligible for bonus depreciation.

The proposed regulations clarify a number of areas that were left unclear in the statute, including when qualified property is "acquired," when "used" property will be eligible for bonus depreciation, and how the new rules apply in the context of partnership items, such as those arising in the context of sections 704(c), 732, 734(b), and 743(b).

Comments regarding the proposed regulations were due by October 9, 2018. A **notice of public hearing** [PDF 186 KB] about the proposed bonus depreciation regulations is in the October 30, 2018, edition of the Federal Register. The hearing is scheduled for November 28, 2018. Outlines of topics to be discussed at the public hearing are due by November 15, 2018.

The following observations are drawn from a KPMG report dated August 9, 2018.

**Key issues for the 2017 tax year: Elections**

As under prior law, a taxpayer is required to claim bonus depreciation unless it elects out. The "election out" is made on an asset recovery class basis. Taxpayers may have any number of reasons for electing out, including avoiding the expiration of income tax credits or net operating losses. If a taxpayer fails to elect out of bonus depreciation on its originally filed return, its only recourse is to seek "9100 relief," which can be an expensive process. Therefore, taxpayers should consider whether the election should be made and for which recovery classes.

In addition, for the tax year that includes September 27, 2017, taxpayers that are otherwise eligible for 100% bonus depreciation can elect to claim 50% bonus depreciation instead. This election differs from the general "election out" provision in that this election, if made, applies to all qualified property of the taxpayer and cannot be made on a class-by-class basis.

Both the election out of bonus depreciation and the election to claim 50% in lieu of 100% bonus depreciation are made entity by entity and by each member of a consolidated group (although the common parent files a single election statement).

Finally, 2017 is the last remaining opportunity to elect to claim refundable alternative minimum tax (AMT) credits in lieu of claiming bonus depreciation under section 168(k)(4). Fiscal year taxpayers may want to consider this election as well to accelerate the refund

of these credits. For tax years beginning after 2017, AMT credits are refundable on a set schedule over a period of years without having to forgo bonus depreciation.

**Qualified property**

Property eligible for bonus depreciation includes:

- Tangible depreciable property with a MACRS GDS recovery period of 20 years or less
- Computer software depreciable under section 167(f)(1)
- Water utility property
- Specified fruit and nut plants
- Qualified film, television, and live theatrical production property

In addition, qualified property includes “qualified improvement property” (QIP) that is acquired and placed in service after September 27, 2017, and before 2018. QIP acquired before September 28, 2017, and placed in service by December 31, 2019, potentially is eligible for bonus depreciation under former section 168(k) (as in effect before amendment by the new law). QIP acquired after September 27, 2017, and placed in service after 2017 is not currently eligible for bonus depreciation. As long as they are made after the building’s initial placed-in-service date, most improvements to the interior of nonresidential real property are QIP, other than expansions, elevators, escalators, or structural work.

Qualified property does not include:

- Property required to use ADS (property for which ADS is elected remains bonus eligible):
    - Foreign-use property, tax-exempt use property, and tax-exempt bond-financed property
    - Nonresidential real, residential rental, and QIP owned by an electing real property trade or business (as defined in section 163(j)(7)(B))
    - Real property with a recovery period of 10 years or more owned by an electing farming business (as defined in section 163(j)(7)(C))
    - Property 50% or more personal use
- Property for which the taxpayer has elected out of bonus depreciation
- Property placed in service and disposed of in the same tax year

- Property for which the taxpayer has elected out of section 168
- Property primarily used in the business of a regulated utility (if placed in service in a tax year beginning after 2017)
- Property used in a business with “floor plan financing” (FPF) if interest on the FPF was taken into account in computing the business interest expense limitation under section 163(j) (if placed in service in a tax year beginning after 2017).

**Original use / certain used property**

To be eligible for 100% bonus depreciation, qualified property must meet either the “original use requirement” or the “used property acquisition requirement.”

The original use requirement is met if the original use of the property—i.e., the first use to which the property is put—commences with the taxpayer. Additional capital expenditures incurred by a taxpayer to recondition or rebuild property acquired or owned by the taxpayer satisfy the original use requirement; however, the cost of reconditioned or rebuilt property does not satisfy the original use requirement (but may satisfy the used property acquisition requirement). For this purpose, property that contains used parts is not treated as reconditioned or rebuilt if the cost of the used parts is not more than 20% of the total cost of the property (whether acquired or self-constructed).

The used property acquisition requirement is met if: (1) the property was not used by the taxpayer or a predecessor at any time prior to the acquisition; (2) the property is acquired by purchase, and not from a “related party” (as defined in section 179(d)(2)); and (3) to the extent the cost of the property is not determined by reference to the basis of other property held at any time by the acquiring taxpayer (e.g., in the case of a like-kind exchange). For this purpose, the property is treated as used by the taxpayer or a predecessor if such party had a depreciable interest in the property at any time prior to the acquisition, whether or not depreciation was claimed.

As an exception to the general rule described above, which disallows bonus depreciation in substituted basis transactions, the proposed regulations provide special rules for property transferred or sold between consolidated group members or transferred in certain tax-free contributions and distributions (e.g. sections 332, 351, 721, and 732). Under these rules, bonus depreciation is generally allowed as long as the original acquisition by the transferor meets the general requirements.

With respect to consolidated groups, generally, if a member of a consolidated group acquires depreciable property in which another member of the group (either current or previous) had a depreciable interest, the property does not satisfy the used property acquisition requirement. See below for a discussion of how the requirement is applied to certain partnership transactions.

**Acquisition-date requirement**

To be eligible for 100% bonus depreciation, qualified property must be acquired and placed in service after September 27, 2017. As provided in the new law, property acquired under a written binding contract is treated as acquired on the date that contract is executed. Previous iterations of section 168(k) included a separate provision for qualified property manufactured, produced, or constructed by the taxpayer ("self-constructed property"), whereby that property was treated as acquired on the date construction began. The new law failed to include such a provision.

In accordance with the written-binding-contract language of the new law, the proposed regulations provide that all property "acquired or constructed" under a written binding contract is treated as acquired on the date the contract was executed. This departure from prior law demands heightened scrutiny of contracts for the acquisition of qualified property to determine whether they are properly considered binding.

Under the proposed regulations, a written binding contract has each of the following elements:

- It is enforceable under state law against the taxpayer or a predecessor;
- It does not limit damages to a specified amount that is less than 5% of the contract price; and
- It is not subject to a condition within the control of either party.

Letters of intent and options are specifically excluded from written-binding-contract treatment. Similarly, supply agreements that are not specific to both amount and design specification are not considered "binding."

The proposed regulations provide special rules for self-constructed property by the taxpayer. As under prior law, the acquisition date of this property is the date physical work of a significant nature begins. The proposed regulations provide a safe harbor under which physical work of a significant nature begins when the taxpayer incurs 10% of the expected cost of the property, excluding the cost of land and any preliminary activities.

While not specified in the proposed regulations, property that is not acquired under a written binding contract and is not self-constructed property is generally treated as acquired as it is placed in the taxpayer's physical possession or control.

Property that is acquired before September 28, 2017, is subject to the provisions of former section 168(k)—i.e., as it existed before amendment by the new law. If such property meets the definition of qualified property, it is eligible for 50% bonus depreciation if placed in service in 2017; 40% bonus depreciation if placed in service in 2018; or 30% bonus depreciation if placed in service in 2018.

**Placed-in-service-date requirement**

To be eligible for 100% bonus depreciation, qualified property must also be placed in service after September 27, 2017, and before January 1, 2023. The new law provides a four-year phase down of 20% per year for qualified property placed in service in 2023 through 2026.

Certain long-lived property, transportation property, and aircraft that are placed in service in 2027 are eligible for 20% bonus depreciation on costs incurred by December 31, 2027. Such assets otherwise receive an extra year for each bonus percentage—e.g., assets placed in service in 2023 are eligible for 100% bonus depreciation, assets placed in service in 2024 are eligible for 80% bonus depreciation, and so on.

**Partnership issues and special rules**

The proposed regulations contain a number of provisions addressing allocation or claiming of bonus depreciation in specific situations, including: the transfer of qualified property in certain partnership-related transactions; non-recognition transactions; basis redeterminations; like-kind exchanges and involuntary conversions; and changes in use. The proposed regulations have particular impact on certain partnership transactions.

In the favorable column, the proposed regulations provide that partnership basis step-ups under section 743(b) generally are eligible for bonus depreciation, so long as the step-up relates to qualified property, the partnership interest was not acquired from a related party, and the acquirer or a predecessor did not previously have a depreciable interest in the acquired portion of the partnership's property. For this purpose, each partner is treated as having a depreciable interest in the partner's proportionate share of the partnership's property.

On the unfavorable side, the following partnership items are not eligible for bonus depreciation:

- Basis determined under section 732(b)
- Step-ups in basis under section 734(b)
- Remedial allocations under section 704
- Depreciation of the section 704(b) basis of zero tax basis contributed property under the traditional or curative method

In addition, the proposed regulations provide rules for the allocation of bonus depreciation when property is placed in service and transferred in a designated non-recognition transaction in the same tax year. The general rule provides that—when property is transferred in a transaction described under section 332, 351, 721, or 731, or in a transaction between consolidated group members—the bonus depreciation (like the

regular depreciation) is allocated between transferee and transferor based upon the number of months the property is held by each party.

The proposed regulations create a new rule to address certain transactions in which qualified property is acquired and placed in service by a taxpayer, but then the taxpayer contributes the property in a section 721(a) transaction to a partnership in which one of the partners had a previous depreciable interest in the property. This type of fact pattern arises in transactions described in Rev. Rul. 99-5, Situation 1. In these transactions, a taxpayer buys property and contributes the property into a partnership in which the seller is also a partner. Under the proposed regulations, if the acquired property is in service at the time of its acquisition, the bonus depreciation is claimed entirely by the buyer; no bonus depreciation is claimed by the partnership. As a result, the buyer would have the obligation for any bonus depreciation elections with respect to the property.

*Section 382 recognized built-in gains, losses determined without regard to section 168(k) immediate expensing: Notice 2018-30*

On May 8, 2018, the IRS issued **Notice 2018-30** [PDF 22 KB], which modifies **Notice 2003-65** [PDF 98 KB], in response to the additional first-year depreciation deduction available under section 168(k)—the "immediate expensing" provision—as enacted by the new law.

Notice 2018-30 provides:

- The hypothetical cost recovery deductions used in the section 338 approach (described in Notice 2003-65) to identify recognized built-in gain or recognized built-in loss under section 382 are determined without regard to section 168(k).

- In computing the amount of cost recovery deductions that are not attributable to an asset's built-in loss on the change date under the section 1374 approach (also described in Notice 2003-65), the hypothetical deductions that would have been allowable had the loss corporation purchased the asset for its fair market value on the change date are determined without regard to section 168(k).

As a result, taxpayers with net unrealized built-in gain that utilize the section 338 approach will generally have less recognized built-in gain immediately following an ownership change (due to the absence of the additional first-year immediate expensing under section 168(k)) than would generally be available in an actual section 338 election. However, the taxpayer's recognized built-in gain in the remainder of the five-year recognition period would reflect the depreciation deductions determined without regard to section 168(k).

**Background**

Released in September of 2003, Notice 2003-65 provides two alternative approaches for the identification of built-in items for purposes of section 382(h):

- The section 1374 approach—which generally identifies built-in items by incorporating the rules of section 1374 (pertaining to the imposition of entity-level tax on net realized built-in gains of an S corporation).

- The section 338 approach—which generally identifies built-in items by comparing the loss corporation's actual items of income, gain, deduction, and loss with those that would have resulted if a section 338 election had been made with respect to a hypothetical purchase of all outstanding stock of the loss corporation on the ownership change date.

Generally, the section 1374 approach treats items of income or deduction as attributable to the pre-change period if an accrual method taxpayer would have taken such items into account prior to the ownership change.

Because the section 338 approach compares the actual items with items that would have resulted from a hypothetical section 338 election, certain built-in gain assets may generate recognized built-in gain to the extent the hypothetical cost recovery deductions that would have resulted from a section 338 election exceed the actual cost recovery deductions.

**Reason for Notice 2018-30**

As explained in Notice 2018-30, the new law amended section 168(k) to extend and modify the additional first-year depreciation deduction for qualified property that is acquired and placed in service after September 27, 2017, and before January 1, 2027. Under the new law, certain used property also may qualify for the additional first-year depreciation deduction.

Notice 2018-30 notes that these changes have collateral consequences in connection with the section 338 approach—e.g., the additional first-year depreciation would increase recognized built-in gain and reduce recognized built-in loss in the first year of the recognition period, and in some situations, the total recognized built-in gain would increase and the total recognized built-in loss would either increase or decrease over the five-year recognition period. The IRS and Treasury determined that these changes are not appropriate and are not mandated by the new law or the legislative history.

Accordingly, the notice indicates that the IRS and Treasury have determined that the hypothetical cost recovery deductions arising from the additional first-year depreciation allowed under section 168(k) do not provide a reasonable estimate of the income (or expense) produced by a built-in gain (or loss) asset during the recognition period. The IRS and Treasury also identified a similar concern under one aspect of the section 1374 approach.

**Notice 2018-30**

Notice 2018-30 modifies the section 338 approach of Notice 2003-65 to provide that, in determining the recognized built-in gain (or loss), the hypothetical cost recovery deductions that would have been allowable if an election under section 338 had been made are determined without regard to section 168(k).

Notice 2018-30 also modifies the section 1374 approach to provide that, in computing the amount of cost recovery deductions that are not attributable to an asset's built-in loss on the change date, the hypothetical cost recovery deductions that would have been allowable had the loss corporation purchased the asset for its fair market value on the change date are determined without regard to section 168(k).

The IRS and Treasury have requested comments on the treatment of built-in items under section 382(h).

Notice 2018-30 is effective for any ownership changes that occur after May 8, 2018.

*Electing out of 100% bonus depreciation deduction for 2017; IRS reminder*

On October 4, 2018, the IRS issued a release reminding business taxpayers that placed qualifying property in service during 2017 but that want to elect **not** to claim the new 100% depreciation deduction "that they have a limited time to file the required election with the IRS." The IRS release—**IR-2018-196**—notes that, in general, individuals and calendar year corporations must file the election with the IRS by October 15, 2018.

As background, as under prior law, a taxpayer is required to claim bonus depreciation unless it elects out. The "election out" is made on an asset recovery class basis. Taxpayers may have any number of reasons for electing out, including avoiding the expiration of income tax credits or net operating losses. If a taxpayer fails to elect out of bonus depreciation on its originally filed return, its only recourse is to request "9100 relief," which can be an expensive process.

In addition, for the tax year that includes September 27, 2017, taxpayers that are otherwise eligible for 100% bonus depreciation can elect to claim 50% bonus depreciation instead. This election differs from the general "election out" provision in that this election, if made, applies to all qualified property of the taxpayer and cannot be made on a class-by-class basis. Both the election out of bonus depreciation and the election to claim 50% in lieu of 100% bonus depreciation are made entity by entity and by members of a consolidated group (although the group files a single election statement).

Finally, there will be only one remaining opportunity to elect to claim refundable alternative minimum tax (AMT) credits in lieu of claiming bonus depreciation under section 168(k)(4). Taxpayers may want to consider this election as well to accelerate the refund of these credits. For tax years beginning after 2017, AMT credits are refundable on a set schedule over a period of years without having to forgo bonus depreciation.

## Depreciation limitations on luxury automobiles and personal use property: Rev. Proc. 2018-25

On April 17, 2018, the IRS issued **Rev. Proc. 2018-25** [PDF 46 KB] regarding:

- The annual depreciation limitations for passenger automobiles (including trucks and vans) first placed in service in calendar year 2018

- The lease inclusion amounts for automobiles first leased in 2018 (as well as amounts for trucks and vans first leased in 2018)

The revenue procedure reflects changes made by the new law to section 280F that impose dollar limitations on the depreciation deductions for passenger automobiles placed in service during 2018 and for each succeeding year. More specifically,

- Table 1 in the revenue procedure provides the depreciation limits for automobiles acquired **before September 28, 2017,** and placed in service during 2018—thus reflecting the section 168(k) additional first-year depreciation deduction [available prior to enactment of the new law].

- Table 2 provides the depreciation limits for automobiles acquired **after September 27, 2017,** and placed in service during 2018—thus reflecting the additional first-year depreciation deduction [provided by the new law].

- Table 3 provides the depreciation limit for automobiles placed in service during 2018 for which no additional first-year depreciation deduction applies (i.e., in situations in which the taxpayer does not use the automobile during 2018 more than 50% for business purposes, or elected out of the additional first-year depreciation deduction, or acquired a used automobile that fails to satisfy the statutory rules).

- Table 4 applies to lessees of passenger automobiles and shows income inclusion amounts for “a range of fair market values” for each tax year after the automobile is first leased.

The same depreciation limitations apply to passenger automobiles, trucks, and vans. These limitations are required to be adjusted annually for inflation beginning in 2019.

Because the inflation adjustments are calculated differently for passenger automobiles than for trucks and vans, the limitations for the two categories have historically differed in years that they have been inflation adjusted. It is expected the limitations will differ again beginning in 2019.

### Expensing certain citrus replanting costs: Rev. Proc. 2018-35

On June 19, 2018, the IRS released **Rev. Proc. 2018-35** [PDF 19 KB], providing procedures by which certain taxpayers may obtain automatic consent to change their method of accounting for expensing certain citrus replanting costs.

As background, the new law added a special rule for certain costs that are paid or incurred after December 22, 2017, and on or before December 22, 2027, to replant citrus plants after loss or damage of the citrus plants by reason of freezing temperatures, disease, drought, pests, or casualty. Under this special rule, the costs may be deducted by a person other than the taxpayer if:

- The taxpayer has an equity interest of at least 50% in the replanted citrus plants and the other person owns the remaining equity interest; or

- The other person acquires all the taxpayer's equity interest in the land on which the citrus plants were located when damaged and replants on that land.

Rev. Proc. 2018-35 modifies and adds to the list of automatic changes under Rev. Proc. 2018-31—i.e., the procedures by which a taxpayer may obtain automatic consent from the Commissioner to change to a method of accounting described in Rev. Proc. 2018-31.

Rev. Proc. 2018-35 provides that a taxpayer that wants to change its method of accounting under the revenue procedure must follow the automatic change procedures in Rev. Proc. 2018-31 as modified to include new provision 12.15: *Change to not apply section 263A to replanting costs for lost or damaged citrus plants pursuant to section 263A(d)(2)(C).*

## Other business-related deductions, exclusions, etc.

### Limit on deduction of net business interest expense

Very generally, the new law disallows a deduction for net business interest expense of any taxpayer exceeding 30% of a business's adjusted taxable income (generally EBITDA for years before 2022 and EBIT thereafter) and floor plan financing interest. In general, business interest expense and business interest income is interest allocable to a trade or business and does not include investment interest expense or income.

The limitation does not apply to certain small businesses with average gross receipts under $25 million, nor does it apply to certain regulated public utilities and electric cooperatives. Furthermore, some taxpayers, such as certain real estate businesses, may elect out of the new limitation if they use an alternative depreciation system for certain property.

*Proposed regulations (and related IRS release)*

On November 26, 2018, the Treasury and IRS released proposed regulations regarding the business interest limitation provisions of section 163(j). The regulations were published in the Federal Register on December 28, 2018, which indicated that written or electronic comments on the proposed regulations were due by February 26, 2019. A public hearing was scheduled for February 27, 2019.

Read the **proposed regulations** [PDF 707 KB] as published in the Federal Register. Read also a related IRS release (**IR-2018-233**).

Most of the discussion below is drawn from a KPMG report dated November 28, 2018, that provided initial impressions and observations about the proposed regulations as initially released on November 26, 2018 (the **"Proposed 163(j) Package"** [PDF 1.5 MB]). The observations regarding potential insurance and exempt organization implications below are drawn from reports issued on December 3, 2018, and November 30, 2018, respectively. Observations have not been updated for any subsequent developments.

## Background

As indicated above, the new law amended section 163(j) to disallow a deduction for business interest when net business interest expense exceeds 30% of adjusted taxable income (ATI) plus floor plan financing interest for taxable years beginning after December 31, 2017. ATI is computed without regard to deductions allowable for interest, depreciation, amortization, or depletion for taxable years before January 1, 2022. For taxable years beginning thereafter, only interest deductions are added back in computing ATI. Business interest expense that is disallowed under section 163(j) is treated as paid or accrued in the succeeding taxable year and may be carried forward indefinitely. New section 163(j) does not, however, permit excess limitation to be carried forward.

As indicated **later in this supplement**, the IRS previously issued Notice 2018-28 on April 6, 2018, in which it confirmed, among other things, that the section 163(j) limitation would be applied on a consolidated group basis.

## Effective date

Significantly, the proposed rules do not relate back to the enactment of section 163(j). Rather, the rules would be applicable for taxable years ending after the date on which the final regulations are published in the Federal Register.

## Reliance

Taxpayers and related parties (determined under sections 267(b) and 707(b)(1)) have the discretion to apply the proposed rules retroactively to a taxable year beginning after December 31, 2017, but must apply such rules on a consistent basis. Therefore, retroactive application would be binding on the taxpayer and all its related parties (or shareholders in certain cases). Further, although there are separate effective date

provisions within the proposed rules, taxpayers cannot pick and choose which provisions of the proposed rules they want to apply retroactively because the proposed rules require that to make an election, the taxpayer must "consistently apply all of the section 163(j) regulations."

**KPMG observation:** Whether this election should be made would depend on the taxpayer's particular facts and circumstances; however, taxpayers may want to consider the time and resources necessary to update their systems and models to accommodate the relatively complex calculations required by these rules.

## Generally applicable provisions: Sections 1.163(j)-1 through -3 & -9 through -11

### Interest for purposes of section 163(j)

*Overview*

The proposed rules would adopt a broad definition of interest (expense and income) by including not only amounts that would be interest under general tax principles, but also items that would not otherwise be treated as interest for U.S. federal income tax purposes. The preamble explains that the proposed rules would treat as interest "certain amounts that are closely related to interest and that affect the economic yield or cost of funds of a transaction involving interest, but that may not be compensation for the use or forbearance of money on a stand-alone basis." The proposed definition of interest includes general principle-based rules, a number of specifically enumerated items that are treated as interest, and an anti-abuse rule.

The preamble notes that the drafters rejected a narrow definition of interest to increase certainty and to prevent avoidance of the rules. Therefore, the proposed rules provide a definition of interest "that addresses all transactions that are commonly understood to produce interest income and expense, including transactions that may otherwise have been entered into to avoid the application of section 163(j)." The preamble notes that treating items that are closely related to interest as interest income or expense "when appropriate to achieve a statutory purpose is not new."

**KPMG observation:** The broad definition of interest for purposes of section 163(j) raises at least two questions. One is an authority issue. Given that section 163(j) limits the deduction for business interest expense, arguably Congress intended that the rule apply only to business interest, which itself must be a subset of what is considered interest under general tax principles or other provisions of the Code. In addition, section 163(j) does not provide a specific grant of authority for Treasury to issue regulations addressing the scope of "interest" or to capture what might be considered "interest equivalents."

The second question is whether the definition of interest in the proposed rule would be limited to section 163(j) or would spread to other areas of the Code, including other parts of section 163. Pending the resolution of these issues, the broad scope of "interest" will

likely influence many taxpayers' analyses of whether to elect to apply the proposed section 163(j) regulations to tax years ending prior to finalization.

*Summary of the definition of "interest"*

The proposed rules would define interest by reference to four general categories, with certain specific defined items identified in the third category:

- *In general:* The proposed rules would treat as interest an amount that is treated as paid, received, or accrued as compensation for the use or forbearance of money on indebtedness, or an amount treated as interest under other provisions of the Code or the regulations thereunder. The definition includes examples of such items: original issue discount (OID) (adjusted by a holder for acquisition premium or amortizable bond premium); amounts treated as OID under various statutory or regulatory rules; qualified stated interest (adjusted by an issuer for bond issuance premium or a holder for amortizable bond premium); market discount to the extent includible in income by a holder; repurchase premium to the extent deductible by the issuer; deferred payments treated as interest under section 483; amounts treated as interest under a section 467 rental agreement; amounts treated as interest under section 988; forgone interest under section 7872; redeemable ground rent treated as interest under section 163(c); and amounts treated as interest under section 636.

- *Swaps with significant nonperiodic payments:* The proposed rules would treat as interest the time value component of a swap with significant nonperiodic payments, other than a cleared swap with significant nonperiodic payments. The proposed rules would treat such swaps as two separate transactions consisting of an on-market, level-payment swap and a loan that must be accounted for by the parties independently of the swap. The preamble explains that the proposed rule would apply in the same manner as section 1.446-3(g)(4) before it was amended on May 8, 2015, by T.D. 9719, except it would not apply to a collateralized swap that is cleared by a derivatives clearing organization or by a clearing agency.

- *Other amounts treated as interest.* The items treated as interest include:

  - *Premium:*

    - Any ordinary income for an issuer under section 1.163-13(d)(4) (under the bond issuance premium rules) would be treated as interest income.

    - Any amount of premium that is deductible by a holder under section 1.171-2(a)(4)(i)(A) or (C) (under the rules if a holder elects to amortize bond premium) would be treated as interest expense of the holder.

  - *Ordinary income or loss on certain debt instruments:*

- Amounts treated as ordinary income by an issuer of a contingent payment debt instrument subject to the noncontingent bond method of section 1.1275-4(b), a nonfunctional currency contingent payment debt instrument subject to section 1.988-6, or an inflation-indexed debt instrument subject to section 1.1275-7 would be treated as interest income to the issuer.

- A holder's ordinary loss on a contingent payment debt instrument subject to the noncontingent bond method of section 1.1275-4(b), a nonfunctional currency contingent payment debt instrument subject to section 1.988-6, or an inflation-indexed debt instrument subject to section 1.1275-7 would be treated as interest expense by the holder.

o *Substitute interest payments:* A substitute interest payment described in section 1.861-2(a)(7) would be treated as interest (but not tax-exempt interest).

o *Section 1258 gain:* Any gain treated as ordinary under section 1258 (conversion transactions) would be treated as interest income.

o *Amounts affecting a taxpayer's effective cost of borrowing:* Income, deduction, gain, or loss from a derivative, as defined in section 59A(h)(4)(A), that alters a taxpayer's effective cost of borrowing with respect to a liability of the taxpayer would be treated as interest expense of the taxpayer. Thus, payments made or received on an interest rate swap, or any gain or loss resulting from a termination of a swap, would be treated as an adjustment to interest expense, subject to the timing rules of section 1.446-4.

o *Yield adjustments:* Income, deduction, gain, or loss from a derivative, as defined in section 59A(h)(4)(A), that alters a taxpayer's effective yield with respect to a debt instrument held by the taxpayer would be treated as an adjustment to interest income of the taxpayer.

o *Certain amounts labeled as fees:* Commitment fees (fees in respect of a lender commitment to provide financing) would be treated as interest if any portion of such financing is actually provided.

o *Debt issuance costs:* Any debt issuance costs subject to section 1.446-5 (borrowing costs required to be capitalized under section 1.263(a)-5(b)) would be treated as interest expense of the issuer.

o *Guaranteed payments:* Any guaranteed payments for the use of capital under section 707(c) would be treated as interest.

**KPMG observation:** A guaranteed payment for the use of capital may represent a payment for the use of property other than money. The regulation as currently drafted could apply to limit any guaranteed payment for the use of capital deduction – even if for the use of property. The treatment of guaranteed payments as interest would not

be subject to a transition rule and may impact partnerships that currently have guaranteed payments.

- *Factoring income:* The excess of the amount that a taxpayer collects on (or realizes on the sale or other disposition of) a factored receivable over the amount the taxpayer paid for the factored receivable would be treated as interest income.

- *Anti-avoidance rule for amounts predominately associated with the time value of money:* Any expense or loss, to the extent deductible, incurred by a taxpayer in a transaction or series of integrated or related transactions in which the taxpayer secures the use of funds for a period of time would be treated as interest expense of the taxpayer if such expense or loss is predominately incurred in consideration of the time value of money.

*Interaction with other provisions affecting the deduction of interest expense*

The proposed rules address the relationship between section 163(j) and certain other provisions of the Code (section 1.163(j)-3).

In general, section 163(j) and the proposed rules would apply only to business interest expense that would be deductible in the current taxable year without regard to section 163(j). Thus, subject to certain exceptions, the section 163(j) limit would apply after provisions that otherwise subject interest expense to disallowance, deferral, capitalization or other limitation.

- *Disallowance provisions:* Business interest expense would not include interest expense permanently disallowed as a deduction under another provision of the Code: for example, section 163(e)(5)(A)(i) (disqualified portion of OID in the case of an applicable high yield discount obligation (AHYDO), or section 265 (interest relating to tax-exempt income).

- *Deferred interest provisions*: Other than sections 461(l), 465, and 469, Code provisions that defer the deductibility of interest expense (for example, section 163(e)(3) or section 267(a)(2) or (3)) would apply before section 163(j). For purposes other than sections 465 and 469, interest expense would be taken into account for section 163(j) purposes in the taxable year when it is no longer deferred under another section of the Code.

- *At risk rules, passive activity loss provisions, and limitation on excess business losses of noncorporate taxpayers:* Section 163(j) would apply before sections 461(l), 465, and 469.

- *Capitalized interest expenses under sections 263A and 263(g):* Sections 263A and 263(g) would apply before section 163(j). Capitalized interest expense under those rules would not be treated as business interest expense for purposes of section 163(j).

- *Reductions under section 246A:* Section 246A would apply before section 163(j). Any reduction in the dividends received deduction under section 246A would reduce the amount of business interest expense taken into account under section 163(j).

- *Other types of interest provisions:* Except as otherwise provided in the proposed rules, provisions that characterize interest expense as something other than business interest expense, such as section 163(d), would govern the treatment of that interest expense, and such interest would not be treated as business interest expense for purposes of section 163(j).

**Adjusted taxable income**

*General rules*

The proposed regulations would define adjusted taxable income (ATI) as the taxable income of the taxpayer for the tax year with certain adjustments.

Taxable income would be computed in accordance with section 63, but computed without regard to the application of the section 163(j) limitation (i.e., taxpayers would treat all business interest expense as deductible for purposes of calculating taxable income). In addition, if a taxpayer is allowed a deduction under section 250(a)(1) for a portion of its foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI), and that is properly allocable to a non-excepted trade or business ("excepted trade or business" is defined below), taxable income would be determined without regard to the taxable income limitation in section 250(a)(2).

**KPMG observation:** This provision would eliminate the section 250 / section 163(j) circularity problem caused by the taxable income limitation contained in section 250(a)(2) which arises because section 163(j) is dependent on taxable income and taxable income is dependent on knowing the amount of deductible interest. Notwithstanding the simplicity provided by this approach, the proposed rules may result in a lower section 163(j) limitation amount for certain taxpayers depending on their profile.

ATI would then be adjusted by adding the following to taxable income:

- Any business interest expense;

- Any net operating loss (NOL) deduction under section 172 (including NOLs arising in tax years before the proposed rules and carried forward);

- Any deductions under section 199A;

- For tax years beginning before January 1, 2022, any deduction for depreciation, amortization, and depletion (including special allowances under section 168(k));

- Any deduction for a capital loss carryback or carryover; and

- Any deduction or loss that is not properly allocable to a non-excepted trade or business.

ATI would also be adjusted by subtracting the following:

- Any business interest income;
- Any floor plan financing interest expense for the tax year; and
- Any income or gain that is not properly allocable to a non-excepted trade or business.

The proposed rules would also clarify that any amount incurred as depreciation, amortization, or depletion, but allocated to and capitalized with respect to inventory property under section 263A and included in cost of goods sold, is not a deduction for depreciation, amortization, or depletion for purposes of determining ATI.

**KPMG observation:** Depreciation expense attributable to manufacturing facilities is considered allocable to inventory whether the inventory is on hand at year end or not, so even depreciation allocable to current sales may not be added back to ATI.

Furthermore, the proposed rules would provide for adjustments for sales and dispositions of certain property for tax years beginning before January 1, 2022, to avoid double counting. In particular, because deductions for depreciation, amortization, and depletion for tax years beginning after December 31, 2017 and before January 1, 2022 (the "Potential Double Counted Deductions") are added back to taxable income in computing ATI, the proposed rules would provide that with respect to the sale or other disposition of property, any Potential Double Counted Deductions with respect to such property (capped at any gain recognized on the sale or other disposition of the property) must be subtracted from ATI.

Similar rules would apply to avoid a double benefit in the context of a sale or other disposition of stock of a member of a consolidated group that includes the selling member with respect to the investment adjustments (as defined under section 1.1502-32) with respect to such stock that are attributable to any Potential Double Counted Deductions, as well as a sale or other disposition of an interest in a partnership with respect to the taxpayer's distributive share of any Potential Double Counted Deductions with respect to property held by the partnership at the time of sale or other disposition, to the extent such Potential Double Counted Deductions were allowable under section 704(d).

*Rules specific to certain entities*

For partnerships, the proposed rules would provide that, for purposes of computing the partnership's ATI, its taxable income is determined under section 703(a) and includes any items described in section 703(a)(1) to the extent otherwise included under the general

ATI rules described above (section 1.163(j)-6). A partnership would also be required to take into account items resulting from adjustments made to the basis of its property pursuant to section 734(b) for purposes of calculating ATI, but "partner basis items" (defined as items from a section 743 adjustment or the operation of section 704(c)(1)(C) used in a non-exempted trade or business) and remedial items are not taken into account in determining the partnership's ATI.

The ATI of a partner in a partnership would be determined under the general ATI rules described above without regard to such partner's distributive share of any items of income, gain, deduction, or loss of the partnership, and is increased by such partner's distributive share of the partnership's excess taxable income. Partner basis items and remedial items would be taken into account by the partner in determining the partner's ATI. In addition, if a partner disposes of an interest in a partnership that owns only non-excepted trade or business assets, any gain or loss on such disposition would be included in the partner's ATI.

For regulated investment companies (RICs) and real estate investment trusts (REITs), ATI is computed without any adjustment that would be made under sections 852(b)(2) or 857(b)(2). Thus, taxable income of a RIC or REIT is not reduced by the deduction for dividends paid, but is reduced by the dividends received deduction (section 1.163(j)-4).
Certain additional rules would apply governing the ATI of C corporations, tax-exempt corporations, consolidated groups, S corporations and S corporation shareholders, controlled foreign corporations (CFCs) and U.S. Shareholders of CFCs, specified foreign persons and foreign partners, and certain beneficiaries of trusts and estates. Some of these rules are described in more detail below.

**Exempt entities and businesses**

Section 163(j) provides mandatory and elective exemptions for certain businesses. The proposed regulations would provide rules implementing the small business exception in section 163(j)(3) for certain taxpayers meeting the $25 million gross receipts test of section 448(c), including rules for the application of section 448(c) to individuals in their own capacity and as owners of interests in flow-through entities. The proposed rules would also implement the exceptions for employee services and for certain regulated utility trades or businesses. Finally, the proposed rules provide mechanics for electing into the exceptions for certain real property trades or businesses and farming businesses. Other than qualifying small businesses, the other exempt businesses are termed "excepted businesses." The import of such term is that taxpayers that do not qualify for the small business exemption and that have excepted and non-excepted businesses must allocate their interest expense and other attributes between such businesses to determine the application of section 163(j) to the non-excepted businesses.

**Electing excepted business status**

Section 1.163(j)-9 of the proposed regulations contains mechanics for making an irrevocable election to be an electing real property trade or business or an electing farming

business (each, an "excepted business"). The proposed rules would make it clear that a taxpayer can separately choose to make an election for each excepted business operated by the taxpayer, including a partnership or a consolidated group. The election by a partnership would not impact any excepted businesses operated outside of the partnership by a partner.

The election would be made by attaching a statement titled "Section 1.163(j)-9 Election" to the taxpayer's timely filed tax return, including extensions, which includes the taxpayer's name, address, social security number or employer identification number, a description of the taxpayer's electing trade or business (including the principal business activity code), and a statement that the taxpayer is making an election under section 163(j)(7)(B) or (C), as applicable.

The proposed rules also would address terminations of the election as a result of a taxpayer ceasing to engage in the electing trade or business along with anti-abuse rules to prevent inappropriate election terminations where the taxpayer or related party subsequently resumes operation of the trade or business within 60 months of the termination. In general, a taxpayer would cease to engage in an electing trade or business if the taxpayer sells or transfers substantially all of the assets of the trade or business to an unrelated party in a taxable asset transfer.

The proposed rules would include an anti-abuse rule to prevent a real property trade or business from being treated as an excepted business if it leases 80% of the value of its real property to a 50% commonly controlled trade or business.

Certain REITs would be given a safe harbor to qualify as an electing real property trade or business.

- If a REIT holds real property, interests in partnerships holding real property, or shares of other REITs holding real property, the REIT would be eligible to make the election. For REITs, section 1.856-10 would apply to define "real property."

- If 10% or less of the value of a REIT's assets consist of "real property financing assets" at the close of the applicable taxable year, then all of the REIT's assets would be treated as assets of an electing real property trade or business.

- If more than 10% of a REIT's assets consist of "real property financing assets" at the close of the taxable year, then the REIT would be required to allocate interest expense, interest income, and other items of expense and gross income to the electing real property trade or business and to non-excepted trades or businesses. "Real property financing assets" would include interests in mortgages, deeds of trust, REMIC regular interests, among others.

**KPMG observation:** The proposed rules make it clear that a taxpayer, including a partnership, can have more than one excepted business and can choose to make a section 163(j)(7) election for each business separately. This may be beneficial, for

example, in circumstances where one excepted business would not be subject to a limitation while another would be, and the taxpayer wants to avoid any adverse consequences of making the election (for example, alternative depreciation system (ADS) depreciation, loss of bonus on qualified improvement property to the extent otherwise allowable in technical corrections to H.R. 1).

**KPMG observation:** The safe harbor for REITs could be helpful for debt incurred directly by a REIT. In our experience, most publicly traded UpREITs borrow at their operating partnership rather than at the REIT level. In those cases, the safe harbor would not apply. However, as discussed below, to the extent there is a lower-tier REIT in the ownership structure, the borrowing operating partnership would likely be able to look-through such REIT for purposes of allocating its debt to an excepted business, provided it owns at least 80% of the vote and value of such REIT stock.

*Rules for allocating interest expense, interest income, and other items of expense and gross income to excepted businesses*

The amount of a taxpayer's interest expense that is properly allocable to excepted trades or businesses is not subject to limitation under section 163(j). The amount of a taxpayer's other items of income, gain, deduction, or loss (including interest income) that is properly allocable to excepted trades or businesses is excluded from the calculation of the taxpayer's section 163(j) limitation. Section 1.163(j)-10 provides rules for allocating interest expense, interest income, and other items of expense and gross income to excepted businesses if a taxpayer has items attributable to excepted and non-excepted businesses.

These allocation rules would not be used to determine if interest expense or interest income is properly allocable to a trade or business and would only be applicable to the extent that a taxpayer has determined that the taxpayer has interest expense or interest income that is properly allocable to a trade or business (for example, by applying section 1.163-8T to determine which items of interest expense are investment interest under section 163(d).)

*Allocation of business interest expense and business interest income*

In general, the proposed rules would allocate business interest expense and business interest income to excepted and non-excepted businesses based on the relative amounts of the taxpayer's adjusted basis in the assets used in its excepted or non-excepted trades or businesses. For this purpose, the adjusted basis of a tangible asset for which depreciation is allowable is determined by using the ADS under section 168(g). Generally, a taxpayer's basis in cash and cash equivalents and customer receivables is not taken into account. A taxpayer making an allocation must attach a statement to its timely filed federal income tax return for the taxable year that includes information about the adjusted basis of the assets and the method(s) used to determine the basis. Failure to file the statement, or filing a statement that does not comply with the requirements, enables the IRS to treat the taxpayer as if all of its interest expense is properly allocable to a non-

excepted business, unless the taxpayer shows that there was reasonable basis for failing to comply with the requirements.

**KPMG observation:** An electing real property trade or business must use the ADS for all real property and qualified improvement property. While not explicitly addressed, we understand from informal discussions with the government that it is intended that the transition for property placed in service prior to the year of election would be subject to the pre-existing rules applicable to a change in use.

The basis determinations must be made quarterly and the average basis for such assets for the taxable year would determine the allocation. However, if 90% of the taxpayer's basis in its assets is allocable to either excepted or non-excepted trades or businesses, then all of the taxpayer's business interest expense or business interest income is allocated to such category.

**KPMG observation:** The basis rules, and particularly those relating to tangible assets, closely resemble the basis rules used to determine qualified business asset investment (QBAI) for purposes of applying the section 951A GILTI rules and the section 250 "FDII" rules. It is reasonable to expect that many of these regulatory provisions would be carried over in future guidance implementing the QBAI determinations.

*Interest expense and interest income look-through rules*

The proposed rules contain look-through rules for interests in partnerships and S corporations which would allow partners and shareholders to treat their own interest expense as allocable to an excepted business conducted by a partnership or corporation. A taxpayer generally may choose to look through its partnership interest or S corporation stock to determine the extent of the taxpayer's adjusted basis in the partnership interest or stock that is allocable to an excepted or non-excepted business. The taxpayer would take into account the taxpayer's share of the partnership's or S corporation's adjusted basis in its assets, taking into account any adjustments under sections 734(b) and 743(b) as well as other specified adjustments. A taxpayer must look through a partnership or S corporation in which it holds directly or indirectly 80% or more of the partnership's capital or profits or S corporation's stock by vote and value.

If at least 90% of a partner's share of a partnership's basis in its assets is allocable to either excepted businesses or non-excepted businesses (without regard to assets not properly allocable to a trade or business), the partner's entire basis in its partnership interest is treated as allocable to either excepted or non-excepted trades or businesses, respectively. A corresponding rule applies to S corporation shareholders.

Similarly, the stock of a domestic C corporation that is not a member of the taxpayer's consolidated group and of a controlled foreign corporation (CFC) is treated as an asset of the shareholder.

- Look-through treatment would apply to such a domestic C corporation or CFC if the shareholder satisfies the ownership requirements of section 1504(a)(2) (for example, 80% of vote and value). If look-through treatment applies, the shareholder must look to the corporation's basis in its assets to determine the extent to which the shareholder's basis in the stock is allocable to an excepted or non-excepted trade or business.

- If at least 90% of such a domestic C corporation's basis in its assets is allocable to either excepted businesses or non-excepted businesses, the shareholder's entire interest in the corporation's stock is treated as allocable to either excepted or non-excepted businesses, respectively.

The proposed rules provide guidance for the treatment of assets that are used in multiple businesses. Basis may be allocated based upon either the relative amounts of gross income that an asset generates, or for land or an inherently permanent structure, the relative amounts of physical space used by the trades or businesses, or the relative amounts of output of those trades or businesses. A taxpayer is required to use the same allocation methodology from one determination period to the next or from one taxable year to the next. In order to change its method of allocation, a taxpayer must submit a letter ruling request, and consent only will be granted in extraordinary circumstances.

**KPMG observation:** Given the need for a letter ruling, it can be important to carefully select an initial allocation method for excepted and non-excepted businesses.

Notwithstanding the rules described above, the proposed rules would require that a taxpayer with qualified nonrecourse indebtedness, within the meaning of section 1.861-10T(b), must directly allocate interest expense from the indebtedness to the taxpayer's assets as provided under section 1.861-10T(b).

*Allocation of other items to compute ATI*

For purposes of determining a taxpayer's ATI, a taxpayer's gross income other than dividends and interest income would be allocated to the trade or business that generated the gross income. If a taxpayer looks through a corporation for purposes of allocating business interest expense or business interest income, as described above, then dividends from, and gain from the disposition of, such stock that is not held for investment is allocated to excepted or non-excepted businesses based on the relative amounts of the payor corporation's adjusted basis in its assets that is allocable to such businesses. If at least 90% of the corporation's adjusted basis is allocable to either excepted or non-excepted businesses, all of the taxpayer's dividend income or gain is treated as allocable to either excepted or non-excepted businesses, respectively. If the taxpayer does not look through the corporation for this purpose, then all of the dividend income or gain would be treated as allocable to a non-excepted trade or business.

Similarly, if a taxpayer recognizes gain or loss from the disposition of a partnership interest or stock in an S corporation that owns non-excepted assets and excepted assets,

investment assets, or both, the taxpayer would determine the proportionate share allocable to non-excepted businesses in accordance with the partnership and S corporation look-through rules described above.

The proposed rules provide additional guidance to allocate expenses other than interest expense.

**KPMG observation:** Oddly, if the applicable ownership threshold is met, it appears that the look-through rule for allocating business interest expense and business interest income of a taxpayer would apply even with respect to stock that is held by an individual as an investment asset and could distort the allocation of business interest expense if such investment stock basis is allocated to non-excepted businesses. In contrast, for purposes of allocating dividend income and stock disposition gain, the look-through rule is only applied if the stock is not held as an investment asset. This rule appears to be inconsistent with the preamble, which does not limit the application of this rule to stock not held for investment.

*Definition of a real property trade or business*

The proposed rules include proposed amendments to section 1.469-9(b) to provide rules relating to the definition of a real property trade or business under section 469(c)(7)(C). The proposed rules would define “real property” to include land, buildings, and other inherently permanent structures that are permanently affixed to land, and exclude from the definition other items, such as machines and equipment that serve an active function and may be permanently affixed to real property. This definition would be narrower than that applied in the REIT context and applicable to the REIT safe harbor described above. The proposed rules also would define “real property operation” and “real property management,” but reserve on the other categories of businesses that qualify as real property trades or businesses under section 469(c)(7)(C). The preamble indicates that the categories of real property trades or businesses under section 469(c)(7)(C) may be defined to not include trades or businesses that generally do not play a significant role in the creation, acquisition, or management of rental real estate.

In addition to the proposed rules, Treasury and the IRS issued Rev. Proc. 2018-59, which provides a safe harbor that allows taxpayers to treat certain infrastructure trades or businesses as real property trades or businesses solely for purposes of qualifying as an electing real property trade or business. The revenue procedure allows taxpayers to treat certain trades or businesses that are conducted in connection with the designing, building, managing, operation, or maintaining of certain core infrastructure projects as real property trades or businesses.

## Treatment of corporations and consolidated groups: Sections 1.163(j)-4, -5

### General C corporation rules

The proposed rules take the position that for purposes of the section 163(j) limitation, all interest expense and interest income of a C corporation *per se* is business interest expense and business interest income and allocable to a trade or business (however, note that business interest expense allocated to an excepted trade or business is not subject to limitation under section 163(j)). In addition, the proposed rules generally would recharacterize investment interest income and expense of a partnership that is allocable to a C corporation partner as business interest income or expense that is properly allocable to a trade or business of the C corporation (though this latter rule would not apply to the extent a C corporation partner is allocated a share of a domestic partnership's subpart F or GILTI gross income inclusions that are treated as investment income at the partnership level).

**KPMG observation**: The definition of business interest expense in section 163(j) excludes investment interest as defined in section 163(d). Large C corporations, however, are not subject to the section 163(d) investment interest limitation. Thus, the proposed rules would prevent such a corporation's interest expense from being within the section 163(d) investment interest definition (although not limited under section 163(d)) and thereby prevent such interest expense from escaping the section 163(j) limitation. Hence, the proposed rules, as presaged in Notice 2018-28, categorically assert that all interest income and expense of a C corporation is *per se* business interest expense and business interest income. This position may be debatable and potentially conflicts with the statutory provision that states that section 163(j) is to be applied at the partnership level, but it is consistent with footnote 688 of the Conference Report.

A C corporation's earnings and profits (E&P) for a taxable year would be calculated without regard to any disallowance of interest expense under section 163(j). Thus, a C corporation with disallowed interest expense for a particular year would calculate its current E&P by subtracting its interest expense for the year, including the disallowed interest expense; the corporation's subsequent deduction of its disallowed interest expense in a later year would not affect its E&P calculation for that later year.

**KPMG observation**: The E&P rule can be expected to complicate tax attribute studies, though it is consistent with the rule in the proposed regulations under "old" section 163(j). However, because the scope of section 163(j) has been broadened considerably and now includes interest expense on third-party and controlled foreign corporation indebtedness, the rule will be encountered more often.

Special E&P rules, in lieu of these general rules, would apply to RICs and REITs, and with respect to excess business interest expense allocated from a partnership to a C corporation partner.

**Consolidated return rules**

The proposed rules generally take a broad, single-entity approach. Consistent with Notice 2018-28, a consolidated group would be subject to a single section 163(j) limitation. Additionally, the proposed rules would require a group's ATI to be calculated on a consolidated basis (though partnerships wholly-owned within the group would not be aggregated with the group). Thus, the group's current-year business interest expense and business interest income would be the sum of the current-year interest items of the members. However, intercompany obligations (indebtedness between members of the same consolidated group) generally would be disregarded for purposes of determining the group's business interest expense and business interest income, as well as its consolidated ATI. Moreover, intercompany items and corresponding items (within the meaning of section 1.1502-13) would be disregarded for purposes of calculating consolidated ATI to the extent they offset in amount. The proposed rules also would provide that, for purposes of calculating consolidated ATI, the FDII/GILTI deduction allowed under section 250(a)(1) would be determined (i) as if it were not subject to the taxable income limitation under section 250(a)(2) and (ii) without regard to the application of section 163(j).

**KPMG observation**: The proposed rules would impose complexity by requiring additional, new consolidated adjustments for purposes of determining the consolidated section 163(j) limitation, calculations that are not currently required. Consolidated corporations with state filing requirements will encounter further compliance complexity, as noted in the state and local tax discussion below.

For purposes of the stock basis/investment adjustment rules of section 1.1502-32, rules similar to those applicable to the absorption of losses would apply. In particular, a member's basis in the stock of a member with disallowed current-year business interest expense would be adjusted only when the disallowed interest expense is absorbed (and not when initially disallowed).

**KPMG observation**: The proposed consolidated section 163(j) rules would increase the importance of maintaining good intercompany transaction accounts and tracking basis in member stock.

Any amount of business interest expense (including carryforwards) not deductible under the above rules generally would be carried forward to subsequent taxable years.

The proposed regulations would provide that a "separate return limitation year" (or "SRLY") limitation applies to disallowed business interest expense carryforwards. A section 163(j) SRLY limitation would not apply to the extent of an "overlap" in the application of section 382 and the SRLY limitation under the principles of section 1.1502-21(g) (the current rules applicable to loss carryovers).

**KPMG observation**: The helpful overlap rule can be expected to apply to a group's acquisition of a previously unrelated target with disallowed business interest expense

carryforwards. However, the section 163(j) SRLY limitation would remain a trap for the unwary in situations not covered by the overlap rule.

The current SRLY limitation for NOL carryovers employs a "cumulative register" concept, meaning that SRLY losses can be deducted to the extent of the SRLY member's cumulative contribution to consolidated taxable income for all years in which it is a member of the group. In contrast, the proposed section 163(j) SRLY limitation would be *annual* rather than cumulative.

**KPMG observation**: The preamble justifies the annual section 163(j) SRLY limitation based on the repeal of the excess limitation carryforward provisions from former section 163(j). Nevertheless, this approach is arguably in contrast with the consolidated return neutrality principles underlying the SRLY loss rules.

A member with disallowed business interest expense that departs a consolidated group generally would take its carryforwards with it. However, as is the case with NOLs, the group would have the priority claim to deduct the member's business interest expense items, to the extent available under section 163(j), including both the departing member's current-year business interest expense (through the date of departure) as well as the departing member's disallowed business interest expense carryforwards from prior years.

Also, consistent with the rules applicable to NOLs, a departing member's disallowed business interest expense carryovers would be potentially subject to attribute reduction under the consolidated unified loss rule of section 1.1502-36(d). A departing member's carryforwards of disallowed business interest expense that survive this gauntlet of rules would be carried forward to its first separate return year, albeit potentially subject to section 382 limitation (or, if applicable, to the section 163(j) SRLY limitation in an acquiring group).

**Section 381(a) transactions**

An acquiring corporation in a section 381(a) transaction (generally, a tax-free section 368(a)(1) asset reorganization or a section 332 subsidiary liquidation) can succeed to the disallowed business interest expense carryforwards of a target corporation. The proposed rules include provisions which generally would limit the amount of the target's disallowed business interest expense that the acquiring corporation could deduct in the acquiring corporation's first taxable year ending after the acquisition. These rules are similar to the current rules in sections 1.381(c)(1)-1 and -2 that apply to an acquiring corporation's use of a target corporation's losses in the acquisition year.

**Sections 382 and 163(j)**

Congress provided in section 163(j) that disallowed business interest expense carryovers are subject to the section 382 loss limitation rules following an ownership change (generally, a cumulative greater-than-50-percentage-point change in the stock ownership of a corporation over a three-year period). The proposed rules would require for a taxable

year in which an ownership change occurs, the *pro rata* allocation of business interest expense between the pre- and post-ownership change periods based on the number of days in each period, regardless of whether a closing of the books election is made under section 1.382-6(b).

**KPMG observation**: Often an ownership change of a target entity occurs in the context of a leveraged acquisition. In this situation, the proposed rules would artificially increase the amount of business interest expense subject to limitation, by allocating a disproportionate amount of post-acquisition interest expense to the pre-acquisition period (thus subjecting it to limitation under section 382).

Section 1.383-1 would modify the existing ordering rule governing the absorption of pre-change losses and tax credits subject to limitation under sections 382 and 383, to provide that disallowed business interest expense carryforwards should be absorbed after pre-change capital losses and all recognized built-in losses, but before NOLs, other pre-change losses, and pre-change credits.

*Transition rules regarding former section 163(j) (section 1.163(j)-11)*

The proposed rules would provide a transition rule for *disallowed disqualified interest*, which is the special term used to define interest expense for which a deduction had been disallowed under former section 163(j) (referred to as "old section 163(j)" in the proposed rules) in the taxpayer's last taxable year beginning before January 1, 2018, and that was carried forward pursuant to old section 163(j).

- Disallowed disqualified interest would be carried forward to the taxpayer's first taxable year beginning after December 31, 2017, and would be subject to disallowance as a disallowed business interest expense carryforward, except to the extent the interest is properly allocable to an excepted trade or business as would be defined in the proposed rules. In general, any business interest expense disallowed under the proposed rules or any disallowed disqualified interest that is properly allocable to a non-excepted trade or business would be carried forward to the succeeding taxable year as business interest expense that is subject to the new section 163(j) limitation on business interest expense (Note that Notice 2018-28 states that this interest will be subject to the section 59A Base Erosion and Anti-Abuse Tax (BEAT) provisions in the same manner as interest paid or accrued in a taxable year beginning after December 31, 2017).

- Earnings and Profits: A taxpayer would not be permitted to reduce its E&P in a taxable year beginning after December 31, 2017, to reflect any disallowed disqualified interest carryforwards to the extent the payment or accrual of the disallowed disqualified interest reduced earnings and profits of the taxpayer in a prior taxable year.

- Joining a consolidated group with a different taxable year: A special rule would apply to the disallowed business interest expense of a target corporation with a taxable year beginning after December 31, 2017 (and thus subject to the new section 163(j) rules)

that joins a consolidated group with a taxable year that started before that date (*e.g.*, a group with a taxable year ending November 30, 2018). In this narrow circumstance, any disallowed interest expense of the target corporation would be carried forward to the acquiring group's first taxable year beginning after December 31, 2017.

### Treatment of partnerships: Section 1.163(j)-6

Section 163(j) is applied to partnership indebtedness at the partnership level. To the extent a partnership's interest deduction is limited, the deferred interest ("excess business interest expense") must be allocated to the partners, which reduces the partners' bases in their partnership interests. Section 163(j)(4) provides that the excess business interest expense is then treated as paid or accrued by the partner to the extent the partner is allocated "excess taxable income," which is adjusted taxable income of the partnership in excess of the amount the partnership requires to deduct its own interest under section 163(j). The proposed rules address many of the issues created as a result of the application of section 163(j) at the partnership level.

As noted above, the proposed rules would provide that a guaranteed payment for the use of capital is treated as interest.

**KPMG observation:** A guaranteed payment for the use of capital may represent a payment for the use of property other than money. The proposed rule as currently drafted could apply to limit any guaranteed payment for the use of capital deduction – even if for the use of property. The treatment of guaranteed payments as interest would not be subject to a transition rule and may impact partnerships that currently have guaranteed payments.

Section 163(j) specifies that excess business interest expense and excess taxable income are allocated to partners in the same manner as "nonseparately stated taxable income or loss of the partnership." As the term nonseparately stated taxable income or loss is not defined by statute or regulations, the proposed rules would provide a complex eleven-step computation for determining a partner's share of partnership excess business interest expense, excess business interest income (the amount of business interest income in excess of the partnership's business interest expense), and excess taxable income for purposes of section 163(j) referred to as "excess items"). This determination would not have an impact on the partnership's allocations under section 704(b).

**KPMG observation:** The stated goal of this computation is to ensure that the total amount of deductible business interest expense and section 163(j) excess items allocated to each partner will equal the partnership's total amount of deductible business interest expense and section 163(j) excess items. The examples provided in the proposed rules are focused on special allocations of items that cause these amounts to differ; however, regulatory allocations, 704(c) allocations, and varying interest may have the same result.

The proposed rules would provide that excess business interest income allocated to a partner from a partnership would allow excess business interest expense from the

partnership to be treated as paid or accrued in that year to the extent of such excess business interest income.

**KPMG observation:** This rule addresses a concern that if a partnership only generates business interest income, it would not be able to cause excess business interest expense to be treated as paid or accrued. Under section 163(j)(4)(B)(ii)(I), only excess taxable income can cause excess business interest expense to be treated as paid or accrued by a partner and excess taxable income does not include business interest income. Despite this statutory language, the proposed rules would treat business interest income like excess taxable income for this purpose.

Regarding the treatment of excess business interest expense, the proposed rules would clarify that, to the extent a partner receives an allocation of excess taxable income or excess business interest income from a partnership in a taxable year, such partner's excess business interest expense is treated as paid or accrued in that year, in an amount equal to the partner's share of the excess taxable income. When the excess business interest expense is treated as paid or accrued, it becomes business interest paid or accrued by the partner and may be deducted by the partner, subject to any partner-level section 163(j) limitation and any other applicable limitations.

The proposed rules would also make it clear that, to the extent a partnership's business interest expense is allowed to be deducted under section 163(j) (that is, it is less than or equal to the partnership's section 163(j) limitation), such business interest expense is not subject to further limitations under section 163(j) at the partner level.

The preamble notes that for partnerships that are engaged in non-passive activities, partners who do not materially participate may be subject to interest limitations under both section 163(j) and section 163(d) for the partnership's business interest expense. In these circumstances, the partnership would be subject to a section 163(j) limitation on the partnership's business interest expense. In addition, section 163(d) would apply to such partner to the extent interest is deductible by the partnership and allocated to the partner, or excess business interest expense allocable to such partner is treated as paid or accrued by such partner. The preamble notes that Treasury and the IRS determined that this is the result of existing statutory provisions, and, therefore, are not providing any additional rules to address this issue.

Partner-level adjustments (for example, section 743(b) adjustments, built-in loss amounts under section 704(c)(1)(C), and remedial allocations of income, gain, loss or deduction to a partner pursuant to section 704(c)), would not be taken into account when computing ATI for purposes of the partnership's section 163(j) limitation. Rather, these partner-level adjustments would be taken into account at the partner level as items derived directly by the partner in determining its own section 163(j) limitation.

The proposed rules would also incorporate the double counting rule set forth in Notice 2018-28 that a partner may only include business interest income from a partnership in its section 163(j) calculation to the extent that business interest income exceeds business

interest expense determined at the partnership level under section 163(j). As indicated above, this excess amount would be referred to as excess business interest income. The proposed rules would further provide that a partner may not include its share of the partnership's floor plan financing for purposes of determining the partner's section 163(j) limitation for business interest expense.

The proposed rules would provide guidance on the interaction between the section 163(j) partnership excess business interest expense rules and the section 704(d) suspended loss rules. In particular, any excess business interest expense from a prior taxable year that was suspended under section 704(d) would not be treated as excess business interest expense in any subsequent taxable year until it is no longer suspended under section 704(d). Consequently, an allocation of excess taxable income or excess business interest income would not result in such excess business interest expense being treated as business interest expense paid or accrued by the partner.

An ordering rule would also require section 163(j) to be applied before the loss limitation rules in section 465 and section 469, and the application of section 461(l).

The proposed rules would provide that, if a partner disposes of *all or substantially all* of its partnership interest (by sale, exchange, or redemption), the partner's basis in its partnership interest would be increased immediately before the disposition to the extent the partner's excess business interest expense has not been deemed paid or accrued by the partner. If the interest was previously deemed paid or accrued, but has not been deducted as a result of the partner's section 163(j) limitation, the basis would not be recovered.

**KPMG observation:** The proposed rules would clarify that partial disposition by a partner, that is, a disposition of less than substantially all of a partner's partnership interest, would not result in a basis increase to the partner's partnership interest. It is unclear what percentage constitutes "substantially all" for purposes of this rule.

**KPMG observation:** The proposed rules would clarify that a disposition would include a "redemption."

In the event a partnership allocates excess business interest expense to one or more of its partners, and in a later taxable year becomes not subject to the requirements of section 163(j), the proposed rules would provide that excess business interest expense from prior taxable years is treated as paid or accrued by the partner in such later taxable year. Thus, the excess business interest expense may be deducted by the partner, subject to any partner-level section 163(j) limitation and any other applicable limitations.

**KPMG observation:** The examples make it clear that this proposed rule would apply to exempt partnerships (partnerships that qualify for the small business exemption). It is not clear whether this rule is intended to apply to excepted businesses, such as an electing real property trade or business.

Investment interest expense, investment income, and investment expense paid or accrued by a partnership and allocated to a C corporation partner are treated by the C corporation as properly allocable to a trade or business of the corporation.

**KPMG observation:** These items do not appear to be "siloed" to the partnership. Rather, they are treated as items of business income earned or expense paid or accrued directly by the C corporation partner and are taken into account in the C corporation partner's own section 163(j) limitation.

The treatment of business interest income and business interest expense with respect to lending transactions between a passthrough entity and an owner of the entity (self-charged lending transactions) is reserved in the proposed rules. The preamble notes that Treasury and the IRS intend to adopt rules to re-characterize, for both the lender and borrower, the business interest expense and corresponding business interest income arising from a self-charged lending transaction to prevent such business interest income and expense from entering into the section 163(j) limitation calculations for the lender and the borrower.

The treatment of excess business interest expense in tiered partnerships is also reserved in the proposed rules. Treasury and the IRS requested comments on how carryforwards and basis adjustments should be taken into account by upper-tier partnerships.

## International implications of section 163(j): Sections 1.163(j)-7, -8

### Application to CFCs

The preamble to the proposed regulations under the former section 163(j) described its purpose as "prevent[ing] erosion of the U.S. base by means of excessive deductions for interest paid by a taxable corporation to a tax exempt (or partially tax exempt) related person." Consistent with that view, those proposed regulations would have limited the application of former section 163(j) to only those foreign corporations that were engaged in a U.S. trade or business. New section 163(j) abandons any focus on the tax status of the recipient of interest and expands its scope to non-corporate taxpayers. Therefore, new section 163(j) clearly has a broader focus than its predecessor. The proposed rules reflect this broadening by providing that section 163(j) now applies to CFCs in addition to foreign persons engaged in a U.S. trade or business.

Notice 2018-28 provided that a domestic corporation's earnings and profits should not be adjusted to reflect any amount of business interest expense disallowed under section 163(j). The proposed rules would clarify that the earnings and profits of foreign corporations would also not be adjusted to reflect any disallowed business interest expense.

**KPMG observation:** If E&P of a CFC is not adjusted to reflect the disallowed amount, the subpart F income of the CFC may be subject to the E&P limitation under section 952(c) because its E&P will be lower than its net subpart F income to the extent it has

any business interest expense that is disallowed under section 163(j). There is no E&P limitation for GILTI inclusions, and so this rule should not affect the amount of a U.S. shareholder's GILTI inclusion.

The proposed rules would set forth two available methods for applying section 163(j) at the CFC-level:

- The default CFC-by-CFC method (the "Default Method" as provided in section 1.163(j)-7(b)); and

- The elective CFC Group method for highly-related CFCs (the "CFC Group Method") as provided in section 1.163(j)-7(b)(3), (c), and (d)).

*The Default Method*

The Default Method would require the section 163(j) limitation to be calculated on a CFC-by-CFC basis with no netting of business interest income of one CFC against the business interest expense of another CFC. This can result in a double counting of GILTI at the U.S. shareholder level when there is intercompany lending between CFCs and the lending CFC has interest expense that is disallowed under section 163(j). This double counting is caused by the fact that interest expense at the borrower CFC that is disallowed under section 163(j) may increase the debtor's GILTI inclusion, while the corresponding interest income is also likely to give rise to an additional GILTI inclusion for the lender.

*The CFC Group Method*

Recognizing the potential unfairness of this double counting (which is addressed in the purely domestic context by the rules for consolidated groups), the proposed regulations provide an alternative, elective method to compute a CFC Group's section 163(j) limitation. In general, the CFC Group Method provides two distinct benefits to CFC Groups in the application of section 163(j). First, the proposed rules would permit CFCs to net intercompany interest income and interest expense within the applicable CFC Group. Thus, under the CFC Group Method, no member of an applicable CFC Group would be subject to the section 163(j) limitation if a CFC Group has only intra-CFC Group debt. Any net business interest expense that remains after the netting of intercompany business interest income and business interest expense, that is, third-party debt or debt from entities outside of the CFC Group, would be subject to limitation under section 163(j), and this calculation would be done at the separate CFC level.

The second benefit is that lower-tier group members can "share" their excess taxable income with upper-tier CFCs. For this purpose, excess taxable income is computed under a complex set of nested definitions. The result is related in concept but distinct in application from a partnership's "excess taxable income" as explained more fully above in the discussion of the partnership rules in section 1.163(j)-(6). The excess taxable income would be calculated at the lowest-tier CFC with the excess limitation and then tier up through the chain of CFCs, becoming a component of ATI at each level.

**KPMG observation:** The determination of the excess taxable income requires a multi-step, complex calculation. In public comments in advance of the promulgation of the proposed rules, government officials questioned whether the complexity was worth the benefit taxpayers would receive from the provision.

If the CFC Group Method is used, a CFC's section 163(j) limitation calculation would not include interest income (as this amount has already been taken into account in deriving net business interest expense) or floor plan financing interest. Therefore, the section 163(j) limitation would be just 30% of ATI. Apart from the excess taxable income adjustments, ATI would be calculated based on section 1.952-2 principles, and dividends from related persons (as defined within the meaning of section 954(d)(3)) would be excluded in calculating the recipient CFC's ATI.

**KPMG observation:** The CFC Group Method does not eliminate the need for CFC-by-CFC computations if the CFC Group has any interest expense paid to non-CFC Group members, and so should not be viewed as a simpler compliance exercise than under the Deficit Method.

The CFC Group Method would be an election that is "made by doing" – that is, by applying the method in calculating a CFC group member's deduction for business interest expense. The filing of a separate statement or form would not be required. Absent such an election, the Default Method applies. The proposed rules would require that the election be consistently applied by all members of the CFC Group and would be irrevocable.

*Definition of CFC group*

A "CFC Group" is defined as two or more applicable CFCs (that is, CFCs with one or more section 958(a) shareholders), if at least 80% of the stock measured **by value** of each CFC member is directly or indirectly owned within the meaning of section 958(a) by a (1) a single U.S. shareholder or (2) certain related U.S. shareholders that own stock of each CFC member in the same proportions. For this purpose, members of a consolidated group would be treated as single person. Thus, CFCs in separate chains owned by different U.S. shareholders may nonetheless be members of the same CFC Group if the U.S. shareholders are members of the same consolidated group.

If CFC members of the CFC Group own more than 80% of an interest in the capital or the profits of a partnership, such partnership would be treated as a CFC Group member, and the partnership interest would be treated as stock for this purpose. Foreign corporations and controlled partnerships engaged in a U.S. trade or business would not be members of an applicable CFC Group (but would be considered part of the CFC Group for purposes of applying the ownership aggregation rules).

Special rules would apply to CFCs that conduct a financial services businesses, which would be treated as a separate CFC subgroup (a "financial services subgroup") and ring-

fenced from the remaining CFC Group for purposes of applying the section 163(j) computation at the CFC-level.

**Effect of CFC inclusions and attributes on U.S. shareholder ATI**

For purposes of calculating the U.S. group's ATI, there would be subtracted any amounts included in the gross income of the U.S. shareholder under sections 78, 951(a) or 951A(a) allocable to a non-excepted trade or business of a CFC, and increased by the amount of deduction allowed under section 250(a)(1) with respect to such amounts. Effectively this reduces from ATI the net impact of subpart F and GILTI inclusions from CFCs.

**KPMG observation:** The purpose of this provision is to prevent the double counting of deemed inclusions at the CFC and U.S. shareholder level. Thus, if the U.S. shareholder holds the majority of the debt, this rule may be disadvantageous because the ATI will essentially be trapped in entities that have excess limitation.

If, however, a CFC Group Election is made, the U.S. shareholder would be allowed to include in ATI a certain amount of CFC Group extraterritorial income not to exceed the U.S. shareholder subpart F and GILTI inclusions (without regard to the section 78 amount) with respect to the CFC Group. For the limited purpose of calculating the add-back to a U.S. corporate partner's ATI, a domestic partnership that is a U.S. shareholder would be treated as a foreign partnership such that the add-back would flow through to the U.S. corporate partner, thereby increasing its ATI.

**KPMG observation:** Taken together, it appears that the ability to 1) tier limitation up a CFC chain and ultimately into the U.S., and 2) offset business interest expense with business interest income between different CFCs, with little apparent downside, will make the CFC Group Method the preferred approach for many U.S. multinational groups. One contrary consideration might be complexity, but in many circumstances, administering the Default Method would be only marginally easier.

**KPMG observation**: The proposed rules address how much interest expense a given CFC can deduct, but do not address how to associate any such deductions with the CFC's subpart F, GILTI, and exempt income in the new international regime. Such rules may be addressed in the forthcoming foreign tax credit proposed regulations package, which will apparently also address amendments to the existing section 861 regulations. (Such regulations were expected imminently at the time these observations were released.) Of critical importance is the interest expense of a holding company and whether it is associated with the tested income of a lower-tier CFC, so to potentially create a tested loss.

**Application of section 163(j) to foreign persons with effectively connected income (ECI)**

Foreign persons are subject to net basis U.S. taxation only on their income that is effectively connected with a U.S. trade or business. Accordingly, the proposed rules

would modify the application of section 163(j) to "scale" the limitation to the applicable U.S. tax base.

**KPMG observation:** The decision to scale the section 163(j) limitation employs a complex computational approach that is layered over the application of the general section 163(j) rules.

Generally, section 882 principles would apply for purposes of determining the foreign person's ATI, with separate computational methods for CFCs with U.S. effectively connected income (ECI) versus non-CFC foreign persons with U.S. ECI.

The definitions for ATI, business interest, business interest income, etc. are modified to limit such amounts to U.S. ECI and expenses properly allocable thereto. A non-CFC foreign corporation would first determine its interest expense under section 1.882-5 and then determine the amount of disallowed business interest expense under section 163(j). Consistent with the overall theme of treating partnerships as entities for purposes of section 163(j), different rules apply for foreign persons earning at least some of their ECI through partnerships than for those all of whose ECI is earned directly.

A CFC with U.S. ECI would first apply section 163(j) general rules and then apply section 1.882-5 **only if** such CFC would have disallowed business interest expense under the first step. For non-CFC foreign persons that are partners in an ECI partnership, the proposed rules would employ similar modifications with respect to excess taxable income, excess business interest expense, and excess business interest income of the partnership to take into account the limitation of such foreign person's liability for U.S. tax to its ECI.

Consistent with other provisions relating to E&P, the proposed rules would provide that the section 163(j) limitation does not affect the determination of U.S. effectively connected E&P (ECE&P) or U.S. net equity for purposes of applying the branch profits tax under section 884.

### Implications for exempt organizations

The proposed regulations contain several references to tax-exempt organizations. In particular, the proposed regulations provide:

- Taxpayers with average annual gross receipts of $25 million or less generally are not subject to the section 163(j) limitation. For organizations that are exempt from tax under section 501(a), the proposed regulations would provide that only gross receipts from unrelated trades or businesses are taken into account in determining whether the $25 million threshold is crossed. Thus, tax-exempt organizations described in section 501(a) with average annual gross receipts from unrelated trades or businesses of $25 million or less generally would not be subject to the section 163(j) limitation. Prop. Reg. section 1.163(j)-2(d)(2)(iv).

- As a general matter, the rules regarding section 163(j) as applied to C corporations would apply to a tax-exempt corporation subject to tax under section 511 only with respect to that corporation's items of income, gain, deduction, or loss that are taken into account in computing the corporation's unrelated business taxable income. Prop. Reg. section 1.163(j)-4(b)(5).

- For tax-exempt organizations subject to tax under section 511, the proposed regulations would provide section 512 and the regulations thereunder determine the rules for allocating all income and expenses between and among trades or businesses that are excepted from the application of section 163(j) (e.g., certain electing real property trades or businesses) and those that are not. Prop. Reg. section 1.163(j)-10(a)(5).

## Implications for insurance industry

Some provisions of the proposed regulations are directly relevant to the insurance industry. These are briefly described below. (Some of these provisions also are discussed elsewhere in this discussion of the proposed regulations.)

*Definition of interest*

The proposed regulations would adopt a broad definition of interest (expense and income) by including not only amounts that would be interest under general tax principles, but also items that would not otherwise be treated as interest for U.S. federal income tax purposes. As long-term obligations, certain insurance arrangements may include a time value of money aspect. However, the proposed regulations do not extend the section 163(j) definition to insurance arrangements. For example, despite its designation, interest on funds withheld is generally not treated as interest on indebtedness, nor is there any Code section or regulation that would treat interest on funds withheld as interest for tax purposes. Furthermore, funds-withheld reinsurance is generally not viewed as a transaction the purpose of which is to secure the use of funds for a period of time.

Finally, the preamble to the proposed regulations states that the intent behind the definition of "interest" in the regulations is to "provide a complete definition of interest that addresses all transactions that are commonly understood to produce interest income and expense, including transactions that may otherwise have been entered into to avoid the application of section 163(j)." Therefore, it appears that interest on funds withheld might not be considered subject to section 163(j) or the proposed regulations.

*Consolidated returns*

The proposed regulations generally take a broad, single-entity approach. Consistent with Notice 2018-28, a consolidated group would be subject to a single section 163(j) limitation. This approach mitigates many of the issues presented by the life/non-life consolidation regime. The proposed regulations rejected an expanded definition to include non-consolidated, affiliated companies. Consequently, if there are non-

consolidated entities (e.g. stand-alone life insurance companies), the net interest income or expense would be determined separately for each non-consolidated company.

*Treatment of partnership investment income*

The proposed regulations clarify that all interest paid or accrued by a C corporation is treated as business interest expense and that all interest received or accrued is treated as business interest income. In addition, the proposed regulations generally provide that a corporate partner will treat its share of partnership investment income and expenses as properly allocable to a trade or business.

However, as prescribed by the statute, section 163(j) is applied to partnership indebtedness at the partnership level, with the result that the partnership's excess business interest expense will retain its character in the hands of the partner (including a C corporation) and can only be offset in future years by income from the partnership.

*Treatment of insurance controlled foreign corporations*

In general, a foreign corporation determines its taxable income (but not its earnings and profits) by applying the interest limitation rules of section 163(j). Consequently, section 163(j) would be expected generally to increase the subpart F income and GILTI of U.S. shareholders. In calculating its own section 163(j) limitation, a U.S. shareholder decreases its applicable taxable income (generally, its taxable income without regard to business interest or depreciation and amortization deductions (ATI)) by subpart F income, GILTI, and the section 78 gross-up (net of the section 250 deduction without regard to the taxable income limitation). Thus, this income cannot be used to increase the U.S. shareholder's section 163(j) limitation.

A special election would be available, however, for CFCs that are at least 80% owned by a single U.S. shareholder or by multiple U.S. shareholders that are related persons. Under this election, the CFC group would determine its applicable net interest expense (the excess, if any, of the aggregate business interest expense of group members over their aggregate business interest income) and allocate it among its members that have interest expense in excess of interest income. This has the effect of netting interest income and expense for intragroup borrowing. Thus, for example, if the total interest income of the CFC group exceeded its total interest expense, the section 163(j) limitation would not apply to any of the CFCs in the group even if individually some had interest expense that exceeded interest income. A member would be subject to the section 163(j) limitation only to the extent that its allocable portion of the applicable net interest expense exceeded 30% of the CFC's ATI. In addition to the group-wide determination of applicable net interest expense, if a group election is made, CFC excess taxable income (e.g., the portion of the CFC's ATI that did not "absorb" its portion of the applicable net interest expense) would "tier up" to the next higher level of CFC and would be included in that CFC's ATI.

Thus, the determination of each CFC's section 163(j) limit is determined from the lowest level to the top level, and any excess taxable income of the top-level CFC is included in the ATI of its U.S. shareholders that are part of the 80% ownership group.

Financial services entities, however, would be subject to a special sub-grouping rule. For purposes of determining and allocating applicable net interest expense, the election would treat certain CFCs that are actively engaged in financial services businesses, including CFCs that are qualifying insurance companies within the meaning of section 953(e)(3), as a separate group. Although the preamble states that this subgrouping rule is intended to avoid distortions created by including in the general group any CFCs that tend to have a disproportionate amount of business interest income or expense, the rule itself could create distortions by excluding from the subgroup a finance or treasury operation that centralizes borrowing in a separate entity that is not a qualifying insurance company, or by excluding CFCs that are active, regulated insurance companies that do not meet the 50% home country net written premium requirement of section 953(e)(3).

### State implications of section 163(j) interest limitation proposed regulations

The proposed rules answer many key federal questions and raise some new ones, but in large part do not clarify how the states that conform to section 163(j) will apply the limitation.

**KPMG observation:** At the time this observation was initially made in a TNF report, there were about five states that had specifically acted to decouple from 163(j); about ten states had not yet updated their conformity to the Code or had not adopted any of the tax reform changes for 2018. Still, there are numerous states that will conform to the federal limitation through their conformity to Code with no specific section 163(j) decoupling provisions (absent further legislative action).

From a state perspective, one of the key provisions in the proposed rules is confirmation that a federal consolidated group would have a single section 163(j) limitation. In the calculation of the consolidated group's limitation, intercompany obligations between members of the same consolidated group would be disregarded for purposes of determining business interest expense and business interest income. However, the section 163(j) limitation for members of an affiliated group not filling a federal consolidated return would not be aggregated and intercompany obligations would not be disregarded in determining the limitation. While providing some clarity for federal taxpayers, this approach would create compliance headaches in many states. For state purposes, a member of the federal consolidated group may be required to file a separate company state return and calculate state taxable income beginning with federal taxable income determined as if the corporation had not elected to file a federal consolidated return. This is the general approach in states that require separate company return filing, and in certain states that require combined group filing but start the calculation of the group's state taxable income with each group member's separate company federal taxable income. For taxpayers filing federal returns on a consolidated basis, this could result in significant differences in the applicable section 163(j) limitation from what is computed on

the taxpayer's federal consolidated income tax return (and any associated carryovers of disallowed interest deductions).

Even in states that generally conform to the federal consolidated return rules, the application of the proposed rules could create state-specific issues. For example, some states require or permit groups of related taxpayers to elect a combined or consolidated filing method that often consists of more or less members than the federal consolidated group (e.g., where the ownership threshold for group membership is greater than 50% rather than the 80% ownership requirement for a federal consolidated return group). In those cases, the section 163(j) limitation may need to be recomputed using the proposed rules for consolidated groups as applied to the state group. Absent state guidance, the way in which these calculations would be done is far from certain.

Interest deductions disallowed under section 163(j) generally may be carried forward indefinitely. In states that require the calculation of the section 163(j) limitation to be done on a separate company basis, the carryforwards of disallowed interest deductions may be significantly different than those calculated for federal purposes. With respect to those carryforwards, the proposed rules include guidance on the application of section 382 limitations and SRLY-type rules for federal consolidated groups. In states that require corporations to file on a separate company basis or use their own rules for allocating tax attributes to members of a combined group, a complicated analysis may be required to determine which entities may carry forward unused section 163(j) interest deduction carryforwards and whether any limits apply to the use of those carryforwards in the state, especially in situations where there is a merger or acquisition.

Over 20 states currently have rules that disallow the deduction of interest or intangible-related interest paid to related parties. Coordinating the state and federal rules in the states that conform to section 163(j) will likely also present complications. For example, it will be necessary to determine whether the character of the interest allowed to be deducted after applying the limitation computed under the state filing method is "related party" interest subject to further state limitations. The proposed rules do not provide any guidance to assist in this state-specific issue.

Complications can also arise when applying state addback rules in a year where the taxpayer deducts interest previously disallowed under section 163(j). The taxpayer in that case would potentially need to trace which portion of the federal limitation related to interest subject to the state addback provision in the year it was limited by section 163(j) and whether it would have been eligible for an exception to that state addback provision.

**KPMG observation:** Only one state, New Jersey, has addressed this issue directly. The state legislature enacted a provision that applies the section 163(j) deduction limitation on a pro rata basis to interest paid to related and unrelated parties.

*Infrastructure safe harbor and section 163(j) limitation: Rev. Proc. 2018-59*

On November 27, 2018, the IRS released **Rev. Proc. 2018-59** [PDF 44 KB]. This revenue procedure provides a "safe harbor" to allow taxpayers to treat certain infrastructure trades or businesses as "real property trades or businesses" solely for purposes of qualifying as an electing real property trade or business for purposes of the business interest limitation under section 163(j).

**Infrastructure safe harbor**

As discussed above, section 163(j) limits the amount of the business interest deduction claimed by certain taxpayers.

- The term "business interest" means any interest properly allocable to a trade or business.

- For purposes of the limitation on the deduction for business interest, the term "trade or business" does not include an "electing real property trade or business."

- Thus, for purposes of section 163(j), an interest expense that is properly allocable to an electing real property trade or business is not properly allocable to a trade or business, and is not business interest expense that is subject to the limitation under section 163(j).

Rev. Proc. 2018-59 explains that the IRS and Treasury are aware that there may be uncertainty as to whether certain infrastructure arrangements between private persons and governmental entities under which private persons maintain or provide other services with respect to certain types of infrastructure projects can qualify as a real property trade or business. In light of these taxpayer concerns, the revenue procedure provides a safe harbor that, if certain requirements are met, allows taxpayers to treat certain trades or businesses that are conducted in connection with the designing, building, managing, operating or maintaining of certain infrastructure projects as real property trades or businesses for purposes of qualifying as an electing real property trade or business under section 163(j)(7)(B). This is referred to as the "infrastructure safe harbor."

The infrastructure safe harbor in Rev. Proc. 2018-59 is based on the proposed eligibility parameters for public infrastructure projects for purposes of the private activity bond financing proposals described in the "Legislative Outline for Rebuilding Infrastructure in America," which the White House released publicly and transmitted to Congress on February 12, 2018. Taxpayers can apply the infrastructure safe harbor to tax years beginning after December 31, 2017.

*Interim guidance on business interest expense limitation under section 163(j): Notice 2018-28 and IR-2018-82*

On April 2, 2018, the IRS issued **Notice 2018-28** [PDF 183 KB], which indicates that Treasury and the IRS will issue proposed regulations to assist taxpayers in complying with section 163(j), as amended by the new law.

The notice describes rules that proposed regulations will include as interim guidance until more comprehensive guidance is developed. The rules would apply only for purposes of determining the limitation on deductions for interest expense under section 163(j). The notice states that, before the issuance of proposed regulations, taxpayers may rely on the notice.

The notice, as well as a related IRS release (**IR-2018-82),** indicate that the proposed regulations will provide that the calculation of the business interest expense limitation will be made at the level of a consolidated group of corporations. In addition, the notice:

- Permits interest disallowed under "old section 163(j)" to be carried forward from the taxpayer's last tax year beginning before January 1, 2018, to the taxpayer's first tax year beginning after December 31, 2017. Such interest would be subject to potential disallowance under "new section 163(j)" in the same manner as any other business interest otherwise paid or accrued in a tax year beginning after December 31, 2017.

- States that regulations will address the interaction of section 163(j) with the Base Erosion and Anti-Abuse Tax (BEAT) in section 59A. In particular, the Notice indicates that regulations (1) will provide that business interest carried forward from a tax year beginning before January 1, 2018, will be subject to section 59A in the same manner as interest paid or accrued in a tax year beginning after December 31, 2017, and (2) will clarify how the BEAT will apply to that interest. Notice 2018-28 thus effectively provides that such interest will not be grandfathered for BEAT purposes despite being paid prior to the effective date of section 59A.

- Clarifies that partners in partnerships and S corporation shareholders cannot interpret newly amended section 163(j) to inappropriately "double count" the business interest income of a partnership or S corporation.

- Provides that all interest paid or accrued by a C corporation on indebtedness of such C corporation will be business interest potentially subject to limitation under section 163(j). The notice also provides that regulations will address whether and to what extent interest that flows through to a C corporation from a passthrough entity (such as a partnership) constitutes business interest.

*Draft Form 8990 and instructions*

In December 2018, the IRS posted a **draft version of the instructions for Form 8990** [PDF 283 KB], "Limitation on Business Interest Expense Under Section 163(j)" (Rev. December 2018).

The draft version of the Form 8990 instructions reflects a "watermark" date of December 7, 2018. A **draft version of Form 8990** [PDF 118 KB] was previously released by the IRS with a "watermark" date of October 29, 2018.

The draft form and instructions include cautionary language that they are not to be relied upon for filing purposes and are subject to change and to OMB approval before being officially released.

*The new section 163(j): KPMG report on selected issues*

Read a September 2018 article by Hershel Wein and Charles Kaufman of KPMG: ***The New Section 163(j): Selected Issues*** [PDF 116 KB]. The article explains the application of new section 163(j), compares the new rules with the prior rules, and discusses selected issues the new statute has created for taxpayers, with a focus on non-partnership entities. The issues addressed involve corporate investment interest, consolidated groups, electing real estate trade or business, and interest equivalents.

*The new section 163(j): KPMG report on partnership issues*

Read a September 2018 article by Hershel Wein and Charles Kaufman of KPMG: ***The New Section 163(j): Partnerships Issues*** [PDF 174 KB]. The article explains that, with respect to business interest expense incurred by a partnership, the drafters of new section 163(j) adopted a unique "entity approach," providing that the new interest limitation is applied and limited at the partnership level. The article provides a detailed explanation of the new interest deduction rules and explains why using the entity approach added significant complexity and ambiguity to the rules for both partners and partnerships.

## Entertainment and certain fringe benefits

*Parking expenses: Notice 2018-99 and Notice 2018-100*

On December 10, 2018, the IRS released **Notice 2018-99** [PDF 171 KB] as interim guidance to use in determining the amount of parking expenses for qualified transportation fringe (QTF) benefits that is nondeductible under section 274(a)(4) and for tax-exempt organizations to determine the corresponding increase in the amount of unrelated business taxable income (UBTI) under section 512(a)(7) attributable to the nondeductible parking expenses.

## Background

Sections 274 and 512 were amended by the new law. Under the new law, section 274(a)(4) generally disallows a deduction for expenses with respect to QTFs provided by taxpayers to their employees. Section 512(a)(7) generally provides that a tax-exempt organization's UBTI is increased by the amount of the QTF expense that is nondeductible under section 274.

As noted in the IRS release, the new law does not address how to determine the amount of the QTF expense that is nondeductible or treated as an increase in UBTI.

## Notice 2018-99

Notice 2018-99 provides guidance for determining the nondeductible amount of parking expenses as well as the amount to be treated as increasing UBTI. The method of determining the nondeductible amount relates to the expense of providing a QTF (not its value) and depends on whether the taxpayer pays a third party to provide parking for its employees or whether the taxpayer owns or leases a parking facility where the employees park.

- **Taxpayer pays a third party for employee parking:** If a taxpayer pays a third party an amount so that its employees may park at the third party's parking lot or garage, the section 274(a)(4) disallowance generally is calculated as the taxpayer's total annual cost of employee parking paid to the third party. However, if the amount the taxpayer pays to a third party for an employee's parking exceeds the section 132(f)(2) monthly limitation on exclusion ($260 per employee for 2018), that excess amount must be treated by the taxpayer as compensation and wages to the employee. In other words, the total of the monthly amount in excess of $260 that is treated as compensation and wages is excepted from the taxpayer's section 274(a) disallowance amount by section 274(e)(2).

- **Taxpayer owns or leases all or a portion of a parking facility:** If a taxpayer owns or leases all or a portion of one or more parking facilities where its employees park, the section 274(a)(4) disallowance may be calculated using any reasonable method. Notice 2018-99 establishes a four-step method that may be used as a safe harbor:

    1. *Percentage of parking spots reserved for employee use*
       This percentage of parking expenses is non-deductible under section 274(a)(4).

    2. *Primary use of remaining parking spots*
       If the primary use (i.e., greater than 50%) of the remaining parking spots is for the general public, the remaining parking expenses remain deductible.

    3. *Percentage of parking spots reserved for non-employee use*
       If the primary use is not for the general public, then the percentage of parking expenses attributed to reserved spots for non-employee use remain deductible.

    4. *Reasonable allocation of remaining parking spots*

Taxpayer must reasonably determine the employee use of any remaining parking expenses not specifically categorized as deductible or non-deductible based on a typical business day.

The IRS notice further provides that using the value of employee parking to determine expenses allocable to employee parking in a parking facility owned or leased by the taxpayer is not a reasonable method because section 274(a)(4) disallows a deduction for the expense of providing a QTF, regardless of its value. **The notice provides that parking expenses do not include depreciation, but do include repairs, maintenance, utility costs, insurance, property taxes, interest, removal of snow, ice, leaf and trash, cleaning, landscape costs, parking lot attendant expenses, security, rent or lease payment or a portion of rent or lease payments.** For tax years beginning on or after January 1, 2019, a method that fails to allocate expenses to "reserved employee spots" cannot be a reasonable method; however, Notice 2018-99 provides a rule that changes in employee reserved spot designations made by March 31, 2019, may be treated as applying retroactively for these purposes.

As further emphasized in a related IRS release—**IR-2018-247**—a key part of the IRS guidance is a special rule allowing "employers to retroactively reduce the amount of their nondeductible parking expenses" if they make changes to their parking arrangements or reduce the number of reserved parking spots by March 31, 2019.

**Future regulations**

Notice 2018-99 states that the IRS and Treasury intend to publish proposed regulations under sections 274 and 512, and that those proposed regulations will include guidance on the determination of nondeductible parking expenses and other expenses for QTFs and the calculation of increased UBTI attributable to QTFs.

According to the notice, until the regulatory guidance is issued, taxpayers and tax-exempt organizations that own or lease parking facilities where their employees park may use "any reasonable method" as provided by Notice 2018-99 to determine the amount of nondeductible expenses under section 274(a)(4) or the amount of the increase in UBTI under section 512(a)(7).

Also according to the notice, until those proposed regulations are issued, taxpayers may rely on the guidance in Notice 2018-99 to determine the amount of nondeductible parking expenses for QTFs under section 274(a)(4), and tax-exempt organizations may rely on the guidance in this notice to determine the amount of the increase in UBTI under section 512(a)(7).

**Notice 2018-100**

A separate IRS notice—**Notice 2018-100** [PDF 82 KB]—provides certain exempt organizations relief from the estimated tax penalty in 2018 for parking QTF benefits for those entities that were not previously required to file a Form 990-T or that will not exceed the $1,000 threshold below which an organization is not required to file a Form 990-T or pay the unrelated business income tax.

*Transitional guidance on deductibility of business meal expenses: Notice 2018-76*

On October 3, 2018, the IRS released **Notice 2018-76** [PDF 35 KB], regarding the deductibility of expenses for certain business meals under section 274, as amended by the new law.

The notice explains that the amendment to section 274 generally disallows a deduction for expenses for entertainment, amusement, or recreation but does not specifically address the deductibility of expenses for business meals. Notice 2018-76 provides transitional guidance on the deductibility of business meals and indicates that:

- The IRS and Treasury intend to issue proposed regulations that will include guidance on the deductibility of expenses for certain business meals
- Taxpayers may rely on this guidance for the treatment of business meal expenses until the proposed regulations are issued

**Background**

The new law repealed deductions for entertainment, amusement, and recreation—even when directly related to the conduct of the taxpayer's trade or business. The 50% deduction limitation for food and beverage expenses associated with a trade or business was generally retained. Prior to the issuance of the notice, there had been uncertainty as to whether the meals provided during an entertainment event would fall under the meal or entertainment deduction limit (for example, a meal in connection with a business client at a ballgame).

**Notice 2018-76**

Notice 2018-76 first explains that the new law did not change the definition of "entertainment" under section 274(a)(1). Thus, the regulations that define entertainment continue to apply.

Next, the notice explains that, while the new law did not address the circumstances in which the provision of food and beverages might constitute entertainment, the legislative history clarified that taxpayers may continue to deduct 50% of the food and beverage expenses associated with operating a trade or business.

When issued, the proposed regulations will (according to the notice) clarify when business meal expenses are nondeductible entertainment expenses and when they are 50% deductible expenses. Under Notice 2018-76, taxpayers may deduct 50% of an otherwise allowable business meal if:

- The expense is an ordinary and necessary expense under section 162(a), paid or incurred during the tax year in carrying on any trade or business;
- The expense is not lavish or extravagant under the circumstances;

- The taxpayer, or an employee of the taxpayer, is present at the furnishing of the food or beverages;
- The food and beverages are provided to a current or potential business customer, client, consultant, or similar business contact; and
- In the case of food and beverages provided during or at an entertainment activity, the food and beverages are purchased separately from the entertainment, or the cost of the food and beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts.

The notice states that the entertainment disallowance rule may not be circumvented through inflating the amount charged for food and beverages.

**Examples**

Notice 2018-76 includes three examples. The examples highlight the need to have food and beverage expenses either paid separately from entertainment costs or on an invoice that separately states the costs of food and beverages.

- In Example 1, a taxpayer invites a business contact to a baseball game. The taxpayer purchases tickets for the game. While at the game, the taxpayer separately purchases hot dogs and drinks. While the game tickets are not deductible, the hot dogs and drinks are subject to a 50% deduction disallowance.
- In Example 2, the taxpayer invites a business contact to attend a basketball game. The taxpayer buys tickets for seats in a suite, which includes food and beverages. The invoice for the tickets states that food and beverages are included in the ticket price. Because the invoice does not separately provide the cost for food and beverages, the entire cost of the ticket is nondeductible.
- Example 3 has the same facts as Example 2, except that the invoice for the suite tickets separately states the cost of food and beverages. Because the food and beverage amount is separately provided on the invoice, this amount is subject to a 50% deduction, while the entertainment portion is disallowed.

## Accounting methods and periods

### Proposed regulations

*Removal of regulations on advance payments, goods, and long-term contracts*

On October 12, 2018, the IRS released for publication in the Federal Register **proposed regulations** [PDF 220 KB] that would remove existing regulations that are no longer necessary after the enactment of the law. The proposed regulations are included in Internal Revenue Bulletin 2018-44 (October 29, 2018).

The proposed regulations would remove Reg. section 1.451-5 relating to the treatment of advance payments for goods and long-term contracts and would affect accrual method taxpayers that receive advance payments for goods, including those for inventoriable goods. In general, Reg. section 1.451-5 permits taxpayers to defer the inclusion of income from advance payments for goods for federal tax purposes until the advance payments are recognized in gross receipts under the taxpayer's method of accounting for financial reporting purposes.

Comments on the proposed regulations must be received by January 14, 2019. A public hearing will be scheduled, if requested, by any person that timely submits comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the Federal Register.

Observations

This action was expected. The new law added new section 451(b) to the Code, which states that, for accrual method taxpayers, the "all events test" is not met any later than when the item of income is taken into account as revenue in a taxpayer's applicable financial statement or such other financial statement as the Treasury Secretary may prescribe.

The new law also added new section 451(c) which permits an accrual method taxpayer that receives an advance payment during the tax year to include the portion of the payment in income in the tax year of receipt as required under section 451(b) and to defer including the remaining portion of the payment until the following tax year, similar to the rules in Rev. Proc. 2004-34. These new Code sections override the deferral method provided by Reg. section 1.451-5. Therefore, it was expected that these regulations would be withdrawn.

Note also that taxpayers that are presently using a method of accounting permitted by Reg. section 1.451-5 would need to make an accounting method change to a permitted method of accounting for advance payments, effective for tax years beginning after December 31, 2017.

Interim guidance has been issued under **Notice 2018-35** [PDF 23 KB] (**discussed below**) permitting taxpayers to continue to rely on Rev. Proc. 2004-34 to make automatic accounting method changes for advance payments until guidance is issued specific to section 451(b) and section 451(c).

Other changes that do not qualify under Rev. Proc. 2004-34 are generally non-automatic method changes and must be filed by the end of the year of change. It is uncertain whether Treasury and IRS will issue procedural guidance providing additional automatic accounting method changes before the end of the 2018 calendar year.

## Revenue procedures

### *Automatic consent procedures, method of accounting changes for timing of revenue recognition: Rev. Proc. 2018-60*

On November 29, 2018, the IRS released **Rev. Proc. 2018-60** [PDF 68 KB], regarding obtaining automatic consent to change to a method of accounting for the timing of recognition of revenue in order to comply with section 451(b), as amended by the new law.

**Background**

Code section 451(b), as amended by the new law, requires accrual method taxpayers to recognize amounts in revenue no later than when such an item is taken into account in the taxpayer's applicable financial statements (AFS). The amendment applies beginning with a taxpayer's first tax year beginning after December 31, 2017, except for provisions related to original issue discount (OID) which apply to tax years beginning after December 31, 2018.

FASB ASC 606, *Revenue from Contracts with Customers*, ("new standards") provides new financial accounting standards for revenue recognition. Rev. Proc. 2018-29, as modified by Rev. Proc. 2018-49, permitted automatic method changes for taxpayers that want to change their method of accounting for the recognition of income to a method that uses the new standards under ASC 606 for identifying performance obligations, allocating transaction price to performance obligations, and/or considering performance obligations satisfied. This guidance permitted an automatic method change for the year in which ASC 606 is adopted for financial accounting purposes.

**Rev. Proc. 2018-60**

Rev. Proc. 2018-60 provides automatic procedures by which taxpayers may comply with the new law's amendments to section 451. Prior to the release of this guidance, many changes to a method of accounting for the timing of recognition of revenue were treated as non-automatic method changes. The new automatic method change added by Rev. Proc. 2018-60 applies to:

- An accrual method taxpayer with an AFS that wants to change its method of accounting for the recognition of income no later than when it is taken into account as revenue in its AFS, or

- An accrual method taxpayer with an AFS that is not adopting ASC 606 in the year of change and wants to allocate the transaction price to performance obligations under section 451(b)(4)

*Form 3115*

Taxpayers are permitted to file a "short" Form 3115, *Application for Change in Accounting Method*. See Section 16.12(4)(a) of Rev. Proc. 2018-31, as modified by Rev. Proc. 2019-60 for specific information required.

A taxpayer is not required to file the duplicate copy with the IRS in Covington, KY. The eligibility requirements prohibiting a method change for the same item in five tax years ending with the year of change are waived for the first, second, or third tax year beginning after December 31, 2017 (beginning after December 31, 2018, for changes involving OID). A taxpayer wishing to make a change under these procedures and a change to adopt the new standards under Rev. Proc. 2018-29, as modified by Rev. Proc. 2018-49, is permitted to file the changes on a single Form 3115.

*Streamlined method change procedures*

The streamlined procedures allow a taxpayer to make a change in method of accounting in the first tax year beginning after December 31, 2017, **without** filing Form 3115. Taxpayers will only be eligible to use the streamlined method change procedures if they are considered a small business taxpayer (average annual gross receipts for the three prior tax years of $25 million or less) or the adjustment under section 481(a) required by the change is zero ($0). However, taxpayers using the streamlined method change procedures do not receive audit protection for the method being changed. The eligibility requirements prohibiting a method change for the same item in five tax years ending with the year of change are waived for the first tax year beginning after December 31, 2017.

*Change in overall method*

In addition, Rev. Proc. 2018-60 modifies the procedures for a change in a taxpayer's overall method from the cash method to an accrual method, permitting a taxpayer to make such a change for a tax year ending after December 31, 2017, to comply with section 451 as modified by the new law. The eligibility requirements prohibiting a method change for the taxpayer's overall method in the five tax years ending with the year of change are waived for the taxpayer's first, second, or third tax year beginning after December 31, 2017. A single Form 3115 may be filed for the change from the cash method to accrual method and a concurrent change to adopt the new standards pursuant to Rev. Proc. 2018-29, as modified by Rev. Proc. 2018-49.

*Effective date*

Rev. Proc. 2018-60 is effective for tax years beginning after December 31, 2017.

The procedures provide that if a taxpayer has a pending Form 3115 with the National Office that was filed on or before November 29, 2018, requesting consent under the non-automatic change procedures for an item that would be eligible for the automatic change procedures described above, the form and user fee will be returned to the taxpayer.

*"Eligible terminated S corporations": Rev. Proc. 2018-44*

On August 22, 2018, the IRS released **Rev. Proc. 2018-44** [PDF 23 KB], regarding an "eligible terminated S corporation" that, because an S corporation election is terminated or revoked, realizes a positive or negative adjustment on changing from the overall cash method of accounting to the overall accrual method.

The revenue procedure provides guidance for implementing section 481(d) as added to the Code by the new law. It also modifies the "list of automatic changes" as provided by Rev. Proc. 2018-31 (**described below**).

For more detail regarding Rev. Proc. 2018-44, see the discussion in the **Passthroughs section** of this supplement.

*Procedures for small businesses to obtain automatic consent for method changes to reflect new law: Rev. Proc. 2018-40*

In August 2018, the IRS released **Rev. Proc. 2018-40** [PDF 74 KB], which sets forth procedures that eligible small business taxpayers may use to obtain automatic consent from the IRS to change their methods of accounting to reflect certain changes made by the new law. Rev. Proc. 2018-40 modifies Rev. Proc. 2018-31 (**described below**) to provide additional automatic changes in method of accounting and to modify existing automatic changes in methods of accounting to reflect the new law. The effective date for this guidance is December 31, 2017.

As background, Rev. Proc. 2018-40 explains that the new law:

- Expands the number of small business taxpayers eligible to use a cash method of accounting, and

- Exempts small business taxpayers from the requirements to capitalize costs—including for certain home construction contracts, for certain long-term contracts, and for inventories

Rev. Proc. 2018-40 also states that the IRS and Treasury expect to issue future guidance to implement the legislative changes.

*List of automatic changes, certain method changes reflecting new law: Rev. Proc. 2018-31*

On May 9, 2018, the IRS issued **Rev. Proc. 2018-31** [PDF 1 MB], providing an updated list of automatic changes to which the automatic change procedures in **Rev. Proc. 2015-13** [PDF 369 KB], as clarified and modified by **Rev. Proc. 2015-33** [PDF 82 KB] and as modified by **Rev. Proc. 2017-59** [PDF 18 KB], and by section 17.02 of **Rev. Proc. 2016-1** [PDF 937 KB], apply. The definitions in section 3 of Rev. Proc. 2015-13 also apply to Rev. Proc. 2018-31.

Rev. Proc. 2018-31 indicates that “significant changes” to Rev. Proc. 2017-30 include:

- Section 6.11, relating to a change in the depreciation of leasehold improvements, modified to remove paragraph (2)(b), relating to the temporary waiver of the eligibility rule in section 5.01(1)(f) of Rev. Proc. 2015-13, because it is obsolete. The waiver of the eligibility rule in section 5.01(1)(d) of Rev. Proc. 2015-13 continues to apply to this change.

- Section 6.18, relating to the revocation of the partial disposition election under the remodel-refresh safe harbor described in Rev. Proc. 2015-56, is obsolete and is removed from the revenue procedure in its entirety.

- Section 11.10, relating to a change to the remodel-refresh safe harbor described in Rev. Proc. 2015-56, is modified to remove paragraph (2), relating to the temporary waiver of the eligibility rules in sections 5.01(1)(d) and (f) of Rev. Proc. 2015-13, because they are obsolete.

Because of the amendments made to sections 263A, 448, and 471 by the new law, Rev. Proc. 2018-31 indicates that the IRS and Treasury expect to issue a revenue procedure providing procedures for making changes implementing measures under the new law. The following sections of Rev. Proc. 2017-30 are modified:

- Section 12.01, relating to certain uniform capitalization (UNICAP) methods used by resellers and reseller-producers, is modified to provide that a small reseller, as defined in section 12.01(3)(b) of Rev. Proc. 2018-31 is not permitted to make a change in method of accounting described in section 12.01(1)(a)(i) of Rev. Proc. 2018-31 for any tax year beginning after December 31, 2017.

- Section 15.03, relating to taxpayers changing to overall cash receipts and disbursements (cash) method, and section 21.03 (now section 22.03 of Rev. Proc. 2018-31), relating to the small taxpayer exception from requirement to account for inventories under section 471, are modified to provide that these changes do not apply for any tax year beginning after December 31, 2017.

- Because of the amendments made to section 118 by the new law, section 15.14, relating to nonshareholder contributions to capital, is modified to provide that the change described in section 15.14(1)(a)(ii) does not apply to contributions made after December 22, 2017.

- Pursuant to Notice 2018-35, section 16.07, relating to changes for advance payments, is modified to provide that the eligibility rule in section 5.01(1)(f) of Rev. Proc. 2015-13, does not apply to a taxpayer that changes to a method of accounting provided under section 16.07(1)(a)(i) of Rev. Proc. 2018-40 for the taxpayer’s first or second tax year ending on or after May 9, 2018.

- Because of the amendments made to section 451 by the new law, section 16.07 also is modified to provide that a taxpayer is not permitted to make a change in method of accounting described in section 16.07(1)(a)(ii) of Rev. Proc. 2018-31 for any tax year beginning after December 31, 2017.

Other "significant changes" to Rev. Proc. 2017-30 include:

- Section 21.15 (now section 22.15 of Rev. Proc. 2018-31), relating to sales-based vendor chargebacks, is modified to remove paragraph (2), relating to the temporary waiver of the eligibility rule in section 5.01(1)(f) of Rev. Proc. 2015-13, because it is obsolete.

- Section 23.01 (now section 24.01 of Rev. Proc. 2018-31), relating to certain taxpayers that have elected the mark-to-market method of accounting under section 475(e) or (f), is modified to provide that the waiver of the eligibility rule in section 5.01(1)(f) of Rev. Proc. 2015-13 no longer applies to this change. The waiver of the eligibility rule in section 5.01(1)(d) of Rev. Proc. 2015-13 continues to apply to this change.

- Section 23.02 (now section 24.02 of Rev. Proc. 2018-31), relating to a taxpayer changing its method of accounting for securities or commodities from the mark-to-market method of accounting described in section 475 to a realization method of accounting, is modified to provide that the waiver of the eligibility rule in section 5.01(1)(f) of Rev. Proc. 2015-13 no longer applies to this change. The waiver of the eligibility rule in section 5.01(1)(d) of Rev. Proc. 2015-13 continues to apply to this change.

*Requests by certain foreign corporations to change tax year: Rev. Proc. 2018-17*

On February 13, 2018, the IRS issued **Rev. Proc. 2018-17** [PDF 24 KB], modifying the circumstances under which the IRS will grant approval of certain requests by certain foreign corporations for changes in annual accounting periods filed under Rev. Proc. 2002-39 and Rev. Proc. 2006-45.

The revenue procedure indicates that it was issued pursuant to section 965(o) to prevent the avoidance of application of section 965 (relating to "mandatory repatriation") by changes in the tax years of certain "specified foreign corporations" (within the meaning of section 965(e)). The revenue procedure applies with respect to any request by a section 965 "specified foreign corporation" to change an annual accounting period that ends on December 31, 2017, regardless when the request was filed. For purposes of applying the revenue procedure, a 52-53-week tax year is deemed to begin on the first day of the calendar month nearest to the first day of the 52-53-week tax year, and is deemed to end or close on the last day of the calendar month nearest to the last day of the 52-53-week tax year (as applicable).

Rev. Proc. 2018-17 explains that a section 965 "specified foreign corporation" with a tax year ending on December 31, 2017, could avoid the purposes of section 965 by changing

its tax year and provides an example. Under the example, if a deferred foreign income corporation (DFIC) with the calendar year as its tax year elected, effective for its tax year beginning January 1, 2017, a tax year closing on November 30, the election could defer by as much as 11 months a U.S. shareholder's inclusion with respect to the DFIC under section 965. Further, the election could, depending on the facts, reduce the amount of the tax liability of a U.S. shareholder of the DFIC by reason of section 965, including through the reduction of the post-1986 earnings and profits of the DFIC.

This revenue procedure is also discussed in the **International section** of this supplement. Read ***TaxNewsFlash*** for more details and observations regarding Rev. Proc. 2018-17.

## Notices

### *Market discount: Notice 2018-80*

On September 27, 2018, the IRS released **Notice 2018-80** [PDF 12 KB], announcing that the IRS and Treasury intend to issue proposed regulations to address the applicability of new section 451(b) to market discount as defined under section 1278(a)(2). The notice indicates that the future proposed regulations would clarify that accrued market discount is not includible in income under section 451(b) (with the guidance to be effective as of January 1, 2018).

### *Transitional guidance regarding advance payments: Notice 2018-35*

On April 12, 2018, the IRS issued **Notice 2018-35** [PDF 23 KB] to provide transitional guidance under new section 451(c). The notice states that the rules in new section 451(c) largely track the approach taken by the IRS in **Rev. Proc. 2004-34** [PDF 108 KB] and that the IRS and Treasury expect to issue future guidance regarding the treatment of advance payments to implement the legislative change.

The notice further indicates that taxpayers (with or without applicable financial statements) receiving advance payments may continue to rely on Rev. Proc. 2004-34 until future guidance is effective.

The notice states that the IRS will not challenge a taxpayer's use of Rev. Proc. 2004-34 to satisfy the requirements of section 451, but that the IRS "will continue to verify on examination that taxpayers are properly applying Rev. Proc. 2004-34."

The IRS also intends to modify Rev. Proc. 2017-30 to enable taxpayers to make a change to a method of accounting that is permitted under Rev. Proc. 2004-34, and to waive the general limitation under which the same method of accounting may not be changed automatically twice within the same five tax years.

# Business credits

## Employer credit for family or medical leave

### *Questions and answers: Notice 2018-71*

On September 24, 2018, the IRS released **Notice 2018-71** [PDF 115 KB], providing guidance—in a "question and answer" (Q&A) format—about the employer credit for paid family and medical leave under section 45S (as added to the Code by the new law).

Notice 2018-71 states that the IRS and Treasury intend to issue proposed regulations under section 45S that will incorporate the notice's guidance.

See **Exempt Organizations section** of this supplement for a brief discussion of Notice 2018-71 and exempt organizations.

**Background**

New section 45S allows eligible employers to claim a credit equal to 12.5% of the amount of wages paid to qualifying employees during any period in which these employees are on family and medical leave if the rate of payment under the program is 50% of the wages normally paid to an employee.

The credit is increased by 0.25 percentage points (but not above 25%) for each percentage point by which the rate of payment exceeds 50%.

- An "eligible employer" is one that allows all qualifying full-time employees not less than two weeks of annual paid family and medical leave, and that allows all less-than-full-time qualifying employees a commensurate amount of leave on a pro rata basis.

- A "qualifying employee" is any employee who has been employed by the employer for one year or more, and who for the preceding year, had compensation not in excess of 60% of the compensation threshold for highly compensated employees. For instance, the employee must not have had compensation from the employer of more than $72,000 in 2017.

The employer credit applies for wages paid in tax years after 2017 and before 2020 (that is, 2018 and 2019).

**Notice 2018-71**

The Q&As in Notice 2018-71 set out details regarding the requirements of section 45S. The notice states that, to be eligible to claim the credit, an employer must have a written policy that satisfies the following requirements:

- The policy must cover all qualifying employees.

- The policy must provide at least two weeks of annual paid family and medical leave for each full-time qualifying employee and at least a proportionate amount of leave from each part-time qualifying employee.

- The policy must provide for payment of at least 50% of the qualifying employee's wages while that person is on leave.

- The policy must include "non-interference" protections for qualifying employees who are not covered by title 1 of the Family and Medical Leave Act of 1993.

Notice 2018-71 provides a transition rule for determining when an employer's written policy must be in place. The notice highlights a transition period allowing eligible employers that set up qualifying paid family leave programs or amend existing programs by December 31, 2018, to be eligible to claim the employer credit for paid family and medical leave, retroactive to the beginning of the employer's 2018 tax year, for qualifying leave already provided.

There are 34 Q&As in Notice 2018-71. The guidance is set out under topics such as:

- Eligible employer

- Family and medical leave

- Minimum paid leave requirements

- Calculating and claiming the credit

Read a related IRS release—**IR-2018-191**

*What employers need to know: KPMG report (April 2018)*

Read an April 2018 report prepared by Susan Reaman and Terri Stecher of KPMG, ***Employers Get Credit for Paying Employees While on Family or Medical Leave*** [PDF 80 KB].

The new law created a tax credit for employers that pay employees while on family and medical leave (FMLA).

The article provides an overview of the credit and explains why employers should review paid leave policies to determine eligibility for the credit and consider the benefits of amending policies to conform to the new law to become eligible for the credit.

Among other things, the article observes that, for companies that already provide paid FMLA leave, it is worth considering whether the benefits may be eligible for the credit. However, even if benefits amounts provided appear to qualify for the credit, adjustments to the written plan document may still be necessary. For companies that do qualify for the

credit, it is important to remember that a deduction is not allowed for the compensation that qualifies for the credit. Therefore, it is worth exploring whether the credit or deduction is more beneficial because an election can be made to not take the credit.

## Miscellaneous business provisions

### Qualified opportunity funds

The new law generally provides for the temporary deferral and partial exclusion of gross income on gains reinvested in a "qualified opportunity fund," as well as the permanent exclusion of gains from the sale or exchange of an investment held for at least 10 years in such a fund. Some of the general rules are described below at a high level.

Among other things, to take advantage of the new law, a taxpayer must sell property to, or exchange property with, an unrelated party in a transaction that generates capital gains income, and then, within 180 days of the sale, the taxpayer must elect to make an investment in a qualified opportunity fund. Generally, the taxpayer's gain on the initial sale is deferred to the extent the gain is invested in a qualified opportunity fund and the deferred gain is recognized as of the earlier of (1) the date that the interest in the qualified opportunity fund is sold, or (2) December 31, 2026. The amount of gain included in income is the excess of the lesser of the deferred gain or the fair market value of the investment over the taxpayer's basis in the investment.

The taxpayer's initial basis in a qualified opportunity fund is zero. In the case of an investment held for at least five years, the basis of the investment is increased by 10% of the deferred gain. If the investment is held for at least seven years, the basis of the investment is increased an additional 5% of the deferred gain.

If the investment is held for at least 10 years, and if the taxpayer so elects, the basis of the property is equal to the fair market value of the investment on the date that the investment is sold or exchanged.

#### *Opportunity zones for Puerto Rico: Legislative change*

The Bipartisan Budget Act of 2018 (Pub. L. No. 115-123) modified the new opportunity zone rules by adding the following special rule for Puerto Rico at the end of section 14000Z-1 (and by making a conforming amendment to section 1400Z-1(d)(1)):

> *(3) SPECIAL RULE FOR PUERTO RICO—Each population census tract in Puerto Rico that is a low-income community shall be deemed to be certified and designated as a qualified opportunity zone, effective on the date of the enactment of Public Law 115–97.*

*Proposed regulations, Rev. Rul. 2018-29, IRS release, and KPMG report*

On October 19, 2018, the Treasury and IRS released proposed regulations under Code section 1400Z-2, which relates to gains that may be deferred as a result of a taxpayer's investment in a qualified opportunity fund (QOF). The Treasury and IRS also released **Rev. Rul. 2018-29** [PDF 41 KB], addressing how a building acquired on land is treated for purposes of satisfying the "original use" and the "substantial improvement" requirements to acquire qualified opportunity zone property.

Read the **proposed regulations** [PDF 279 KB] as published in the Federal Register on October 29, 2018. Some unsubstantial changes were made to the version of the proposed regulations published in the Federal Register, relative to the version released on October 19.

Comments on the proposed regulations must be received by December 28, 2018. A public hearing initially was scheduled for January 10, 2019 (but might be rescheduled).

**Background**

As noted in an IRS release (**IR-2018-206**) accompanying release of the proposed regulations, opportunity zones are designed to provide tax benefits that encourage investment in distressed communities. Under a nomination process completed earlier this year, 8,761 communities in all 50 states, the District of Columbia, and five U.S. territories were designated as qualified opportunity zones. Opportunity zones retain their designation for 10 years.

Investors may defer and potentially exclude up to 15% of capital gains invested in a QOF within 180 days from the date of the sale or exchange up to the earlier of the date the investment is sold or to December 31, 2026. Also, taxpayers may permanently exclude any additional gains from the investment held for at least 10 years.

According to the IRS release, "almost all capital gains qualify for deferral" and concerning capital gain of a partnership, the rules allow either a partnership or its partners to elect deferral. Similar rules apply to other pass-through entities, such as S corporations and their shareholders, and estates and trusts and their beneficiaries.

According to the preamble, the proposed regulations address:

- The type of gains that may be deferred by investors
- The time by which corresponding amounts must be invested in QOFs
- The manner in which investors may elect to defer specified gains

The proposed regulations also include guidance for QOFs, including rules for self-certification, valuation of QOF assets, and guidance on qualified opportunity.

**More information—KPMG report**

Read a more detailed discussion of the IRS and Treasury guidance in an October 22, 2018 **KPMG report: New rules for opportunity zones** [PDF 1.3 MB]. The report includes initial impressions and observations regarding the proposed rules (as released by the IRS on October 19, 2018). The report notes that the proposed rules provide much needed clarity for taxpayers seeking to take advantage of investments in a QOF and allow gain deferral and potential exclusion of gains for investments in economically underserved areas across the nation, including U.S. possessions and the District of Columbia.

*Draft Form 8996 and Instructions*

The IRS has posted a **draft version of Form 8996** [PDF 105 KB] and related **draft instructions** [PDF 208 KB] to be used by investment vehicles to self-certify as qualified opportunity funds. The IRS cautions that draft forms should not be filed and are subject to change and to OMB approval before being officially released and that taxpayers should not rely on draft forms, instructions, and publications for filing. The draft form and instructions have a "watermark" date of October 19, 2018.

*General issues regarding opportunity zones: IRS FAQs*

On April 24, 2018, the IRS posted the first set of **"frequently asked questions" (FAQs)**. The list of questions was updated on June 7, 2018.

The **FAQs** define what is a qualified opportunity zone, what is a qualified opportunity fund, and how to obtain the tax benefits for an opportunity zone investments. The FAQs explain that approval or action by the IRS to certify a qualified opportunity fund is not required and that eligible qualified opportunity funds can self certify. To self certify, the FAQs indicate that a taxpayer merely completes a form (to be released in the summer of 2018) and attaches that form to the taxpayer's federal income tax return for the tax year. Also, the FAQs provide examples of how gains from the sale of stock in 2017 or 2018 may be eligible for deferral under the opportunity zone rules.

*List of opportunity zones and general information: Notice 2018-48 and Treasury website*

On June 20, 2018, the IRS released **Notice 2018-48** [PDF 3.87 MB], which lists the population census tracts designated by the Treasury as qualified opportunity zones. The notice is 383 pages long and reflects the complete list of opportunity zone designations.

As background, on June 14, 2018, the U.S. Treasury's Community Development Financial Institutions Fund (CDFI Fund) released the complete list of opportunity zones and noted that this list would also be provided in a future edition of the Internal Revenue Bulletin (IRB)—hence the IRS notice. See Treasury's **CDFI Fund webpage** for opportunity zone resources, including a map of opportunity zones.

*Procedures for designating opportunity zones: Rev. Proc. 2018-16*

On February 8, 2018, the IRS released **Rev. Proc. 2018-16** [PDF 47 KB] as guidance to the "chief executive officers" of any U.S. state, U.S. possession, and the District of Columbia regarding the procedure for designating population census tracts as qualified opportunity zones.

*Explanation of deferral and exclusion opportunities: KPMG reports*

As noted above, read an October 22, 2018, discussion of the proposed opportunity zone rules in **KPMG report: New rules for opportunity zones** [PDF 1.3 MB].

See also a February 2018 article by Katherine Breaks, Rich Blumenreich, and Susan Reaman of KPMG for an overview of the new rules for qualified opportunity zone investments: ***Opportunity Knocks under Tax Reform*** [PDF 74 KB].

## Expanded nondeductibility of certain fines and penalties

*Transitional guidance on expanded nondeductibility of certain fines and penalties and information reporting: Notice 2018-23*

On March 27, 2018, the IRS issued **Notice 2018-23** [PDF 48 KB] as transitional guidance concerning the expanded nondeductibility of certain fines and penalties paid to a governmental or nongovernmental regulatory entity and new information reporting requirements under section 6050X.

The notice announces that the IRS and Treasury intend to issue proposed regulations to implement the new law's measures. The notice provides transitional guidance until the regulations are proposed. The IRS notice requests that suggestions for proposed regulations be submitted by May 18, 2018.

With regard to the information reporting required under new section 6050X, the notice indicates that governmental entities are not required to comply with these new requirements "until the date specified in the proposed regulations." That specified date would not be earlier than January 1, 2019. The notice also provides that information reporting will not be required with respect to amounts required to be paid or incurred under a binding court order or agreement entered into before the specified date.

The transitional guidance provided with respect to the section 6050X reporting requirement does not affect or delay the applicability of section 162(f). Accordingly, Notice 2018-23 provides guidance on the identification requirement for determining amounts that qualify for the section 162(f)(2) exception.

### Alaska native corporations and settlement trusts

*Reminder about benefits and reporting: IRS release*

On January 30, 2018, the IRS issued a release—**IR-2018-16**—reminding Alaska native corporations and Alaska native settlement trusts of certain benefits in the new law. The release also reiterates that the new law requires that certain contributions made by native corporations to settlement trusts in 2017 be reported to the settlement trusts by January 31, 2018.

As noted in the release, the new law allows a native corporation to assign certain payments to a settlement trust without treating the payments as income for federal tax purposes. If a native corporation assigns payments to a settlement trust, a deduction for these payments is not allowed. However, native corporations may choose to deduct contributions made to a settlement trust. The deduction is limited to the amount of the native corporation's taxable income for that year. Any unused deduction may be carried forward 15 additional years.

# Compensation

## Withholding from wages and retirement & annuity distributions: Notice 2018-92

On November 26, 2018, the IRS released **Notice 2018-92** [PDF 60 KB] as interim guidance for the 2019 calendar year on income tax withholding from wages and from retirement and annuity distributions. See discussion of Notice 2018-92 in **Individuals section** below.

## Excise tax on excess tax-exempt organization executive compensation

### Notice 2019-09

On December 31, 2018, the IRS released **Notice 2019-09** [PDF 557 KB] (92 pages) as interim guidance regarding the excise tax imposed under section 4960 on the amount of remuneration in excess of $1 million and on any excess parachute payment paid by an applicable tax-exempt organization to a covered employee.

Notice 2019-09 states that the Treasury and IRS intend to issue proposed regulations on the excise tax under section 4960 and that the future regulations will incorporate the guidance that is provided in the notice. The future regulations would be prospective and would not apply to tax years beginning before the issuance of those future regulations.

The guidance provided by Notice 2019-09 is in 39 questions and answers (Q&As) that also include definitions of the following terms:

- Applicable tax-exempt organization
- Excess remuneration
- Covered employee
- Excess parachute payment

In addition, Notice 2019-09 instructs taxpayers how to report and pay the excise tax. The notice state that, until further guidance is issued, to comply with the requirements of section 4960, taxpayers may base their positions upon "a good faith, reasonable interpretation of section 4960" and that the guidance reflected in Notice 2019-09 constitutes such a good faith, reasonable interpretation of the statute.

### Form 4720 filing requirement: Proposed regulations and draft form

On November 5, 2018, Treasury and IRS released for publication in the Federal Register proposed regulations (REG-107163-18) specifying which return to use to pay certain excise taxes imposed by sections 4960 and 4968 and the time for filing the return. Section 4960 is the provision added by the new law that requires tax-exempt organizations to pay a 21% excise tax on remuneration over $1 million and on "excess parachute payments" paid to "covered employees." (See the **Exempt Organizations section** of this supplement for discussion of the section 4968 excise tax.) The **proposed regulations** [PDF 92 KB] were published in the Federal Register on November 7, 2018. Comments were due by December 7, 2018.

The proposed regulations amend existing procedural regulations to provide that persons (including governmental entities) liable for section 4960 or 4968 excise taxes are required to file a return on Form 4720, *Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code*. In addition, the proposed regulations provide that a person required to file a Form 4720 to report an excise tax under section 4960 or 4968 must file a Form 4720 by the 15th day of the fifth month after the end of the person's tax year during which the excise tax liability was incurred.

In August 2018, the IRS posted a **draft version of Form 4720** [PDF 238 KB] for 2018 and accompanying **draft instructions** [PDF 425 KB] that added Schedules N and O for reporting related to sections 4960 and 4968, respectively. The draft forms, as well as the draft instructions, include cautionary language that they are not to be used for filing purposes, and are subject to change and to OMB approval before being officially released.

### KPMG report

Read an article written by Alexandra O. Mitchell, Preston J. Quesenberry, and Randall S. Thomas, ***An Excess of Uncertainty: The New Tax on Tax-Exempt Compensation*** [PDF 988 KB], published in Tax Notes on June 25, 2018. The article examines the new

excise tax imposed on remuneration exceeding $1 million paid by tax-exempt organizations to certain employees. It also discusses technical issues arising from the statute's having borrowed several terms and concepts from section 162(m), explores numerous questions raised by other defined terms in the statute, and offers possible interpretations for consideration.

## Modification of limitation on excessive employee remuneration: Notice 2018-68

On August 21, 2018, the IRS released **Notice 2018-68** [PDF 79 KB] on section 162(m)—as modified by the new law—concerning the allowable deduction for remuneration paid by any publicly held corporation with respect to a "covered employee."

### Background

Section 162(m) disallows the deduction by any publicly held corporation for applicable employee remuneration paid to any covered employee to the extent that such remuneration for the tax year exceeds $1 million. The new law expanded the scope of section 162(m) and repealed exceptions to the deduction limitation of $1 million.

The new law's provisions expanded the definition of "covered employee" to include the principal executive office, principle financial officer, and the top three other highest-paid officers. Once an employee is treated as a covered employee, the individual retains that status for all future years, including with respect to payments made after retirement, death, etc. The new law expanded the definition of "publicly held corporation" to include all domestic publicly traded corporations and certain publicly trade foreign companies.

The new law provided a transition rule for the section 162(m) changes. The new provisions do not apply to any remuneration paid under a written, binding contract in effect on November 2, 2017, which was not materially modified on or after that date.

### Notice 2018-68

According to Notice 2018-68, stakeholders requested initial guidance on certain aspects of the amendments made to section 162(m)—in particular the amended rules for identifying covered employees and the operation of the grandfather rule, including when a contract will be considered materially modified so that it is no longer grandfathered. Notice 2018-68 addresses these limited issues.

Notice 2018-68 also examines the term "written binding contract" for purposes of grandfathering. Remuneration is grandfathered if it is payable under a written binding contract that was in effect on November 2, 2017, and not materially modified after that date, only to the extent the corporation is obligated under applicable law (such as state contract law) to pay the remuneration under the contract if the employee performs services or satisfies the vesting conditions. Further, a "material modification" occurs when the contract is amended to increase the amount of compensation payable to the

employee. Several examples are provided to illustrate these measures, including examples addressing contract renewals.

Notice 2018-68 provides that the covered employees who are the three highest compensated executive officers for the tax year (other than the principal executive officer (PEO) or principal financial officer (PFO) or an individual acting in that capacity) are determined regardless of whether the executive officer is serving at the end of the publicly held corporation's tax year and regardless of whether the executive officer's compensation is subject to disclosure for the last completed fiscal year under applicable rules of the U.S. Securities and Exchange Commission (SEC). The notice provides examples to illustrate how the covered employee rules are to apply. Based on the examples, the three highest executive officers could be individuals who for various reasons are not on the SEC disclosure, but are still one of the three highest compensated executive officers during the year.

The IRS and Treasury have requested comments on the application of the SEC disclosure rules to determine the three most highly compensated executive officers for a tax year that does not end on the same date as the last completed fiscal year.

In addition, Notice 2018-68 states that the IRS and Treasury expect to issue further guidance on the amendments to section 162(m) in the form of proposed regulations.

**Additional information**

For more information, read an October 2018 article prepared by Robert Delgado, Gary Cvach, and Terri Stecher of KPMG–***Bad Grandpa: Notice 2018-68 Provides Initial 162(m) Guidance, Including a Narrowly Crafted Grandfathering Provision*** [PDF 112 KB]. The article provides additional insights on a variety of issues under Notice 2018-68, including:

- The definition of a covered employee
- Grandfathering under the prior section 162(m) rules
- Material modifications

## Treatment of qualified equity grants

### Initial guidance on section 83(i): Notice 2018-97 and related IRS release

On December 7, 2018, the IRS released **Notice 2018-97** [PDF 287 KB], as initial guidance on the application of section 83(i)—a provision that allows certain employees to defer the recognition of income attributable to the receipt or vesting of qualified stock.

**Background**

Section 83(i) was added to the Code by the new law. The new provision allows certain employees to defer federal income tax on compensation related to certain stock options and restricted stock unit (RSU) plans granted by private companies. Under this provision, if "qualified stock" is transferred to a "qualified employee," then the employee may make an election within 30 days of vesting to have the income tax deferred until the earliest of: (1) the first date the stock is transferable; (2) the date the employee becomes an "excluded employee;" (3) the first date the stock become readily tradable on an established securities market; (4) the date that is five years after vesting; or (5) the date the employee revokes the election.

Also, the company must be an "eligible company"—meaning that its stock may not be readily tradable on an established securities market during any previous year; it must have a written plan during the year; and not less than 80% of all employees who provide services within the United States may be granted options and RSUs with the same rights and privileges.

**Notice 2018-97**

Notice 2018-97 provides guidance on specific aspects of section 83(i), including:

- The application of the requirement that grants be made to not less than 80% of all employees who provide services in the United States to the eligible corporation
- The application of federal income tax withholding to the deferred income related to the qualified stock
- The ability of an employer to opt out of permitting employees to elect the deferred tax treatment even if the section 83(i) requirements are otherwise met

As further explained in a related IRS release—**IR-2018-246**—under section 83(i)(3)(A), executives, highly-compensated officers and those owning 1% or more of the corporation's stock cannot make the deferral election.

Future guidance under section 83(i) is expected to be issued in the form of proposed regulations and would incorporate the guidance provided in Notice 2018-97.

*Application of 80% requirement*

Notice 2018-97 provides that a determination that the corporation is an eligible corporation must be made on a calendar year basis, and whether the corporation has satisfied the 80% requirement is based solely on the stock options or the RSUs granted in that calendar year to employees who provide services to the corporation in the United States (or any possession of the United States).

In calculating whether the 80% requirement is satisfied, the corporation must take into account the total number of individuals employed at any time during the year in question as well as the total number of employees receiving grants during the year (in each case, without regard to excluded employees or part-time employees described in section 4980E(d)(4)), regardless of whether the employees were employed by the corporation at the beginning of the calendar year or the end of the calendar year.

*Employment taxes*

A section 83(i) election is valid only for federal income tax purposes and does not change or defer the timing of FICA and FUTA payable with respect to qualified stock.

Notice 2018-97 indicates that the IRS and Treasury expect to issue proposed regulations providing that the rate of income tax withholding under section 3402(t)(1) on deferral stock will be the maximum rate of tax in effect under Code section 1 and that withholding is to be applied: (1) without reference to any payment of regular wages; (2) without allowance for the number of allowances or other dollar amounts claimed by the employee on Form W-4, *Employee's Withholding Allowance Certificate*; (3) without regard to whether the employee has requested additional withholding; and (4) without regard to the withholding method used by the employer.

Thus, under the anticipated proposed regulations, only one rate—the maximum rate of tax under Code section 1—would be used in withholding on deferral stock under section 3402(t), and employers would not be able to increase or decrease the rate at the request of the employee.

Pursuant to Code section 3402(t) and Notice 2018-97, and unless and until superseding guidance is issued, with respect to wages resulting from deferral stock under section 3402(t), employers must withhold taxes at the maximum rate of income tax under Code section 1 without regard to whether the employee has requested additional withholding and without regard to any withholding allowances or dollar amounts entered on the employee's Form W-4.

The notice summarizes these points, as follows:

- Deferral stock constitutes wages under section 3401(i) and is to be treated as received on the earliest date described in section 83(i)(1)(B) in an amount equal to the amount included in income under section 83 for the tax year that includes such date.

- When the wages are treated as paid under section 3401(i), the employer must make a reasonable estimate of the value of the stock and make deposits of the amount of income tax withholding liability based on that estimate.

- The wages included under section 3401(i) are subject to withholding at the maximum rate of tax in effect under Code section 1, and withholding is determined without regard to the employee's Form W-4.

- By January 31 of the following year, the employer must determine the actual value of the deferral stock on the date it is includible in the employee's income and report that amount and the withholding on Form W-2 and Form 941.

- With respect to income tax withholding for the deferral stock that the employer pays from its own funds, the employer may recover that income tax withholding from the employee until April 1 of the year following the calendar year in which the wages were paid.

- An employer that fails to deduct and withhold federal income tax under section 3402 is liable for the payment of the tax whether or not the employer collects it from the employee, unless section 3402(d) applies.

*Escrow arrangement*

In general, Notice 2018-97 requires that an employee making the section 83(i) election must agree that the stock will be held in an escrow arrangement (as described in the notice) so that the income tax withholding requirements are satisfied. If the employee does not agree, then the employee is not a "qualified employee."

**KPMG observation:** In effect, the corporation can preclude employees from making a section 83(i) election by declining to establish an escrow arrangement consistent with the requirements of the notice – alleviating concerns that it inadvertently created conditions that allow employees to make section 83(i) elections or that the corporation needs to comply with section 83(i) requirements.

**Designation of stock as "not eligible"**

The terms of a stock option or RSU may provide that no election under section 83(i) will be available with respect to stock received on exercise of the stock option or settlement of the RSU. This "not eligible" designation would inform employees that no section 83(i) election may be made—even if the stock is qualified stock.

# Retirement savings

## Application of hardship distribution rules in light of modification to casualty loss deduction rules: Proposed regulations

On November 9, 2018, the Treasury and IRS issued **proposed regulations** updating the section 401(k) and section 401(m) regulations to reflect, among other things, the application of the hardship distribution rules in light of the modification to the casualty loss deduction rules made by the new law.

The proposed regulations were scheduled to be published in the Federal Register on November 14, 2018.

## Extended rollover period for rollover of plan loan offset amounts

### Modified "safe harbor" explanations for plan administrators to provide for recipients of rollover distributions: Notice 2018-74

On September 19, 2018, the IRS released **Notice 2018-74** [PDF 148 KB], which modifies two "safe harbor" explanations with respect to eligible qualified plan rollover distributions, to reflect legislative changes as well as to take into consideration other guidance.

**Background**

Regulations provide that the plan administrator of a qualified plan must, within a reasonable period of time before making an eligible rollover distribution, provide the distributee with a written explanation that complies with the rules under section 402(f).

Notice 2014-74 provided two safe harbor explanations for plan administrators. One safe harbor explanation was for payments not from a designated Roth account, and the other was for payments from a designated Roth account. Specifically, Notice 2014-74 provided that these safe harbor explanations could be used by plan administrators and payors to satisfy the section 402(f) rules—provided that these reflected current law.

**Notice 2018-74**

Notice 2018-74 modifies the two safe harbor explanations (originally provided by Notice 2014-74) that may be used to satisfy the requirement under section 402(f) that certain information be provided to recipients of eligible rollover distributions.

The modified safe harbor explanations reflect legislative changes, including measures under the new law, and other IRS guidance issued after Notice 2014-74. These changes include measures relating to qualified plan loan offsets and guidance issued on self-certification of eligibility for a waiver of the deadline for completing a rollover (described in Rev. Proc. 2016-47). The notice also includes other clarifying changes.

Notice 2018-74 also provides in two appendices the following items to help with the implementation of the modified safe harbor explanations:

- Appendix A contains two model safe harbor explanations—one for distributions that are not from a designated Roth account, and a second for distributions from a designated Roth account.

- Appendix B provides instructions on how to amend the safe harbor explanations contained in Notice 2014-74 to reflect the revisions included in the modified safe harbor explanations in Appendix A.

## Repeal of special rule permitting recharacterization of IRA contributions

### Recharacterization of IRA contributions: FAQs

On January 29, 2018, the IRS issued a message announcing that it has updated a list of "frequently asked questions" (FAQs) with respect to the recharacterization rules of Roth IRA contributions to take into account the new law. The IRS subsequently updated those FAQs.

The **FAQs** (as of April 9, 2018) are reproduced below from the IRS website. The last two questions specifically address changes made by the new law.

| **What is a recharacterization of a contribution to a traditional or Roth IRA?** |
|---|
| A recharacterization allows you to treat a regular contribution made to a Roth IRA or to a traditional IRA as having been made to the other type of IRA. A regular contribution is the annual contribution you're allowed to make to a traditional or Roth IRA: up to $5,500 for 2018, $6,500 if you're 50 or older (see **IRA Contribution Limits** for details). It does not include a conversion or any other rollover. |
| **How do I recharacterize a regular IRA contribution?** |
| To recharacterize a regular IRA contribution, you tell the trustee of the financial institution holding your IRA to transfer the amount of the contribution plus earnings to a different type of IRA (either a Roth or traditional) in a trustee-to-trustee transfer or to a different type of IRA with the same trustee. If this is done by the due date for filing your tax return (including extensions), you can treat the contribution as made to the second IRA for that year (effectively ignoring the contribution to the first IRA). |
| **Can I recharacterize a rollover or conversion to a Roth IRA?** |
| Effective January 1, 2018, pursuant to the Tax Cuts and Jobs Act (Pub. L. No. 115-97), a conversion from a traditional IRA, SEP or SIMPLE to a Roth IRA cannot be recharacterized. The new law also prohibits recharacterizing amounts rolled over to a Roth IRA from other retirement plans, such as 401(k) or 403(b) plans. |
| **How does the effective date apply to a Roth IRA conversion made in 2017?** |
| A Roth IRA conversion made in 2017 may be recharacterized as a contribution to a traditional IRA if the recharacterization is made by October 15, 2018. A Roth IRA conversion made on or after January 1, 2018, cannot be recharacterized. For details, see "Recharacterizations" in Publication 590-A, Contributions to Individual Retirement Arrangements (IRAs). |

# Passthroughs and sole proprietorships

## Deduction for qualified business income (new section 199A)

New section 199A provides a deduction for qualifying income of certain noncorporate owners of some passthrough entities and sole proprietorships. This new 20% deduction

generally is available for qualified business income (including income from publicly traded partnerships and qualified REIT dividends) for tax years beginning after December 31, 2017. Eligible taxpayers can claim the 20% deduction for the first time on their 2018 federal income tax returns.

The provision is complex and contains a number of important limitations and special rules. The deduction does not apply to tax years beginning after December 31, 2025.

### Application of new deduction to cooperatives: Legislation enacted

The Consolidated Appropriations Act, 2018 (Pub. L. No. 115-141) includes changes to new section 199A with respect to certain cooperatives and grain companies. These changes are discussed in the **Cooperatives section** of this supplement.

### Final regulations

On December 14, 2018, OMB's Office of Information and Regulatory Affairs (OIRA) acknowledged receipt of final regulations from the Treasury concerning whether and to what extent an individual (including a trust or estate) is entitled to a deduction under section 199A with regard to trade or business income earned through a sole proprietorship, partnership, or S corporation.

### Proposed regulations on new deduction, FAQs, and Notice 2018-64

On August 8, 2018, the Treasury and IRS released proposed regulations (REG-107892-18) concerning the new deduction. The **proposed regulations** [PDF 405 KB] were published in the Federal Register on August 16, 2018. Comments were due by October 1, 2018. Taxpayers may rely on the proposed regulations in their entirety prior to finalization.

The IRS also released in connection with the proposed regulations a list of "frequently asked questions" (the **FAQs**) and **Notice 2018-64** [PDF 36 KB] as a proposed revenue procedure on methods for calculating W-2 wages for purposes of section 199A.

#### Overview

According to a **Treasury release**, the proposed regulations:

- Provide that all small business income below $315,000 for married couples filing jointly (and $157,000 for single filers) is eligible for the deduction.

- Provide clarity and flexibility for filers over those income thresholds by: (1) including "aggregation rules" for filers with passthrough income from multiple sources; (2) issuing guidance relating to specified service trade or business (SSTB) income, which is not eligible for the section 199A deduction for taxpayers with income above a certain

threshold; and (3) allowing a de minimis exception to avoid unnecessary compliance costs for businesses earning only a small percentage of SSTB income.

- Establish anti-abuse safeguards to prevent improper tax avoidance schemes, such as relabeling employees as independent contractors. The anti-abuse provisions are generally proposed to apply to tax years ending after December 22, 2017.

Qualified business income includes domestic income from a trade or business. Income earned as an employee, capital gains, interest, and dividend income are excluded from this definition. A taxpayer's ability to claim the 20% deduction with regard to that income may be limited by a W-2 wage or W-2 wage and qualifying basis limitation.

The proposed regulations provide guidance on how to compute the 20% deduction, define certain terms, and include anti-avoidance guidance under section 199A.

The proposed regulations are divided into the following subsections:

- Operational rules
- Determination of W-2 wages and the unadjusted basis immediately after acquisition (UBIA) of qualified property
- Qualified business income (QBI), qualified REIT dividends, qualified publicly traded partnership (PTP) income
- Aggregation rules
- Specified service trade or business (SSTB) and the trade or business of performing services as an employee
- Special rules for relevant passthrough entities (RPEs), PTPs, trusts, and estates
- Anti-avoidance rules for multiple trusts

**Initial impressions**

The following discussion summarizes and lists certain items that stood out in an initial review of the proposed regulations and related IRS guidance.

- Neither section 199A nor the legislative history provides a definition of "trade or business" and the proposed regulations generally define the term consistent with its meaning under section 162(a), with an extension of that definition for rental or licensing of tangible or intangible property to a commonly controlled trade or business (i.e., taxpayers may aggregate the rental with the commonly controlled trade or business if certain requirements are met).

- The proposed regulations provide guidance with respect to whether certain items generate QBI. For instance, the proposed regulations address whether income under section 751, income under section 707(a), guaranteed payments under section 707(c), gain or loss under section 1231, and interest on working capital constitute QBI.

- For taxpayers that have multiple trades or business, the proposed regulations also allow for taxpayers generally to use a reasonable method to allocate expenses among the trades or businesses.

- Provided that certain requirements are met, the proposed regulations allow taxpayers to aggregate trades or businesses conducted by separate entities, which may allow a taxpayer to maximize its section 199A deduction in calculating its W-2 wage and UBIA limitations. However, the IRS and Treasury did not adopt the section 469 rules for such aggregation. The IRS and Treasury have requested comments on a proposed approach to aggregation in tiered structures.

- There is a limitation on QBI based on W-2 wages and UBIA of qualified property. In addition, a netting approach is used if an individual has QBI of less than zero from one trade or business, but has overall QBI greater than zero for all trades or businesses together. In that case, the individual must offset the net income in each trade or business with the net loss from each trade or business before applying the limitations based on W-2 wages and UBIA of qualified property.

- The section 199A deduction does not reduce net earnings from self-employment under section 1402 or net investment income under section 1411.

- The proposed regulations provide that adjustments to the basis of partnership property under either section 734 or section 743 are not treated as separate qualified property. Further, the proposed regulations contain rules for determining a taxpayer's unadjusted basis in qualified property that was acquired in a like-kind exchange, involuntary conversion, or other non-recognition transaction (including a section 721 contribution to a partnership or a section 351 contribution to an S corporation).

- The proposed regulations provide more detail regarding a determination of whether a business is an SSTB and provide a de minimis rule pursuant to which a business with gross receipts of $25 million or less will not be treated as an SSTB if less than 10% of its gross receipts are from the performance of services in the prescribed fields. For trades or businesses with gross receipts greater than $25 million, a trade or business is not an SSTB if less than 5% of the gross receipts are attributable to the performance of services in the prescribed fields.

- The proposed regulations set out rules for certain specified entities—e.g., RPEs, PTPs, trusts, and estates—to follow for purposes of computing the entities' or their owners' section 199A deduction.

- To address efforts by certain taxpayers to circumvent the threshold amount or other rules, the proposed regulations include anti-avoidance rules that take aim at the use of multiple trusts to avoid exceeding the threshold amounts described in section 199A.

**More information**

For more information, read an October 2018 article by Deanna Harris of KPMG on ***Proposed Regulations under Section 199A*** [PDF 209 KB].

### Proposed regulations relating to RICs and REITs

On December 13, 2018, OMB's Office of Information and Regulatory Affairs (OIRA) acknowledged receipt of proposed regulations from the Treasury under section 199A as guidance for RICs and REITs (regulated investment companies and real estate investment trusts).

## Tax gain on sale of certain partnership interests on look-through basis

Very generally, new section 864(c)(8) treats as "effectively connected" with a U.S. trade or business a foreign person's gain or loss from a disposition of an interest in a partnership that is engaged in a trade or business in the United States. The new law also created two alternative withholding regimes that are triggered if a portion of the gain (if any) on any disposition of an interest in a partnership would be treated under section 864(c)(8) as effectively connected with the conduct of a trade or business in the United States.

The new withholding rules apply with respect to dispositions of certain partnership interests occurring after December 31, 2017. However, the new substantive tax rules under section 864(c)(8) apply to transfers of interests in certain partnerships occurring on or after November 27, 2017.

### Proposed regulations

On December 20, 2018, the Treasury and IRS released proposed regulations as guidance under section 864(c)(8) concerning sales of U.S. trade or business partnership interests. The **proposed regulations** [PDF 222 KB] were published on December 27, 2018, with comments and requests for public hearing due by February 25, 2019.

The discussion below is drawn from a KPMG report on the proposed regulations as initially released on December 20, 2018; the report was issued on December 21, 2018.

**Background**

The IRS in 1991 issued Rev. Rul. 91-32, concluding that a foreign partner's capital gain or loss on the sale of a partnership interest is properly treated as effectively connected with a U.S. trade or business if and to the extent that a sale of the underlying assets by the partnership would have resulted in effectively connected income for the foreign partner.

In 2017, the U.S. Tax Court in *Grecian Magnesite Mining v. Commissioner* refused to follow the revenue ruling in determining that a foreign partner was not subject to U.S. tax on a sale of a partnership interest (to the extent the gain was not attributable to U.S. real property interests).

In response, section 864(c)(8) was enacted as part of the new law to provide that gain or loss on a sale of a partnership interest by a foreign person is treated as effectively connected with a U.S. trade or business to the extent that the foreign person would have had effectively connected gain or loss had the partnership sold its underlying assets.

A separate provision of the new law—section 1446(f)—requires that the transferee of a partnership interest withhold 10% of the amount realized on a sale or exchange of the interest unless the transferor certifies that it is not a foreign person and provides a U.S. taxpayer identification number. If the transferee fails to withhold the correct amount, the new law imposes an obligation on the partnership to deduct and withhold from distributions to the transferee partner an amount equal to the amount the transferee failed to withhold, plus interest.

In December 2017, the IRS released Notice 2018-08 (the "PTP Notice"), **discussed below**. The PTP Notice temporarily suspends the requirement to withhold on amounts realized in connection with the sale, exchange, or disposition of certain interests in publicly traded partnerships.

In April 2018, the IRS released Notice 2018-29 (**discussed below**) that announced an intent to issue proposed regulations under section 1446(f) that apply in the case of a disposition of a partnership interest that is not publicly traded and provided temporary guidance. Read ***TaxNewsFlash***

**Proposed regulations**

The proposed regulations generally:

- Set out rules for how to calculate the amount of gain or loss that may be treated as effectively connected gain or loss—including how to determine the foreign transferor's distributive share of the partnership's effectively connected unrealized gain or loss
- Provide guidance on the interaction of section 751(a) and section 864(c)(8)
- Clarify the meaning of the term "non-separately stated taxable income or loss of the partnership" for purposes of section 864(c)(8)
- Clarify that section 864(c)(8) only applies to recognized gain or loss
- Coordinate the application of section 864(c)(8) with section 897(g)

- Provide guidance on the interaction of section 864(c)(8) and potential reductions or exemptions from tax under any applicable tax treaty

- Include an anti-abuse provision in the form of an anti-stuffing rule

**Calculation of "ECI gain or loss"**

The proposed regulations essentially break down the calculation of a foreign transferor's effectively connected gain or loss into four steps:

- Determine foreign transferor's "outside gain" or "outside loss" which serves as a limit on the foreign transferor's effectively connected gain or loss

- Determine the partnership's effectively connected unrealized gain or loss

- Determine the foreign transferor's distributive share of the partnership's effectively connected unrealized gain or loss

- Apply the foreign transferor's limit on effectively connected gain or loss to the foreign transferor's distributive share of the partnership's effectively connected unrealized gain or loss to determine the foreign transferor's effectively connected gain or loss on the transfer of its partnership interest

*Interaction with section 751*

In determining a foreign transferor's "outside gain" or "outside loss," the proposed regulations provide that a foreign transferor must take the general recharacterization rule under section 751 into account.

In general, under section 751 the sale or exchange of a partnership interest can give rise to ordinary income or loss to the extent attributable to the transferor's share of the partnership's "hot" assets (i.e., ordinary assets such as inventory and unrealized receivables, which is broadly defined for this purpose). As a result, the proposed regulations treat a foreign transferor as having two separate limits on the amount of its effectively connected gain or loss:

- A limit determined by the amount of capital gain or loss recognized on the transfer of the partnership interest under section 741 ("outside capital gain" or "outside capital loss")

- A limit determined by the amount of ordinary gain or loss recognized on the transfer of the partnership interest under section 751 ("outside ordinary gain" or "outside ordinary loss")

*Non-separately stated taxable income or loss*

Section 864(c)(8)(B) provides that a transferor partner's distributive share of gain or loss on the deemed sale is determined in the same manner as the transferor partner's distributive share of the "non-separately stated taxable income or loss of the partnership."

As noted in the preamble of the proposed regulations, the term "non-separately stated taxable income or loss of the partnership" is not defined in the Code or regulations. The proposed regulations provide that a partner's distributive share of any items of deemed sale effectively connected gain or deemed sale effectively connected loss is determined under all applicable Code sections (including section 704), taking into account allocations of tax items applying the principles of section 704(c), including any remedial allocations under Reg. section 1.704-3(d) and any section 743 basis adjustment pursuant to Reg. section 1.743-1(j)(3).

The IRS and Treasury have proposed this approach because, according to the preamble, applying section 704 more closely ties the results of the deemed sale to the economic results of an actual sale, as compared (for example) to an approach that did not consider special allocations or considered only a partner's share of ordinary business income, which would distort the economic agreement among the partners.

The IRS and Treasury are considering whether section 704 and the regulations thereunder adequately prevent the avoidance of the purposes of section 864(c)(8) through allocations of effectively connected gain or loss to specific partners and whether additional guidance is necessary to prevent abuse. Comments were requested.

**Source of gain or loss**

Neither section 864(c)(8) nor the proposed regulations addresses the source of gain or loss from the transfer of a partnership interest. The proposed regulations, however, provide that gain or loss recognized on the transfer of an interest in a partnership that is engaged in a trade or business within the United States may be treated as effectively connected gain or loss even if it is from sources without the United States. Treasury and the IRS have requested comments as to whether, and what, additional guidance is necessary regarding the source of gain or loss subject to section 864(c)(8).

**KPMG observation**: By directly characterizing gain on the sale of a partnership interest as ECI, section 864(c)(8) bypasses the mechanism of attributing the sale to an office or fixed place of business of the partnership (as the IRS argued in Rev. Rul. 91-32) which would result in U.S. sourcing by virtue of section 865(e)(3). This leads to the somewhat anomalous possibility of "foreign source ECI." The significance of this relates primarily to the possibility of claiming foreign tax credits against the U.S. tax liability in the event that the gain is also subject to a foreign tax.

**Nonrecognition transactions**

The proposed regulations provide that the gain or loss on the transfer of a partnership interest that is subject to tax as effectively connected gain or loss is limited to gain or loss otherwise recognized under the Code. When a nonrecognition provision results in a foreign transferor recognizing only a portion of its gain or loss on the transfer of an interest in a partnership, section 864(c)(8) may apply with respect to the portion of the gain or loss recognized.

The preamble notes that, while section 864(c)(8)(E) authorizes regulations or other guidance with respect to the application of section 864(c)(8) to nonrecognition transactions, the proposed regulations do not contain special rules applicable to nonrecognition transactions. According to the preamble, Treasury and the IRS recognize that certain nonrecognition transactions may have the effect of reducing gain or loss that would be taken into account for U.S. federal income tax purposes—for example, if a partnership that conducts a trade or business within the United States owns property not subject to tax under section 871(b) or 882(a) in the hands of a foreign partner, the partnership may distribute that property to the foreign partner rather than a U.S. partner. Comments are requested regarding whether other Code provisions adequately address transactions that rely on section 731 distributions to reduce the scope of assets subject to U.S. federal income taxation, and Treasury and the IRS may propose rules addressing these types of transactions.

**KPMG observation:** The request for comments suggests that Treasury and the IRS may be considering something like a section 751(b) exchange approach to policing disproportionate distributions of ECI-generating property. As with section 751(b) itself, tax professionals expect such an approach, if applied broadly, would entail significant complexity. While Treasury and the IRS's concern is understood, a more general principal purpose anti-abuse rule might be a more appropriate balance between their concern and administrative complexity.

**Coordination with section 897**

In the proposed regulations, the limitation on effectively connected gain or loss in section 864(c)(8)(B) is based on a deemed sale by the partnership of all of its assets—including all United States real property interests held by the partnership—which are treated as effectively connected assets under section 897. To coordinate the taxation of United States real property interests under sections 897(g) and 864(c)(8), the proposed regulations provide that when a partnership holds United States real property interests and is also subject to section 864(c)(8) because it is engaged in the conduct of a trade or business within the United States (without regard to section 897), the amount of the foreign transferor's effectively connected gain or loss will be determined under section 864(c)(8)—and not under section 897(g). Therefore, the reduction called for by section 864(c)(8)(C) is not necessary.

### Tiered partnerships

The proposed regulations clarify that when a foreign transferor is a partner in an upper-tier partnership, and the upper-tier partnership transfers an interest in a lower-tier partnership that is engaged in the conduct of a trade or business within the United States, the upper-tier partnership must determine its effectively connected gain or loss by applying the principles of the proposed regulations.

### Treaties

The proposed regulations state that for purposes of applying any U.S. income tax treaty, the transfer of an interest in a partnership that has a permanent establishment in the United States will be treated in the same manner as a sale of property forming part of a permanent establishment or a sale of the permanent establishment itself. Rules are provided that generally equate the gain attributable to the permanent establishment with effectively connected gain as otherwise computed under the regulations (but adjusted to reflect items which might be effectively connected income but yet exempt under the treaty).

**KPMG observation**: Neither section 864(c)(8) nor the accompanying legislative history speaks to the application of U.S. income tax treaties to sales of partnership interests. The position taken by the proposed regulations is generally consistent both with Rev. Rul. 91-32 and with language included in the Technical Explanation to a number of U.S. income tax treaties negotiated after the revenue ruling was issued.

### Anti-stuffing rule

The proposed regulations include an anti-stuffing rule applicable to both these proposed regulations and section 897. This is intended to prevent inappropriate reductions in amounts characterized as effectively connected with the conduct of a trade or business within the United States under section 864(c)(8) or section 897.

### Withholding provisions under section 1446

The preamble notes that there is no guidance concerning withholding measures in the proposed regulations, and that the IRS and Treasury intend to issue guidance under section 1446(f) “expeditiously.”

### Applicability dates

The proposed regulations apply to transfers occurring on or after November 27, 2017, the effective date of section 864(c)(8). If any provision is finalized after June 22, 2019, the Treasury and IRS expect that such provision will apply only to transfers occurring on or after the date when the regulations are filed with the Federal Register.

## Transfers of non-publicly traded partnership interests, withholding on transfer: Notice 2018-29 and IR-2018-81

On April 2, 2018, the IRS issued **Notice 2018-29** [PDF 188 KB] (22 pages), providing interim guidance regarding withholding of U.S. tax related to transfers of interests in non-publicly traded partnerships under section 1446(f).

As the IRS explained in a related release—**IR-2018-81**—the new law treats a foreign taxpayer's gain or loss on the sale or exchange of a partnership interest as effectively connected with the conduct of a trade or business in the United States to the extent that gain or loss would be treated as effectively connected with the conduct of a trade or business in the United States if the partnership sold all of its assets. In these situations, the new law also imposes a withholding tax on the disposition of a partnership interest by a foreign taxpayer.

### Overview

Very generally, Notice 2018-29:

- States that Treasury and the IRS intend to issue regulations regarding the disposition of an interest in a non-publicly traded partnership, including rules and procedures relating to qualifying for exemptions from withholding or reductions in the amount of withholding under the new provision

- Includes interim guidance to allow for the effective and orderly implementation of the new provision

- Suspends secondary partnership-level withholding requirements

- Does not affect the tax liability imposed as a result of the new law and does not affect the suspension of the application of withholding in the case of a disposition of certain publicly traded partnership interests as announced in Notice 2018-08 (discussed below)

- Requests comments on (1) the rules described in the notice and (2) what additional guidance is needed to assist taxpayers in applying section 1446(f)

- States the IRS and Treasury expect to issue additional future guidance

- Confirms that section 1446(f)(1) withholding on dispositions of non-publicly traded partnership interests is effective as of January 1, 2018, but waives penalties and interest if all forms and payments due on or before May 31, 2018, are filed with and paid over to IRS on or before May 31, 2018.

- Indicates that it does not affect a transferor's liability under section 864(c)(8), although it contains rules that modify or suspend withholding under section 1446(f).

**Reporting and paying over section 1446(f)(1) withholding**

Notice 2018-29 provides guidance on how to comply with the primary section 1446(f)(1) withholding obligations and temporarily suspends the secondary section 1446(f)(4) withholding obligation.

According to the notice, withholding agents must use FIRPTA procedures, pay over withheld amounts within 20 days of transfer, and modify FIRPTA withholding forms until forms and other guidance are issued under section 1446(f)(1).

More specifically, section 5 of the notice indicates that persons required to withhold under section 1446(f)(1) must use the FIRPTA-related rules in section 1445 and the regulations thereunder for purposes of reporting and paying over the section 1446(f)(1) tax, except as otherwise provided, including:

- Using Form 8288, U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests, and Form 8288-A, Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests. The transferee must:
    - Include the statement "Section 1446(f)(1) withholding" at the top of both the relevant Form 8288 and Form 8288-A
    - Enter the amount subject to withholding under section 1446(f)(1) on line 5b of Part I of the Form 8288 and on line 3 of Form 8288-A and enter the amount withheld on line 6 of Part I of Form 8288 and on line 2 of Form 8288-A
- Reporting and paying over withholding within 20 days of a transfer of a partnership interest

The notice indicates that, at the time it was issued, the IRS was not planning on issuing withholding certificates under section 1446(f)(3), such as those provided on Form 8288-B, *Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests.*

Notice 2018-29 generally applies to section 1446(f) withholding the general Code rules that impose liability for tax, penalties, and interest for failure to withhold and timely pay over withheld amounts. Section 5 of the notice, however, effectively waives penalties and interest if withholding is properly reported and paid over to IRS on or before May 31, 2018, stating:

The Treasury and the IRS intend to issue regulations providing that with respect to any forms that were required to be filed, or amounts that were due, under section 1446(f) on or before May 31, 2018, no penalties or interest will be asserted if these forms are filed with, and such amounts are paid over to, the IRS on or before May 31, 2018.

**Other rules**

Notice 2018-29 includes sections on the following topics:

- Definitions [section 3 of notice]

- Rules of general applicability [section 4 of notice] including when a transferor must have a U.S. taxpayer identification number (TIN) and requirement that certifications be signed under penalties of perjury

- Interim guidance on reporting and paying over the amount required to be withheld under section 1446(f)(1), and generally adopting the forms and procedures relating to dispositions of U.S. real property interests under section 1445 and the regulations thereunder

- Effective date [section 5 of notice]

- Guidance on affidavits of non-foreign status by generally adopting the rules in section 1445 [section 6 of notice]

- An exemption from withholding if the transferee receives a certification from the transferor that: (1) the disposition will not result in gain [section 6.02 of notice]; or (2) less than 25% of the transferor's effectively connected taxable income from the partnership for each of the prior three years was less than 25% of the transferor's total income from the partnership (this does not require a partnership level computation under section 864(c)(8) or other determination) [section 6.03 of notice]; or (3) the transferor obtained from the partnership a record certifying that the partnership's effectively connected gain under section 864(c)(8) would be less than 25% of the total gain on the deemed sale of all its assets [section 6.04 of notice]

- No withholding is required in a transaction in which no gain is recognized, pending future guidance on nonrecognition transactions (including coordination with rules under section 897) [section 6.05 of notice]

- In computing the amount realized and generally subject to 10% withholding under section 1446(f)(1), a transferee may generally rely on: (1) a transferor's most recently issued Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.,* [section 7.02 of Notice 2018-29] or (2) a certification from the partnership providing the transferor's share of partnership liabilities [section 7.03 of notice]

- The total amount required to be withheld generally is limited to the total amount of cash and property to be transferred, although this limitation may cease to apply after future guidance is provided [section 8 of notice]

- Section 1446(f) withholding applies to certain partnership distributions that result in gain under section 731, but that the partnership may generally rely on its books and

records, or on a certification from the distributee partner to determine if the distribution exceeds the partner's basis [section 9 of notice]

- Guidance on the interaction of section 1446(f) and section 1445 [section 10 of notice]
- Withholding under section 1446(f)(4) will not apply until regulations or other guidance has been issued under that section [section 11 of notice]
- Future regulations will address tiered partnerships, including to clarify that section 1446(f)(1) withholding will apply to the sale of an upper tier partnership owning a lower tier partnership that would have effectively connected gain under section 864(c)(8) [section 12 of notice]
- A request for comments and IRS contact information [section 13 of notice]

### Transfers of publicly traded partnership interests, suspension of withholding: Notice 2018-08

On December 29, 2017, the IRS issued **Notice 2018-08** [PDF 20 KB], which indicates that the IRS and Treasury are suspending the application of new section 1446(f) in the case of dispositions of certain publicly traded partnership interests. The notice:

- Provides background on new sections 864(c)(8) and 1446(f)
- Describes the revised timeline for the application of new section 1446(f) to a disposition of certain interests in publicly traded partnerships
- Requests comments and provides contact information

## Short-term capital gain with respect to applicable partnership interests (carried interest)

### Future regulations to clarify treatment of partnership interests held by S corporations: Notice 2018-18

On March 1, 2018, the IRS issued **Notice 2018-18** [PDF 13 KB], which states that Treasury and the IRS intend to issue regulations providing guidance on the application of section 1061 and that the regulations will provide that the term "corporation" under section 1061(c)(4)(A) does not include an S corporation. In other words, the notice clarifies that the future regulations will provide that the term "applicable partnership interest" for purposes of the exception under section 1061 for partnership interests directly or indirectly held by a corporation does not include a partnership interest directly or indirectly held by an S corporation.

Read a related IRS release: **IR-2018-37**

**Background**

The new law added section 1061 to the Code, to address the taxation of "applicable partnership interests."

Under that provision, if one or more "applicable partnership interests" is held by a taxpayer at any time during the tax year, some portion of the taxpayer's long-term capital gain with respect to those interests may be treated as short-term capital gain. The provision requires that, to obtain long-term capital gain treatment for applicable partnership interests, the required asset-holding period must be greater than three years.

New section 1061 applies only with respect to "applicable partnership interests." To qualify as such, the partnership interest has to be transferred to, or held by, the taxpayer in connection with the performance of substantial services by the taxpayer (or a related person) in any "applicable trade or business."

Two exceptions may apply to exclude treatment of certain partnership interests as applicable partnership interests. Specifically, under:

- Section 1061(c)(4)(A), an applicable partnership interest does not include a partnership interest held by a corporation.

- Section 1061(c)(4)(B), an applicable partnership interest does not include a capital interest that provides the partner with a right to share in partnership capital commensurate with: (1) the amount of capital contributed (determined at the time of receipt of the partnership interest); or (2) the value of the interest included in income under section 83 upon receipt or vesting.

New section 1061 provides authority for the issuance of regulations or other guidance as necessary to carry out the purposes of the provision.

Read a more detailed discussion of section 1061 in a January 2018 KPMG report: ***New tax law: Issues for partnerships, S corporations, and their owners*** [PDF 528 KB].

**Notice 2018-18**

The notice states that the forthcoming regulations will clarify that the term "corporation" in section 1061(c)(4)(A) does not include an S corporation.

The notice indicates that the regulations would be effective for tax years beginning after December 31, 2017 (i.e., the effective date for section 1061).

## Provisions relating to "eligible terminated S corporations": Rev. Proc. 2018-44

On August 22, 2018, the IRS released **Rev. Proc. 2018-44** [PDF 23 KB] regarding "eligible terminated S corporations" that, because an S corporation election is terminated or revoked, realize a positive or negative adjustment on changing from the overall cash method of accounting to the overall accrual method.

The revenue procedure provides guidance for implementing section 481(d) as added to the Code by the new law. It also modifies the "list of automatic changes" as provided by Rev. Proc. 2018-31. (See discussion of Rev. Proc. 2018-31 in **Accounting Methods and Periods section** of this supplement.)

### Background

New section 481(d) relates to accounting method changes required as a result of an S corporation's conversion to C corporation status. Under this provision, in the event of an eligible terminated S corporation, any section 481(a) adjustment arising from an accounting method change attributable to the corporation's revocation of its S corporation election is to be taken into account ratably during the six-year period (tax years) beginning with the year of the method change (as opposed to the normal four-year spread for positive adjustments, and one-year pick up for negative adjustments).

### Rev. Proc. 2018-44

Rev. Proc. 2018-44 provides rules relating to adjustments that are attributable to certain revocations of S corporation elections. It also modifies Rev. Proc. 2018-31—which provides guidance on the automatic consent of the Commissioner to a change in method of accounting for certain taxpayers that want to change their overall method of accounting from the cash method to an accrual method, including taxpayers required to make this change under section 448.

Rev. Proc. 2018-44 provides that an "eligible terminated S corporation" required to change from the cash method to an accrual method as a result of a revocation of its S corporation election and that makes this change in method of accounting under a provision of Rev. Proc. 2018-31 for the first tax year that it is a C corporation, must take the resulting positive or negative adjustment required by section 481(a)(2) into account ratably during the six-year period beginning with the year of change.

Rev. Proc. 2018-44 also allows an eligible terminated S corporation that is permitted to continue to use the cash method after the revocation of its S corporation election and that changes to an accrual method pursuant to Rev. Proc. 2018-31 for the first tax year that it is a C corporation to optionally take the resulting positive or negative adjustment required by section 481(a)(2) into account ratably during the six-year period beginning with the year of change.

The guidance applies to adjustments under section 481(a)(2) that result from an eligible terminated S corporation's change to an overall accrual method of accounting in the C corporation's first tax year after the revocation of the S corporation election when the revocation occurs during the first two-year period beginning on December 22, 2017 (the date of enactment of the new law).

In addition to the change to an accrual method (as described by Rev. Proc. 2018-31), an eligible terminated S corporation may have other changes in method of accounting that result in adjustments required by section 481(a) that are attributable to its revocation of its S corporation election. Rev. Proc. 2018-44 states that: "Any such change is not within the scope of this revenue procedure."

## KPMG reports

### The new law and publicly traded partnerships

Read a June 2018 report prepared by KPMG, ***Tax Reform and Publicly Traded Partnerships*** [PDF 167 KB]. This report considers certain changes that affect natural resource publicly traded partnerships, discusses issues surrounding implementation of the new rules for these partnerships, and identifies issues for which further guidance may be necessary.

# International

The new law made fundamental changes to the taxation of multinational entities. In general, the new law shifts the United States from a system of worldwide taxation with deferral to a participation exemption regime with current taxation of certain foreign income. To accomplish this, the new law includes several features, including:

- A 100% deduction for dividends received from 10%-owned foreign corporations
- A minimum tax on "global intangible low-taxed income" (GILTI)
- As a transition to the new regime, deemed repatriation of previously untaxed "old earnings." A 15.5% rate applies to earnings attributable to liquid assets and an 8% rate applies to earnings attributable to illiquid assets

Furthermore, the new law includes significant additional anti-base erosion measures, including a base erosion anti-abuse tax (BEAT). The BEAT generally applies to certain payments paid or accrued in tax years beginning after December 31, 2017.

The new law includes several other provisions targeted at cross-border transactions, including revised treatment of hybrids, a new special deduction for certain foreign-derived intangible income, and rules for outbound transfers of intangibles.

## Application of section 956 given participation exemption system

### Proposed regulations

On November 1, 2018, the Treasury and IRS released for publication in the Federal Register **proposed regulations** [PDF 206 KB] concerning the amount determined under section 956 for corporate United States shareholders. The proposed regulations were published in the Federal Register on November 5, 2018. Comments and requests for a public hearing were due by December 5, 2018.[6]

The proposed regulations are intended to provide that the application of section 956 is consistent with the new participation exemption system.

Following are some initial impressions and observations about the proposed regulations drawn from a KPMG report dated November 4, 2018.

**Why did Treasury and the IRS issue these proposed regulations?**

For distributions made after December 31, 2017, a domestic corporate shareholder that is a 10% owner of a foreign corporation—including a controlled foreign corporation (CFC)—is generally eligible for a 100% deduction with respect to the foreign-source portion of a dividend received from the foreign corporation (a "section 245A dividend").

Nevertheless, a repatriation of undistributed foreign earnings through a deemed section 956 inclusion is generally subject to a different tax treatment than a "section 245A dividend." This is despite the fact that the historical justification for section 956 generally was to treat investments in U.S. property by a CFC in the same manner as a distribution by the CFC. Thus, with the new law, although "section 245A dividends" are fully deductible, a section 956 inclusion (e.g., a loan from a CFC or other investment in U.S. property by the CFC) would still be fully taxable to its U.S. shareholder (subject to a deemed foreign tax credit for the taxes properly attributable to that income).

Taxpayers may frequently be indifferent to actual distributions and investments in U.S. property because the new "global intangible low-taxed income" (GILTI) regime and the existing subpart F rules require a large portion of most CFC earnings to be currently included in a U.S. shareholder's income and thus create lots of previously taxed income, and distributions and investments in U.S. property are both shielded by previously taxed income (PTI)—in which case the tax treatments will converge and only require a

6 Previously, on October 31, 2018, the Treasury and IRS had released a version of these proposed regulations, and with that release, noted that the proposed regulations had been submitted to the Federal Register for publication; that such publication was pending; and that the version of the proposed regulations released on October 31 "… may vary slightly from the published document if minor editorial changes are made during the [Federal Register] review process. The document published in the Federal Register will be the official document."

shareholder to take untaxed earnings into account after PTI is exhausted. Nevertheless, if a CFC earns significant income other than subpart F/GILTI income (e.g., subpart F income subject to the high-tax election), the CFC will have untaxed earnings. In that case, the different tax treatments, described above, of a "section 245A dividend" and section 956 inclusion could provide both a planning opportunity and a trap for the unwary.

For example, as a planning opportunity (and without regard to the proposed regulations discussed below), it would be possible for a CFC that had suffered foreign tax at a rate higher than the U.S. rate of 21% to choose to loan untaxed earnings to its U.S. shareholder, trigger a section 956 inclusion, and obtain the benefits of excess foreign tax credits attributable to that income, rather than to distribute the earnings in a "section 245A dividend"—in which case, the 100% dividends received deduction would be available, but foreign tax credits attributable to the earnings would be disallowed.

Conversely, as a trap for the unwary, a section 956 inclusion of low-taxed earnings would generally cause the CFC's undistributed earnings to be subject to residual taxation in the United States, even though a dividend distribution might have been eligible for a full deduction under section 245A.

To address these discontinuities, Treasury and the IRS issued these new section 956 proposed regulations to better harmonize the treatment of actual (section 245A) and deemed (section 956) dividend distributions.

**What do the proposed regulations generally do?**

For tax years of CFCs beginning on or after the date the regulations are finalized (i.e., if finalized in 2018, the regulations will be effective for calendar year taxpayers beginning on January 1, 2019), the section 956 regulations are modified to reduce the amount of the deemed inclusion that a U.S. shareholder would otherwise take into account ("the tentative section 956 amount") by the amount of the section 245A deduction that the shareholder would otherwise be allowed if the shareholder had received a distribution from the CFC in an amount equal to the "tentative Section 956 amount" (the hypothetical distribution).

A taxpayer can elect to apply the proposed regulations for tax years of CFCs beginning after December 31, 2017, provided that the taxpayer and persons related to the taxpayer consistently apply the proposed regulations with respect to all CFCs in which they are U.S. shareholders.

For example, assume a first-tier CFC loans $120 to its U.S. shareholder, and thus the "tentative section 956 amount" is $120. The amount of the section 956 deemed inclusion relating to this $120 is reduced to the extent of the "section 245A deduction" that would have arisen if the CFC had instead made a $120 dividend distribution to the U.S. shareholder.

The rules also apply for lower-tier CFCs, by treating the CFC as if it were directly owned by the U.S. shareholder and the CFC made a hypothetical distribution to the U.S. shareholder (through each entity by reason of which the U.S. shareholder indirectly owns the shares and pro rata with respect to the equity that gives rise to the indirect ownership) equal to the "tentative section 956 amount." Thus, section 956 / section 245A parity is generally restored because the U.S. shareholder can no longer get better (or worse) treatment by making a section 956 investment.

**Implications of the proposed regulations**

- Under the proposed regulations, section 956 will become irrelevant to many corporate U.S. shareholders of CFCs either because the section 956 inclusion is sourced to previously taxed income (and thus, the section 956 inclusion is a distribution out of PTI) or because the hypothetical distribution is fully eligible for a section 245A deduction (and thus the "tentative section 956 amount" is reduced to zero). Individuals are not eligible for the section 245A deduction, so section 956 will be more relevant to individual U.S shareholders of CFCs (because the hypothetical distribution would not reduce their "tentative section 956 amount").

- The proposed regulations might facilitate merger and acquisition (M&A) transactions by making it somewhat less pressing to unwind U.S. "sandwich structures" and otherwise tailor collateral packages to avoid section 956 inclusions (by pledging less than 66⅔ % of the stock of a CFC as collateral for the obligation of a U.S. shareholder). It will be interesting to see whether lenders start requesting 100% of the shares of a CFC as collateral for these debts. Taxpayers with hybrid debt issued by their CFCs should be wary of making such a pledge, as described below.

- Section 956 inclusions will still arise, even for corporate U.S. shareholders, if the hypothetical distribution of foreign earnings would give rise to a hybrid dividend—a dividend amount for which the CFC received a deduction or other tax benefit with respect to a foreign income tax—in which case, a section 245A deduction would not be available (and thus the hypothetical distribution would not reduce the tentative tax amount). Thus, taxpayers with "PECs" or other hybrid instruments in their structure will need to continue to monitor for section 956 investments if they want to avoid a taxable inclusion of any untaxed foreign earnings of those CFCs. The section 245A deduction also might not be available if the holding period for the CFC stock is not met or the CFC's earnings are attributable to effectively connected income or dividends distributions from a U.S. subsidiary.

- At the time the KPMG report was issued, it was not clear whether a foreign tax credit would be available for the taxes attributable to a section 956 inclusion that results because the hypothetical distribution would be a hybrid dividend that would fail to qualify under section 245A. Future guidance from the IRS with respect to foreign tax credits hopefully would clarify this question.

## Mandatory repatriation ("transition tax")

### Final regulations

On December 6, 2018, OMB's Office of Information and Regulatory Affairs (OIRA) acknowledged receipt of final regulations from the Treasury as guidance concerning the "transition tax" measures under section 965 as enacted by the new law.

### Proposed regulations

The Treasury and IRS on August 9, 2018, published **proposed regulations** [PDF 453 KB] (REG-104226-18) relating to the transition tax under section 965. Comments on the proposed regulations were due October 9, 2018.

The proposed regulations are generally consistent with prior guidance issued by the Treasury and IRS notices (**discussed below**). The proposed regulations answer several open technical and structural questions, but also raise others. The following discussion is drawn from a KPMG report issued on August 10, 2018, and examines the framework of the proposed regulations and the significant issues answered and raised therein.

**Answers to questions**

*Proposed regulations*

There had been speculation that Treasury would follow the prior IRS notices with temporary and proposed regulations with immediate legal effect, or at least would issue proposed regulations that affirmatively allowed for taxpayer reliance. As is, the proposed regulations only allow reliance for the payment and election rules contained in Prop. Reg. section 1.965-7. Otherwise, the proposed regulations do not constitute law and have only limited binding effect.

*Section 965(b) PTI*

Treasury helpfully settled on the term "section 965(b) PTI" for the previously taxed earnings (PTI) generated by the allocation of "specified foreign corporation" (SFC) deficits (specified E&P deficits) to SFCs with a section 965(a) earnings amount.[7]

The proposed regulations also cleared up questions on the tax treatment of distributions of this PTI. Taxpayers are allowed a foreign tax credit for withholding taxes imposed on section 965(b) PTI as it is distributed up a section 958(a) chain of ownership. Those

[7] See Prop. Reg. section 1.965-2(e), (f). The corporations with such deficits are E&P deficit foreign corporations (EPDFCs) and the SFCs with positive earnings are deferred foreign income corporations (DFICs). See section 965(b)(3)(B) (defining an EPDFC) and section 965(d)(1) (defining a DFIC).

foreign tax credits are subject to the “applicable percentage” haircut determined under section 965(g)(2). But no credit is allowed for the SFC’s foreign income taxes that are otherwise attributable to such PTI. In addition, section 965(b) PTI is not subject to gain or loss recognition under section 986(c).

*Basis adjustments*

The proposed regulations address the basis consequences of section 965(a) inclusion amounts, as well as those arising from section 965(b) PTI. Prop. Reg. section 1.965-2(d). With respect to section 965(a) inclusion amounts, the proposed regulations effectively provide an expanded section 961(a) approach. Consistent with section 961(a), the basis adjustments apply to the basis in SFC stock or interests in passthrough entities that are directly held by the section 958(a) “United States shareholder” (USSH). In addition, if a first-tier passthrough entity owns SFC stock or interests in other passthrough entities that ultimately own SFC stock, the basis in any intermediary passthrough entities and the SFC stock owned by any first-tier or intermediary passthrough entity is also adjusted.

Nevertheless, the proposed regulations do not provide any adjustments for SFC stock owned directly or indirectly by another foreign corporation. It is unclear whether and to what extent this silence is saying something about how section 961(c) does (to the extent section 961(c) is self-executing) or could apply to lower-tier SFC inclusions. The preamble to the proposed regulations gives no indication. At the very least and as discussed below, presumably lower-tier adjustments will be addressed in future guidance.

With regard to section 965(b) PTI, there was some concern under the statute that section 965(b) PTI was not accompanied by a section 961 basis adjustment. If so, distributions of such PTI would eventually result in gain recognition, potentially at multiple levels in an SFC chain, in an amount equal to the section 965(b) PTI.

The proposed regulations allow a USSH to elect to make basis adjustments to the stock of both the EPDFC and any DFIC whose accumulated post-1986 deferred foreign income is reduced by the specified earnings and profits (E&P) deficit of such EPDFC. Prop. Reg. 1.965-2(f)(2). These adjustments follow the same modified section 961(a) approach, discussed above and, therefore, do not contemplate adjustments for any SFC stock owned directly or indirectly by other corporations. The basis adjustment election must be consistently made by all USSHs that are related under section 267(b) or section 707(b).

Making such an election prevents a DFIC from having the eventual gain recognition that would arise upon the distribution of the section 965(b) PTI. It also allows a USSH to take advantage of the gain reduction rule otherwise applicable to section 965(a) PTI, with respect to inclusion-year distributions of section 965(b) PTI. Nevertheless, such election reduces the basis of any EPDFC by the amount of the section 965(b) PTI, and to the extent the EPDFC does not have adequate basis, results in gain recognition. Therefore, the decision to make the basis adjustment election, keeping in mind the consistency requirement, will often require a careful weighing of the benefits and burdens.

For more on the basis adjustment, including the timing of the basis election, see **discussion of Notice 2018-78**, which was issued on October 1, 2018 (after the issuance of the proposed regulations).

*No section 965(h) cliff*

Under the statute and the IRS notices, there was concern that the failure to correctly determine the "net tax liability" under section 965(h)(6) would effectively render the section 965(h) installment election void, creating potential interest and penalty exposure. The proposed regulations helpfully provide that understatements of net tax liability can be corrected and added to future installments, provided the understatement is not attributable to negligence, intentional disregard of the statute or regulations, or fraud. Prop. Reg. section 1.965-7(b)(1)(ii)(C).

This standard raises the question of whether a taxpayer that disregards the proposed regulations in filing its return that is due prior to the finalization of such regulations will be considered to have been negligent or to have retroactively intentionally disregarded the regulations.

In addition, such standard will likely prompt taxpayers to be deliberate in documenting their processes and positions with respect to their section 965 liability.

*Compliance burdens*

The statute, IRS notices (discussed below), and the proposed regulations allow taxpayers a number of choices on how section 965 applies to them. The disclosures required under the proposed regulations to explain the taxpayer's positions are a cost of such choices. The proposed regulations provide for the following elections and affirmative taxpayer statements:

- Election to make the section 961(a) basis adjustment for DFIC stock by the amount of section 965(b) PTI (which has the corollary effect of reducing the basis of EPDFCs)

- Election to calculate November 2, 2017 post-1986 earnings and profits (for non-52-53 week taxpayers) and November 2, 2017 and December 31, 2017 post-1986 earnings and profits (for 52-53 week taxpayers) under the alternative method for calculating earnings and profits by effectively "closing the books" at a relevant month-end and pro-rating to the measurement date

- Statement rebutting the application of a presumption with respect to the anti-avoidance rules in Prop. Reg. section 1.965-4

- Statement explaining the exclusion of cash amounts giving rise to double counting

- Reporting the use of specified deficits if the section 965(a) USSH's pro rata share of specified E&P deficits exceeds its aggregate section 965(a) inclusion amount, and

- Electing under sections 965(h) (eight-year installment treatment), 965(i) (S corporations), 965(j) (REITs), and 965(n) (segregating NOLs and current year losses)

These elections and statements are due by the due date for the taxpayer's tax return (including extensions). In certain cases, limited transition relief is granted if the relevant tax returns are filed before the finalization of the proposed regulations. In each situation, however, the proposed regulations provide that relief under Reg. section 301.9100-2 or Reg. section 301.9100-3 (i.e., "9100 relief") is not available for late elections.

*Form 5471 filing*

Outside of section 965, Notice 2018-13 addressed the effect of the repeal of section 958(b)(4) on certain reporting requirements.

In particular, Notice 2018-13 provided that the instructions to Form 5471 would contain a filing exception if "…the foreign corporation is a CFC solely because **such** United States person is considered to own stock of the CFC owned by a foreign person under section 318(a)(3)" (emphasis added). This exception left a concern that it may not apply in situations when the foreign corporation was considered owned by multiple United States persons.

The preamble to the proposed regulations restates the commitment to change the Form 5471 instructions but replaces "such" with "a" so that the exception applies when "...the foreign corporation is a CFC or specified foreign corporation solely because **a** United States person is considered to own the stock of the CFC or other specified foreign corporation owned by a foreign person under section 318(a)(3)" (emphasis added).

This change appears intended to address the "multiple United States person owners" issue.

**Open questions (and things that might not be working right)**

*Double counting cash*

As discussed later in this supplement, Notice 2018-07 provided:

> *All members of a consolidated group that are United States shareholders will be treated as a single United States shareholder for purposes of determining the aggregate foreign cash position of the consolidated group and for purposes of taking such aggregate foreign cash position into account under section 965(c)(1).*

Notice 2018-07 further provided that:

> *[T]he Treasury Department and the IRS intend to issue regulations providing that, with respect to a United States shareholder, any receivable or payable of a specified*

> *foreign corporation from or to a related specified foreign corporation will be disregarded to the extent of the common ownership of such specified foreign corporations by the United States shareholder.*

For this purpose, "related" was determined by reference to section 954(d)(3), which determines relatedness of corporations by reference to 50% control or common control. Taken together, these provisions provided that receivables and payables held between SFCs owned by a consolidated group would be disregarded for purposes of determining a USSH's aggregate foreign cash position.

The proposed regulations do not follow Notice 2018-07 in that they do not provide "single United States shareholder" treatment for purposes of determining the aggregate foreign cash position. Rather, each USSH computes its aggregate foreign cash position; the amounts for all of the group's USSHs are aggregated; and then the cash is notionally spread to the USSHs based on the ratio of the group's cash to the section 965(a) inclusion amount. Prop. Reg. section 1.965-8(e)(3).

The preamble to the proposed regulation does not provide an explanation for this change. In addition, the proposed regulation's rule for disregarding related SFC obligations still appears to apply only to the extent of an SFC's common USSH ownership. Therefore, that rule would not appear to apply to the extent that SFCs are owned by different USSHs within a consolidated group.

*When does section 965(b) PTI arise?*

It is not clear if section 965(b) PTI arises when a specified E&P deficit entirely eliminates a DFIC's section 965(a) earnings amount. The proposed regulations provide that section 965(b) PTI arises "provided the section 958(a) U.S. shareholder includes the section 965(a) inclusion amount with respect to the deferred foreign income corporation in income." Prop. Reg. section 1.965-2(d)(1). This language suggests that no section 965(b) PTI arises if there is no section 965(a) inclusion amount by the DFIC.

Presumably the DFIC's earnings that are offset by the deficit would remain as undistributed foreign earnings potentially eligible for the 100% dividends received deduction under section 245A. Nevertheless, an example in the proposed regulations clearly concludes that a DFIC with no section 965(a) inclusion amount will have its earnings converted to section 965(b) PTI. Prop. Reg. section 1.965-2(j), *Example 5.*

In addition, section 965(b)(4)(A)'s rule creating section 965(b) PTI does not appear to be conditioned on a DFIC earnings giving rise to a section 965(a) inclusion amount. It is therefore unclear whether the operative rule's seeming requirement for a section 965(a) inclusion amount was intended.

*When does the E&P bump from deficit allocations arise?*

Section 965(b)(4)(B) provides that, to the extent a specified E&P deficit of an EPDFC is allocated to a DFIC, the earnings and profits (E&P) of the EPDFC is increased "with respect to" the EPDFC's tax year to which section 965 applies. The timing of this increase could be relevant in determining whether any deemed paid foreign tax credits (FTCs) could arise with respect to a fiscal year EPDFC, as well as the treatment of distributions from an EPDFC in the inclusion year.

The proposed regulations deny the FTC possibility by providing that the increase to E&P does not occur until the subsequent year for purposes of section 902, but do not provide any explicit rule regarding the manner when the E&P increase arises as a more general matter. This amount is also not current year E&P as defined in section 316(a)(2).

*Distributions between measurement dates*

The proposed regulations retained the anti-E&P double counting measure provided in Notice 2018-07. Prop. Reg. section 1.965-4(f).

This provision ignores certain payments between related SFCs made between the November 2, 2017 and December 31, 2017 measurement dates. As relates to distributions between related SFCs, the coordination between this rule and the proposed regulation's general rules regarding the ordering and characterization of various distributions, and the application of section 965 and the "regular" subpart F rules is unclear. See Prop. Reg. section 1.965-2(b).

In particular, the latter ordering rules say to determine the consequences of SFC-to-SFC distributions before taking into account the USSH's section 965 consequences. That would suggest that such distributions generally move non-section 965 PTI and section 959(c)(3) earnings and profits before section 965 is taken into account. The anti-double counting measure would then apply to disregard the distribution for purposes of applying section 965. This could result in the section 965 inclusion being sourced from the distributing, lower-tier SFC, while untaxed earnings (and the associated cash) are at the distributee, upper-tier SFC.

It is unclear whether any section 965 PTI would be created in this situation, and this treatment creates concerns that foreign taxes could be trapped in chains of SFCs and potentially be lost

*Dividing by zero?*

The proposed regulations provide for a "haircut" of foreign taxes paid or deemed paid when such taxes are properly attributable to a section 965(a) inclusion or a distribution of section 958(a) or (b) PTI. Prop. Reg. section 1.965-5.

The amount of the "haircut" is equal to the applicable percentage.

In cases when the USSH does not have a section 965(a) inclusion because its specified deficits exceed its pro rata share of deferred foreign income, application of the proposed regulation's definition of applicable percentage would provide a "divide by zero" result.

Because this rule is disallowing a portion of the foreign taxes that may be claimed as a foreign tax credit, the rule could be read to require no disallowance in such case. Because taxes are generally creditable upon 965(b) PTI distributions, this could mean that any taxes paid with respect to a distribution of section 965(b) PTI could be creditable. As a policy matter, this result does not appear unreasonable, notwithstanding the strangeness of the computation.

*Holding the line*

In a number of areas, the proposed regulations retained rules that had raised policy and administrability concerns.

*Computing deficits and PTI*

Treasury kept its position from Notice 2018-13 that an EPDFC's specified E&P deficit is determined taking into account all of an EPDFC's earnings and profits, including PTI. In the preamble, Treasury justified this position on a very literal distinction between the definition of post-1986 PTI and the definition of accumulated post-1986 deferred foreign income, which does specifically exclude PTI earnings and profits.

Treasury did not, however, articulate a policy justification for why the retention versus distribution of PTI earnings and profits by a CFC in pre-reform years should affect the overall determination of net untaxed earnings and profits that are subject to section 965, or whether this result was actually intended by Congress. [The formulation of these paragraphs is essentially unchanged since being introduced in the then-Ways and Means Committee Chairman's 2014 tax reform bill.]

The preamble does indicate that Treasury is "considering other rules with respect to the definitions of post-1986 earnings and profits, accumulated post-1986 deferred foreign income, and specified E&P deficit in connection with the finalization of these proposed regulations," citing the broad grant of regulatory authority in section 965(o), and requested comments thereon.

*Subpart F and post-1986 earnings and profits*

A taxpayer's post-1986 earnings and profits as of a measurement date are calculated by subtracting only the subpart F income of the SFC that accrued through such date (apparently determined by using a closing-of-the-books method). Prop. Reg. section 1.965-1(f)(7).

*Accounting methods and entity classification*

Accounting method changes and check-the-box elections may be disregarded without regard to whether the change in method or check-the-box election were made with a principal purpose of changing the amount of a section 965 element—i.e., a reduction of the USSH's section 965(a) inclusion amount or aggregate foreign cash position, or an increase in the USSH's foreign taxes deemed paid pursuant to section 960 because of a section 965(a) inclusion amount. Prop. Reg. section 1.965-4(c).

Additionally, with respect to accounting method changes, the proposed regulations provide that such change will be disregarded for section 965 purposes even if the change is from an impermissible method to a permissible one and even if the method is specifically allowed pursuant to Rev. Proc. 2015-13.

*Comments and more to come*

Given the proposed nature of the regulations, it remains to be seen the extent to which the proposed regulations are merely setting out Treasury's "opening" position, while it is still deliberating a range of options. The preamble expressly recognized certain areas where Treasury has not necessarily settled on a final position.

*Hovering deficits*

The proposed regulations helpfully provided that for purposes of section 965, hovering deficits under section 381 are treated like any other earnings and profits deficit. Prop. Reg. section 1.965-1(f)(29)(iii).

The proposed regulations did not address the treatment of foreign tax credits "trapped" within such deficits, which are otherwise currently addressed in Reg. section 1.367(b)-7. Treasury requested comments on the treatment of hovering deficits including, for example, when a hovering deficit creates a specified earnings and profits deficit.

*Basis issues*

The preamble requested comments on the extent to which further rules are needed with respect to basis adjustments, including for purposes of determining interest expense allocation under Reg. section 1.861-12T(c)(2).

*Section 904 foreign tax credit limitation*

The proposed regulations did not address the treatment of section 965 inclusions under the section 904 foreign tax credit rules. The preamble requested comments on the extent to which any section 904 guidance is needed, and, in particular, with respect to the determination of the section 904 limitation on distributions of section 965 PTI.

*Sections 959 and 961*

The proposed regulations did not address the application of section 959 to the differing varieties of PTI arising in the inclusion year. In particular, ordering rules appear necessary to determine how to account for such PTI. It appears that Treasury is working on separate section 959 guidance, perhaps working toward finalization of the 2006 proposed regulations under sections 959 and 961. See Prop. Reg. sections 1.959-1 to -4; 1.961-1 to -4.

Such guidance would presumably address inclusion-year PTI issues and the application of section 961(c) to lower-tier SFCs as a result of the application of section 965.

## Notices

### *Basis adjustment election under section 965 proposed regulations: Notice 2018-78*

On October 1, 2018, the IRS released **Notice 2018-78** [PDF 19 KB] concerning the basis election allowed with respect to the proposed regulations under section 965 (discussed above). The notice explains that the Treasury and IRS:

- Have determined that requiring taxpayers to make a binding basis election before the proposed regulations are finalized "would be too onerous for taxpayers"
- Will help alleviate this burden by modifying in the final regulations a transition rule to now allow taxpayers to make the basis election up to 90 days after the date of publication of the final regulations in the Federal Register, if the taxpayer's tax return due date was otherwise due before then
- Will provide in the final regulations that, if a basis election was made on or before the date of publication of the final regulations, the basis election may be revoked no later than 90 days after the Federal Register publication
- Will clarify in the final regulations that all members of a consolidated group that are section 958(a) U.S. shareholders of a specific foreign corporation are also treated as a single section 958(a) U.S. shareholder for purposes of Prop. Reg. section 1.965-3(b)
- Clarify the time for taxpayers affected by Hurricane Florence to make elections under section 965 and to file transfer agreements (required under the proposed regulations) that are due on or after September 7, 2018, and before January 31, 2019: these taxpayers are granted additional time—until January 31, 2019—to file the elections or transfer agreements

On October 9, 2018, the IRS released a "**notice of availability"** [PDF 128 KB] explaining that Notice 2018-78 was issued in advance of final regulations under section 965 "due to the imminent filing deadlines that could otherwise apply to the forms and elections described therein."

### *Special elections, reporting, and paying the transition tax: Notice 2018-26*

On April 2, 2018, the IRS issued **Notice 2018-26** [PDF 120 KB], addressing forthcoming guidance under the section 965 transition tax. *The discussion below is drawn from a* TaxNewsFlash *issued shortly after the issuance of the notice and has not been modified to reflect subsequent developments*.

The notice described a wide-ranging series of new rules and procedures relating to computations of certain items relevant to the transition tax, anti-abuse rules, certain special elections under or relevant to section 965, and the mechanics of how taxpayers report and pay the transition tax.

Notice 2018-26 also provided relief to taxpayers from certain estimated tax requirements and penalties arising from the enactment of the transition tax under section 965 and the change to existing stock attribution rules in the new law.

The main portion (section 3) of Notice 2018-26 announced that future regulations under section 965 would:

- Include anti-abuse rules under section 965 that would address, inter alia, transactions entered into on or after November 2, 2017, that reduce a U.S. shareholder's 965 tax liability through reduction of the shareholder's foreign cash position, reduction in the E&P subject to the transition tax, or reduction in the shareholder's "pro rata share" of the E&P subject to the transition tax (section 3(04)(a))

- Ignore for section 965 purposes the effect of any accounting method change filed on or after November 2, 2017, for an SFC's tax year ending in 2017 or 2018 that would reduce the 965 tax liability for the SFC's U.S. shareholder, even if the method change was properly made, and also ignore the effect of any "check-the-box" election filed on or after November 2, 2017, if the effect of the election is to reduce a U.S. shareholder's 965 tax liability, even if the election would have been effective for a date prior to November 2, 2017 (section 3((04)(b))

- Provide an exception to "specified foreign corporation" (SFC) status for certain foreign corporations when that status arises only because of the application of the constructive ownership rules of sections 318 and 958 to, inter alia, a partnership from a less than 5% partner therein (section 3(01) of Notice 2018-26)

- Address the inclusion of the "foreign cash positions" for SFCs that are transferred by the U.S. shareholder, or go out of existence, in between the various cash measurement dates set forth in section 965 (section 3(02))

- Allow taxpayers to take into account a share of the foreign income taxes paid or accrued by SFCs in between November 2, 2017, and December 31, 2017, (the measurement dates) in determining the earnings and profits (E&P) of the SFCs subject

to the transition tax, which appear largely limited to calendar-year taxpayers (section 3(03))

- Address procedural matters, including: (a) how taxpayers document their aggregate foreign cash position; (b) confirming that U.S. investors in U.S. shareholders that are domestic passthrough entities may make the elections under sections 965(h), (m), and (n) with respect to their share of passthrough 965 amounts, and also addressing how S corporations that are owners of other domestic passthrough entities take into account those amounts for purposes of the 965(i) election; (c) how to determine the net tax liability under section 965(h) (the eight-year installment election); (d) confirming that the section 965(n) election applies both in determining the amount of net operating loss (NOL) for the current year of the 965 inclusion as well as the absorption of NOL carrybacks or carryforwards into the 965 inclusion year; and (e) filing deadlines for certain U.S. individuals living abroad (section 3(05))

- Provide that the 965(c) deduction is not treated as an itemized deduction by individuals, including for purposes of the 2% floor under section 67 or the alternative minimum tax deduction disallowance in section 56 (section 3(06))

Substantive sections (sections 4-7) of Notice 2018-26 announced:

- A modification to the definition of “accounts payable” and “accounts receivable” that were described in Notice 2018-13 (discussed below) to exclude any receivable or payable with an initial term of one year or more

- Guidance under section 962 in connection with section 965, including that the electing individual must himself or herself be a U.S. shareholder with respect to the foreign corporation (i.e., it is not sufficient to be an investor in a domestic passthrough entity that is the U.S. shareholder) and that, consistent with the legislative history, the section 965(c) deduction will apply for purposes of deemed tax calculation arising from the section 962 election

- Guidance concerning the application of the estimated tax rules in sections 6654 and 6655 and a waiver of the penalty imposed under those sections with respect to estimated taxes in connection with section 965 and the repeal of section 958(b)(4)—in particular, the notice provided that a taxpayer's required installments of estimated tax need not include amounts attributable to its net tax liability under section 965 to prevent the imposition of estimated tax penalties

- The effective dates of the regulations and other guidance under section 965, including a clarification of an effective date previously announced in Notice 2018-13

A related IRS release—**IR-2018-53**—noted that the IRS had already released Notice 2018-7, Notice 2018-13, and Rev. Proc. 2018-17 concerning section 965, and that future additional guidance would be released “in the weeks ahead.”

### *Additional guidance about transition tax on foreign earnings: Notice 2018-13*

On January 19, 2018, the IRS issued **Notice 2018-13** [PDF 82 KB] concerning the transition tax imposed under new section 965 and reflecting the repeal of section 958(b)(4). *The discussion below is drawn from a* TaxNewsFlash *issued shortly after the issuance of the notice and does not reflect subsequent developments.*

Notice 2018-13 announced that the IRS and Treasury intend to issue regulations for determining amounts included in gross income by a United States shareholder under section 951(a)(1) by reason of new section 965.

Notice 2018-13:

- Provided background on section 965 and the repeal of section 958(b)(4)
- Described the regulations that the IRS and Treasury intend to issue with respect to section 965
- Described a modification that the IRS and Treasury intend to make with respect to regulations under section 965 that were described in Notice 2018-07
- Provided guidance under section 863 in connection with the repeal of section 958(b)(4) and announced the IRS's intention to update the instructions for Form 5471 as a result of the repeal
- Described the effective dates of the regulations and other guidance
- Requested comments

A related IRS release—**IR-2018-09**—explained the notice (in addition to describing the to-be-issued regulations) and addressed the calculation of earnings under the transition tax and other rules to clarify certain aspects of the new law.

The notice also provided taxpayers targeted relief from certain unintended regulatory and reporting consequences arising from a change to existing stock attribution rules in the recent tax legislation.

### *Transition tax on foreign earnings: Notice 2018-07*

On December 29, 2017, the IRS issued **Notice 2018-07** [PDF 151 KB] (as well as a related IRS release–**IR-2017-212**). *The discussion below is drawn from a* TaxNewsFlash *issued shortly after the issuance of the notice and does not reflect subsequent developments.*

Notice 2018-07 described regulations that the IRS and Treasury intend to issue, including rules for determining the amount of cash and cash equivalents for purposes of applying

the 15.5% rate and rules for determining the impact of intercompany transactions (including distributions) on the amount of foreign earnings subject to the transition tax.

Notice 2018-07 provided background on section 965, describes the effective dates of future regulations, and requests comments.

## Revenue procedures

### *Excise tax relief for RICs with section 965 inclusions: Rev. Proc. 2018-47*

On September 6, 2018, the IRS issued **Rev. Proc. 2018-47** [PDF 21 KB] to provide excise tax relief for certain regulated investment companies (RICs) that have inclusions under section 951(a)(1) by reason of section 965 for the excise tax year ended on December 31, 2017.

The revenue procedure applies to any amount that section 965 would (but for the revenue procedure) require a RIC to include in gross income under section 951(a)(1) for the RIC's excise tax year ended on December 31, 2017 (a "2017 inclusion").

Rev. Proc. 2018-47 states that IRS will not challenge a RIC's treatment of a 2017 inclusion if the RIC:

- Treats the 2017 inclusion in the same manner as a specified gain (within the meaning of section 4982(e)(5)(B)(i)) that (but for section 4982(e)(5)) would be properly taken into account during the portion of the RIC's 2017 excise tax year that is after October 31, and

- Treats any deduction under section 965(c) attributable to the 2017 inclusion in the same manner as a specified loss (within the meaning of section 4982(e)(5)(B)(ii)) that (but for section 4982(e)(5)) would be properly taken into account during the portion of the RIC's 2017 excise tax year that is after October 31.

### *Section 965 and specified foreign corporations changing tax years: Rev. Proc. 2018-17*

On February 13, 2018, the IRS issued **Rev. Proc. 2018-17** [PDF 24 KB], modifying the circumstances under which the IRS will grant approval of certain requests by certain foreign corporations for changes in annual accounting periods filed under Rev. Proc. 2002-39 and Rev. Proc. 2006-45.

The revenue procedure indicates that it was issued pursuant to section 965(o) to prevent the avoidance of application of section 965 by changes in the tax years of certain SFCs (within the meaning of section 965(e)). The revenue procedure applies with respect to any request by an SFC to change an annual accounting period that ends on December 31, 2017, regardless when the request was filed. For purposes of applying the revenue procedure, a 52-53-week tax year is deemed to begin on the first day of the calendar month nearest to the first day of the 52-53-week tax year, and is deemed to end or close

on the last day of the calendar month nearest to the last day of the 52-53-week tax year (as applicable).

Rev. Proc. 2018-17 explains that an SFC with a tax year ending on December 31, 2017, could avoid the purposes of section 965 by changing its tax year and provides an example. Under the example, if a deferred foreign income corporation (DFIC) with the calendar year as its tax year elected, effective for its tax year beginning January 1, 2017, a tax year closing on November 30, the election could defer by as much as 11 months a U.S. shareholder's inclusion with respect to the DFIC under section 965. Further, the election could, depending on the facts, reduce the amount of the tax liability of a U.S. shareholder of the DFIC by reason of section 965, including through the reduction of the post-1986 earnings and profits of the DFIC.

This revenue procedure is also summarized in the **Accounting Methods and Periods section** of this supplement. Read February 2018 *TaxNewsFlash,* ***Effects of prohibited tax year changes for "specified foreign corporations"*** for more details and observations regarding Rev. Proc. 2018-17.

## Other administrative guidance and forms

### *Draft forms*

The IRS has posted draft forms, instructions, and schedules that, if finalized, would be used to report information about the transition tax. The drafts include cautionary language that they are not to be used for filing purposes and are subject to change and to OMB approval before being officially released.

The first two forms below have a "watermark" date of August 30, 2018, while the others have a watermark date of September 5, 2018:

- **Form 965** [PDF 108 KB] Inclusion of Deferred Foreign Income Upon Transition to Participation Exemption System
- **Schedule H (Form 965)** [PDF 97 KB] *Amounts Reported on Forms 1116 and 1118 and Disallowed Foreign Taxes.*
- **Form 965 (Schedule A)** [PDF 100 KB] *U.S. Shareholder's Section 965(a) Inclusion Amount*
- **Form 965 (Schedule B)** [PDF 110 KB] *Deferred Foreign Income Corporation's Earnings and Profits (E&P)*
- **Form 965 (Schedule C)** [PDF 90 KB] *U.S. Shareholder's Aggregate Foreign Earnings and Profits Deficit (E&P)*

- **Form 965 (Schedule D)** [PDF 94 KB] *U.S. Shareholder's Aggregate Foreign Cash Position*

- **Form 965 (Schedule E)** [PDF 98 KB] *U.S. Shareholder's Aggregate Foreign Cash Position – Detail*

- **Form 965 (Schedule F)** [PDF 107 KB] Foreign Taxes Deemed Paid by Domestic Corporation for tax years of foreign corporations whose last taxable year, beginning before January 1, 2018, ends during the U.S. shareholder's 2018 tax year

- **Form 965 (Schedule G)** [PDF 107 KB] Foreign Taxes Deemed Paid by Domestic Corporation for tax years of foreign corporations whose last taxable year, beginning before January 1, 2018, ends during the U.S. shareholder's 2017 tax year.

In addition, in December 2018, the IRS released the following forms and instructions:

- **Draft version of the instructions** [PDF 231 KB] for Form 965, *Inclusion of Deferred Foreign Income Upon Transition to Participation Exemption System* (watermark date of December 11, 2018)

- **Draft instructions** [PDF 192 KB] for Form 965-A, *Individual Report of Net 965 Tax Liability* (watermark date of December 17, 2018)

- **Draft instructions** [PDF 180 KB] for Form 965-B, *Corporate and Real Estate Investment Trust (REIT) Report of Net 965 Tax Liability and Electing REIT Report of 965 Amounts* (watermark date of December 17, 2018)

*Return filing and tax payment obligations: IRS FAQs for 2018 Returns*

On December 12, 2018, the IRS posted a set of questions and answers (referred to as "FAQs") concerning issues relating to section 965 filing and reporting requirements for 2018 tax returns.

These **FAQs** (*Questions and Answers about Tax Year 2018 Reporting and Payments Arising under Section 965*, posted December 12, 2018) provide answers to questions related to tax year 2018 return filing and payment obligations arising under section 965—including reporting and payment obligations resulting from amounts included in income for the 2017 tax year. The IRS explained that a prior version of FAQs provide answers to questions regarding tax year 2017 return filing and payment obligations arising under section 965.

**Background**

The IRS in March 2018 originally released FAQs to be used by taxpayers in filing 2017 tax returns that report amounts under section 965 and paying the tax required by section 965.

Subsequently, the IRS updated the FAQs about reporting related to section 965 on 2017 tax returns.

See **discussion of prior FAQs** later in this supplement.

**Overview of FAQs**

Among the FAQs in the December 2018 release are items addressing the following issues:

- When a section 965(h) election was made on a 2017 tax return—with the taxpayer electing to pay the section 965(h) net tax liability portion of the 2017 income tax liability in eight annual installments—how was the section 965(h) net tax liability portion of the 2017 income tax liability assessed and how does the taxpayer make the second installment payment?

- When a section 965(h) election is made on the 2018 tax return—with the taxpayer electing to pay the section 965(h) net tax liability portion of the 2018 income tax liability in eight annual installments—how is the section 965(h) net tax liability portion of the 2018 income tax liability assessed and how does the taxpayer make the first installment payment?

- When a section 965(h) election was made for the 2017 tax year and there is an unsatisfied but properly deferred payment obligation for the 2017 section 965(h) net tax liability, and if the 2018 income tax payments (including estimated tax payments) exceed the 2018 tax year income tax liability and the taxpayer has fully paid all of the 2017 section 965(h) net tax liability annual installment payment obligations that are due, can the taxpayer receive a refund of (or a credit to the 2019 tax year) of the amount of the 2018 income tax overpayment?

- When a section 965(h) election is made on the 2018 tax return and if the 2018 payments, including estimated tax payments, exceed the 2018 net income tax liability (as described under section 965(h)(6)(A)(ii) (net income tax determined without regard to section 965)) and the first annual installment (due in 2019) is pursuant to an election under section 965(h), can the taxpayer receive a refund of the excess amounts or a credit of the excess amounts to the 2019 estimated income tax?

- When a section 965(h) election is made on the 2018 tax return, how will the IRS apply the 2018 estimated tax payments (including amounts elected to be applied as a credit against estimated tax from the 2017 tax year) to the 2018 net tax liability under section 965?

- When the taxpayer reported income under section 965 on either the 2017 or 2018 tax returns (or both), what forms must be completed and attached to the 2018 income tax return?

The IRS has provided three examples illustrating the principles of these FAQs.

**Observations**

In a December 12, 2018 *TaxNewsFlash*, it was observed that:

- The IRS timely issued these FAQs on issues related to the payment and reporting of obligations arising under section 965 for the 2018 tax year, thereby affording taxpayers sufficient time to consider the implications of section 965 with respect to payments, including estimated tax payments, for their 2018 tax year.

- These FAQs include clarifications and updates to the procedures for making tax year 2017 section 965(h) installment payments due in 2018, and for making tax year 2018 section 965(h) net tax liability payments (either in installments or in full).

- Taxpayers will want to take these FAQs and their effects into account when reviewing and calculating tax year 2018 and 2019 estimated tax payments.

- Taxpayers with a section 965 inclusion will also want to determine that first quarter 2019 tax payments are made separately, specifically dedicated to tax year 2019.

- Payments for first quarter 2019 included with 2018 estimated tax payments or paid with a Form 7004, *Application for Automatic Extension of Time To File Certain Business Income Tax*, Information, and Other Returns, pursuant to the FAQs, will be applied to a taxpayer's section 965(h) future installments and not to tax year 2019 estimated tax.

**Additional KPMG initial impressions**

In a separate KPMG report also issued on December 12, 2018, the following additional initial observations were made.

First, FAQ 1 and FAQ 2 appear to be similar to those provided in the FAQs for 2017. Section 965 payments—whether for the full amount of the 2018 inclusion, the first installment payment for 2018 inclusions for which the taxpayer makes a section 965(h) election, or the second installment payment for 2017 inclusions for which the taxpayer made the section 965(h) election—are to be paid separately from "non-section 965" liabilities. Pursuant to the new FAQs, taxpayers will have additional options for the method of payment—now including EFTPS, wire transfers, or mail. Installment payments with respect to the 2018 inclusions (but not the second installment for 2017 inclusions) may also be made using electronic funds withdrawal. The IRS will issue payment vouchers six to eight weeks in advance of the due date, informing taxpayers of the amount of their second section 965 installment payment.

Next, the FAQs provide some "bad news" and some "good news."

- FAQ 4 provides what may be viewed as the "bad news." For 2018 inclusions for which the taxpayer makes the section 965(h) election to pay in installments, the IRS will follow the same approach that it followed in 2017—i.e., the IRS will apply any overpayments for 2018 to subsequent section 965 installments with respect to the 2018 inclusion, rather than to refund or credit the excess. Because taxpayers now have advance notice of the IRS's intended rules of application, taxpayers need to plan accordingly to consider limiting any unnecessary overpayments and unintended application of payments.

- FAQ 3 provides the "good news." A taxpayer that makes payments in 2018 that exceed the taxpayer's regular tax liability and its second section 965(h) installment liability for 2017, may receive a refund or credit of the excess rather than having to apply it to the third and subsequent installments (this assumes the taxpayer does not have a section 965 inclusion for the 2018 tax year).

- FAQ 5 explains how the IRS will apply 2018 payments to a 2018 inclusion for which the taxpayer made the section 965 (h) election. This treatment will follow the same approach that the IRS took for 2017 inclusions—i.e., first, to regular [non-section 965] liability, and then to the section 965 liability.

- FAQ 6 requires the filing of Form 965 with the 2018 return if the taxpayer had a section 965 inclusion in either 2017 or 2018.

*Return filing and tax payment obligations: IRS FAQs for 2017 Returns*

On March 13, 2018, the IRS released a list of "frequently asked questions" (FAQs) about return filing and tax payment obligations relating to the transition tax under new section 965. The initial list was updated on April 13, 2018, June 4, 2018, and November 6, 2018, while a "special update" relating to time for filing transfer agreements with respect to certain acceleration events was issued on October 8, 2018. Read the updated FAQs on the IRS website at: **Questions and Answers about Reporting Related to Section 965 on 2017 Tax Returns**.

See also the **discussion below** of an IRS Chief Counsel memorandum regarding FAQ 14.

**Initial list of FAQs**

The initial list of FAQs released on March 13, 2018, addressed the following questions:

- Who is required to report amounts under section 965 on a 2017 tax return?

- How are amounts under section 965 reported on a 2017 tax return?

- Is there any other reporting in connection with section 965 required on a 2017 tax return?

- What elections are available with respect to section 965 on a 2017 tax return?
- Who can make an election with respect to section 965 on a 2017 tax return?
- When must an election with respect to section 965 be made?
- How is an election with respect to section 965 made on a 2017 tax return?
- Is a Form 5471 with respect to all SFCs with respect to which a person is a United States shareholder required to be filed with the person's 2017 tax return, regardless of whether the specified foreign corporations are CFCs?
- Are domestic partnerships, S corporations, or other passthrough entities required to report any additional information to their partners, shareholders, or beneficiaries in connection with section 965?
- How should a taxpayer pay the tax resulting from section 965 for a 2017 tax return?
- If not already filed, when should an individual taxpayer electronically file a 2017 tax return?
- If a person has already filed a 2017 tax return, what should the person do?

Note that the initial list of FAQs confirmed that domestic partnerships, domestic trusts, and S corporations cannot make any section 965-related election for their investors.

The FAQs also suggest that the IRS wants corporate taxpayers with section 965 liabilities to include the net section 965 inclusion, 965(c) dividends received deduction (DRD), and associated foreign tax credits on a separate schedule, and not to report those amounts on Form 1120 or Form 1118.

The IRS further requested that taxpayers make the payments for their section 965 liabilities separate from their regular tax liabilities.

**April update to FAQs**

The updated FAQs, as posted on April 17, 2018, amended and expanded the rules related to payment of the transition tax liability, including allowing the transition tax to be paid out of an overpayment of estimated income taxes. Under the updated FAQs, taxpayers subject to section 965 mandatory repatriation would have any excess of estimated tax payments over their regular net income tax liability (determined without regard to section 965) applied to their tax liability under section 965.

FAQ 13 provides:

> *Q13. How will the IRS apply 2017 estimated tax payments (including credit elects from 2016) to a taxpayer's net tax liability under section 965?*

*A13. The IRS will apply 2017 estimated tax payments first to a taxpayer's 2017 net income tax liability described under section 965(h)(6)(A)(ii) (its net income tax determined without regard to section 965), and then to its tax liability under section 965, including those amounts that are subject to payment in installments pursuant to an election under section 965(h).*

In addition, the FAQs, as updated in April, provide that any estimated tax overpayment remaining after application of estimated taxes paid to a taxpayer's regular net income tax (determined without regard to section 965) and to the taxpayer's first annual installment (due in 2018) pursuant to an election under section 965(h) will not be refunded or credited to the taxpayer and instead will be applied to future annual installments until no overpayment remains.

FAQ 14 provides:

*Q14. If a taxpayer's 2017 payments, including estimated tax payments, exceed its 2017 net income tax liability described under section 965(h)(6)(A)(ii) (its net income tax determined without regard to section 965) and the first annual installment (due in 2018) pursuant to an election under section 965(h), may the taxpayer receive a refund of such excess amounts or credit such excess amounts to its 2018 estimated income tax?*

*A14. No. A taxpayer may not receive a refund or credit of any portion of properly applied 2017 tax payments unless and until the amount of payments exceeds the entire unpaid 2017 income tax liability, including all amounts to be paid in installments under section 965(h) in subsequent years. If a taxpayer's 2017 tax payments exceed the 2017 net income tax liability described under section 965(h)(6)(A)(ii) (net income tax determined without regard to section 965) and the first annual installment (due in 2018) pursuant to an election under section 965(h), the excess will be applied to the next successive annual installment (due in 2019) (and to the extent such excess exceeds the amount of such next successive annual installment due, then to the next such successive annual installment (due in 2020), etc.) pursuant to an election under section 965(h).*

Amendments were also made to some of the other FAQs.

- FAQ 10 was amended to reflect and refer to and to take into account new FAQs 13 and 14
- FAQ 3, regarding section 965 reporting requirements
- FAQ 5, regarding who can make a section 965 election
- FAQ 8, regarding Form 5471 filing requirements

- FAQ 9, regarding passthrough entity reporting to partners and shareholders, was edited

Note that the new procedures provided by FAQs 13 and 14 were surprising to many, primarily due to the fact that they came so close to the traditional tax payment deadline for calendar year corporations for 2017 (April 17, 2018). Until issuance of these amended FAQs late on April 13, many taxpayers had assumed that, if their 2017 estimated tax payments and credits totaled more than their regular tax liability plus the first section 965 installment, any excess payments would be refunded or available to be used as a credit elect towards 2018 estimated taxes. That assumption became inoperative based on the April update to the FAQs.

Taxpayers who planned to elect the installment option provided by section 965(h) and accounted for their first annual section 965 liability installment in their estimated taxes paid for 2017 prior to the IRS's issuance of the original FAQs issued on March 13, 2018, found themselves in a dilemma when the original FAQs were issued, requiring two separate and distinct payments of tax—one for regular tax liability and one for section 965 liability. In other words, the original FAQs implied that taxpayers were (1) precluded from applying estimated tax payments to the section 965 liability, and (2) required to make a new, separate payment with respect to their section 965 liability.

In order to comply with the instruction provided in the original FAQs, some taxpayers, taking a reasonable and conservative approach, then made a second, separate payment to the IRS representing their section 965 liability assuming that the resulting overpayment of estimated taxes could be refunded to them or credited to tax year 2018 estimated taxes. FAQ 14 effectively denies these taxpayers the ability to obtain a refund or make a credit elect, and instead provides that the estimated tax overpayment for tax year 2017 will be applied by the IRS to taxpayers' future annual section 965 installments until no 2017 overpayment remains. This can be a particularly harsh result for taxpayers, such as individual taxpayers, who may have limited options available to remediate.

In addition, FAQ 14 negatively affects some taxpayers who, before the April updated FAQs were issued, made an extension payment with their applications for extension of time to file to also cover their Q1 estimated tax payment. Pursuant to FAQ 14 as it is currently written, the only way a credit elect comes out of 2017 estimated taxes paid to 2018 estimated tax for "section 965(h) taxpayers" is if the credit is larger than the deferred section 965(h) liability. As a result, those taxpayers needed to consider whether making a new, separate payment for 2018 Q1 estimated taxes using a 2018 voucher was necessary. If 2018 Q1 estimated taxes had not yet been paid, section 965(h) taxpayers would make separate 2018 Q1 estimated tax payments using a 2018 voucher.

Further, IRS guidance provides that the second and later section 965 installments are not due until the due dates for their respective returns and do not have to be taken into account for estimated tax purposes. As a result, FAQ 14 has effectively accelerated one and possibly more of these later installment payments.

Due to FAQ 14, taxpayers who fully accounted for their first annual section 965 liability installment in their estimated taxes paid for 2017 and had not yet made this second payment would not make a second payment and instead would allow the IRS to follow the procedures outlined in new FAQs 13 and 14.

Corporate taxpayers that fully accounted for their first annual section 965 liability installment in their estimated taxes paid for 2017 and made this second payment would, if applicable and available, seek a "quick refund" of their overpayment of estimated taxes by filing Form 4466, *Corporate Application for Quick Refund of Overpayment of Estimated Tax*. Because section 6425 requires that a Form 4466 be filed by the original unextended due date of a corporation's return and before the day on which the corporation files its return, affected corporate taxpayers who intended to file their returns by the original unextended due date, in this case Tuesday, April 17, 2018, would not have filed their return until April 17, 2018, and would have filed their Form 4466 on Monday, April 16, 2018. Affected corporate taxpayers who intended to file their returns by their extended due date after April 17, 2018, would have filed their Form 4466 no later than Tuesday, April 17, 2018.

**June 4 update to FAQs**

In the June 4 update to the FAQs, the IRS added the following questions and answers:

> *Q15: If a taxpayer that has made a section 965(h) election for 2017 filed a 2017 income tax return that calculated an overpayment without including the taxpayer's total net tax liability under section 965, and the taxpayer attempted to elect to credit the calculated overpayment to its estimated tax liability for 2018, will the IRS determine an addition to tax for an underpayment of taxpayer's 2018 estimated taxes because the credit elect won't be available for the first required 2018 estimated tax installment?*
>
> *A15: No. The IRS has determined that no addition to tax for an underpayment of estimated taxes under section 6654 or 6655 will apply (nor be increased) if a taxpayer makes an estimated tax payment sufficient to satisfy both the underpayment of the first required estimated tax installment for 2018 and the full amount of the second required estimated tax installment for 2018 on or before the due date for the second installment (i.e., June 15, 2018, for calendar year taxpayers). This relief from the addition to tax for the underpayment of estimated taxes applies only to taxpayers whose first required installment for 2018 was due on or before April 18, 2018.If the IRS sends a taxpayer a notice of an addition to tax for underpayment of estimated tax under section 6654 or 6655 and the taxpayer meets all the conditions for relief described above (including making the required payment by the due date for the second installment), the taxpayer should contact the IRS office that issued the notice and request abatement of the addition to tax for underpayment of estimated taxes in accordance with the provisions in these FAQs and updated instructions to Forms 2210 and 2220.*
>
> *Q16: If an individual fails to timely pay his or her first installment of tax due under section 965(h), will the IRS assess an addition to tax for failure to pay? Will the*

*taxpayer's requirement to pay all subsequent installments be accelerated under section 965(h)(3)?*

*A16: If an individual meets the criteria in this paragraph and pays the total amount of the first installment on or before the due date for the second installment, the IRS will not assess an addition to tax for failure to timely pay the first installment and will not accelerate subsequent installments under section 965(h)(3). An individual with a net tax liability under section 965 is required to report the liability on his or her tax return for the year in which or with which the inclusion year of the deferred foreign income corporation ends and pay the full amount of that liability on the unextended due date of that return, unless the individual elects to pay the liability in eight annual installments pursuant to section 965(h)(1). However, the IRS has determined that, if an individual's net tax liability under section 965 in the individual's 2017 taxable year is less than $1 million, the individual makes a timely election under section 965(h), and the individual did not pay the full amount of the first installment by the due date under section 965(h)(2), the failure to make the payment will not result in an acceleration event under section 965(h)(3) so long as the individual pays the full amount of the first installment (and its second installment) by the due date for its 2018 return (determined without regard to extensions). For this purpose, the relevant due date generally is April 15, 2019. In the case of United States citizens or residents whose tax homes and abodes, in a real and substantial sense, are outside the United States and Puerto Rico, and United States citizens and residents in military or naval service on duty, including non-permanent or short term duty, outside the United States and Puerto Rico, the relevant due date is June 17, 2019, which is provided by Treas. Reg. sections 1.6081-5(a)(5) and (6). Although the IRS will not assess an addition to tax for failure to timely pay the first installment, a taxpayer will be liable for interest on such amount from the due date of the installment. See section 6601.*

*If the IRS sends a taxpayer a notice of an addition to tax for failure to timely pay the first installment, and the taxpayer meets all the conditions for relief described above (including making the required payment by the due date for the second installment due under section 965(h)), the taxpayer should contact the IRS office that issued the notice and request abatement of the addition to tax for failure to timely pay the first installment in accordance with the provisions in these FAQs.*

*Q17: If an individual has filed his or her 2017 tax return, but has not made the section 965(h) election, may the individual file another 2017 return on which he or she makes the election?*

*A17: Yes. If an individual with a net tax liability under section 965 in the individual's 2017 tax year has already filed his or her tax return and did not make an election under section 965(h), such individual can make the section 965(h) election by filing a Form 1040X that complies with the procedures set forth in these FAQs (including, for example, the IRC 965 Transition Tax Statement(s) described in Q&A 3 and the election statement described in Q&A 7) on or before the due date of the individual's 2017 return, taking into account any additional time that would have been granted if*

*the individual had made an extension request. For this purpose, the IRS will treat the individual as if he or she had requested a Q17 for and received the extension.*

Note that the addition of FAQ 15 in June provides penalty relief for taxpayers who intended to apply an existing 2017 overpayment to their Q1 2018 estimated tax payment or who included with their 2017 filing extension request a payment containing an amount sufficient to cover their Q1 2018 estimated tax payment, and who did not make a separate and timely Q1 2018 estimated tax payment specifically earmarked for such purpose following the late issuance on April 13, 2018, of IRS FAQs 13 and 14, regarding the application of 2017 overpayments of tax. This relief was made necessary by the IRS's late issuance, on March 13, 2018 (revised April 13, 2018), of FAQ 10 regarding how to make the section 965 payments and the late issuance on April 13, 2018, of inconsistent and possibly contradictory guidance in the form of FAQs 13 and 14 regarding how IRS intends to apply 2017 overpayments (first to 2017 tax liability, then to the first installment of section 965 tax liability due with the 2017 return, and then any remainder to future installments of section 965 tax liability).

Pursuant to FAQ 15, taxpayers who intended to have a 2017 overpayment applied to their Q1 2018 estimated tax payment but cannot, due to the application of FAQs 13 and 14 and who did not make a timely separate and specifically identified Q1 estimated tax payment, may avoid the addition to tax for an underpayment of estimated taxes under section 6654 or 6655 if the Q1 2018 estimated tax payment is made on or before the due date for their second estimated tax payment (June 15, 2018, for calendar year taxpayers) and their second estimated tax payment is timely made in full. **This relief is limited to taxpayers whose first required installment for 2018 was due on or before April 18, 2018, and the deadline for making the Q1 2018 payment was June 15, 2018.**

**October 8 "Special Update"—Time to file transfer agreement with respect to certain acceleration events**

On October 8, 2018, the IRS posted a "special update" at the beginning of the FAQs, allowing taxpayers more time to file a transfer agreement with respect to an acceleration event that occurred before September 10, 2018. The update states:

> *The proposed regulations in 1.965-7 call for certain transfer agreements to be filed by October 9, 2018 in accordance with rules provided in forms, instructions, or other guidance. The IRS is aware that taxpayers need more guidance on where and how to submit these agreements and plans to provide further guidance in the near future. Transfer agreements filed in accordance with this future guidance will still be considered timely filed notwithstanding the October 9, 2018 date mentioned in the proposed regulations.*

As background, a section 965(h) election to defer the mandatory repatriation tax liability is extinguished when an acceleration event occurs pursuant to section 965(h)(3) and Prop. Reg. section 1.965-7(b)(3)(ii).

One such acceleration event is a cessation of business, which includes: (1) a person that was not a member of any consolidated group becoming a member of a consolidated group; and (2) when a consolidated group ceases to exist, or otherwise no longer files a consolidated return.

If, for example, there was an acquisition in 2018 in which a standalone target made a section 965(h) election in its 2017 return and was acquired by and joined a consolidated group—or if the common parent of a consolidated group that made a section 965(h) election was acquired by and joined a different consolidated group—an acceleration event has occurred, and the section 965 tax liability becomes due on the date of the acceleration event.

There is an exception to exclude these situations from the definition of an acceleration event when a transfer agreement is filed. Under Prop. Reg. section 1.965-7(b)(3)(iii)(B):

- For acceleration events occurring prior to September 10, 2018, the filing is due October 9, 2018.
- For acceleration events occurring after September 10, 2018, the deadline is 30 days.

There is no 9100 relief to timely file the transfer agreement.

**November 6 update to FAQs**

On November 6, 2018, the IRS added three new FAQs regarding transfer agreements. The new FAQs are as follows:

> *Q18: When and where can I file a "Transfer Agreement Under Section 965(h)(3)"and "Transfer Agreement Under Section 965(i)(2)(C)" (hereafter, "Transfer Agreement")?*
>
> *A18: You may file a Transfer Agreement at IRS' Memphis Compliance Service Collection Operations at the following address:*
>
> *Memphis CSCO5333*
> *Getwell Road MS 81*
> *Memphis, TN 38118*
>
> *Transfer Agreements will be considered timely filed if filed by the date provided in the final regulations under section 965.*
>
> *Q19: In addition to the terms of agreement that are required to be included in a Transfer Agreement Under Section 965(h)(3) under the proposed regulations, will the IRS need any additional information from an eligible section 965(h) transferee in order to properly process a Transfer Agreement Under Section 965(h)(3)?*

*A19: Yes, for the IRS to properly process a Transfer Agreement, an eligible section 965(h) transferee must consent to the immediate assessment of the portion of the eligible section 965(h) transferor's section 965(h) net tax liability remaining unpaid in the Transfer Agreement. This may be done in one of the following manners:*

*(i) Transfer Agreements may include the following statement directly above the perjury jurat and the signatures of the eligible section 965(h) transferor and eligible section 965(h) transferee:*

> *By signing this transfer agreement, [the eligible section 965(h) transferee] waives the right to a notice of liability and consents to the immediate assessment of the portion of the eligible section 965(h) transferor's section 965(h) net tax liability remaining unpaid, as shown in paragraph [insert paragraph number of the transfer agreement]. [The eligible section 965(h) transferee] understands that by signing this agreement, [the eligible section 965(h) transferee] will not be able to contest this liability in Tax Court, except as additional transferee or fiduciary liability is determined for this year; or*

*(ii) An eligible section 965(h) transferee may include an executed Form 870T, Waiver of Restrictions on Assessment and Collection of Transferee or Fiduciary Liability, with the Transfer Agreement Under Section 965(h)(3) filed with the IRS, as described in A18, consenting to the immediate assessment of the portion of the eligible section 965(h) transferor's section 965(h) net tax liability remaining unpaid as set forth in the Transfer Agreement Under Section 965(h)(3).*

*The IRS will not be able to process a Transfer Agreement Under Section 965(h)(3) until such time as the eligible section 965(h) transferee has consented to the immediate assessment of the portion of the eligible section 965(h) transferor's section 965(h) net tax liability remaining unpaid as set forth in the Transfer Agreement under Section 965(h)(3). While the eligible section 965(h) transferor's section 965(h) net tax liability remaining unpaid will be immediately assessed against the eligible section 965(h) transferee, the remaining installments will not become immediately due as long as the eligible 965(h) transferee agrees to be liable for the remaining installments in the same manner as the eligible 965(h) transferor and meets other requirements of section 965(h). Transfer agreements filed before the date provided in the final regulations under section 965, including transfer agreements filed in reliance on the proposed regulations, will be subject to any additional information requests issued by the Commissioner pursuant to proposed §1.965-7(b)(3)(iii)(C)(1).*

*Q20: If I have previously filed my Transfer Agreement Under Section 965(h)(3) or Section 965(i)(2)(C) on or before the publication date of this FAQ, what actions should I take?*

*A20: If you have previously filed a Transfer Agreement, the Transfer Agreement should be filed again at the IRS office set forth in A18. If a Transfer Agreement Under Section 965(h)(3) does not contain the consent language set forth in A19, the IRS will*

*not be able to process the Transfer Agreement until such time as the eligible section 965(h) transferee has consented to the immediate assessment of the portion of the eligible section 965(h) transferor's section 965(h) net tax liability remaining unpaid as set forth in the Transfer Agreement Under Section 965(h)(3). To be processable by the IRS, the Transfer Agreement Under Section 965(h)(3) may either (i) include the language provided in A19 or (ii) the eligible section 965(h) transferee may execute and attach a Form 870T to the refiled Transfer Agreement. If a Transfer Agreement is submitted without the consent language or a Form 870T, the IRS will request that the transferee execute a Form 870T.*

### *Overpayments and section 965(h): IRS Chief Counsel memorandum*

An **IRS Chief Counsel memorandum** [PDF 131 KB] dated August 2, 2018, addresses certain taxpayer questions about overpayments and section 965(h).

The questions addressed in the memorandum concern situations in which taxpayers made elections under section 965(h) to pay the transfer tax in installments, and also had made estimated tax payments with respect to their 2017 income tax liability (before enactment of the new law in late December 2017) of amounts greater than the portion of their 2017 income tax liability not subject to payment in installments and their first installment payment of their section 965(h) net tax liability.

The memorandum explains that the IRS:

- Will apply any excess amount to the next successive annual installment due in 2019, and to the extent such excess exceeds the amount of that installment due, then to the next such successive annual installment until the excess amount has been fully applied

- Will not refund any excess installment payment to the taxpayer prior to there being an overpayment of the entire liability

- Will not apply its offset refund bypass procedures

While the memorandum addresses the situation in which a taxpayer filed its 2017 return and made the section 965(h) election to pay the section 965 tax in installments, the analysis does not address situations in which taxpayers have not yet filed their 2017 returns—e.g., they filed a request for extension of the due date of their 2017 returns.

**Background**

As discussed above, the IRS previously published FAQs relating to section 965 and the 2017 tax year. FAQ 14 addressed whether taxpayers making an election under section 965(h) could receive refunds of any 2017 payments or estimated tax payments that exceeded the sum of their 2017 net income tax liability described under section 965(h)(6)(A)(ii)—which is the taxpayer's net income tax liability determined without regard

to section 965, plus the taxpayer's first annual installment pursuant to an election under section 965(h) due in 2018.

The FAQ concluded that taxpayers are not eligible for a refund of this amount unless and until the amount of payments exceeds the entire unpaid 2017 income tax liability, including all amounts to be paid in installments under section 965(h) in subsequent years. The FAQ further provided that any excess amount paid would instead be applied to the "next successive annual installment (due in 2019), and to the extent such excess exceeds the amount of that installment due, then to the next such successive annual installment (due in 2020), etc."

**Analysis in memorandum**

The IRS Chief Counsel memorandum acknowledges that taxpayers raised concerns about the legal basis for the answer provided in FAQ 14. Some taxpayers have expressed a desire to obtain a refund of, or apply as a credit to their next year's estimated tax liability, any amount that exceeds the amount currently due. Questions have also been raised about whether the IRS's "offset refund bypass" procedures apply.

The memorandum examines the IRS's legal authority to make a credit or refund, and the limited circumstances in which the IRS may exercise that authority. Specifically, the memorandum notes that section 6402(b) does not authorize the IRS to apply any amount as a credit to the succeeding year's estimated income tax except to the extent that such amount constitutes an overpayment.

The memorandum explains that section 965 increases the subpart F income of deferred foreign income corporations, and through the operation of section 951, a pro rata share of that income is included in income by the corporations' United States shareholders in the tax period during which the corporations' inclusion year ends. This in turn increases a United States shareholder's income tax liability. While section 965(h)(1) allows a United States shareholder of a deferred foreign income corporation to elect to pay the transfer tax liability in eight installments, it does not permit the United States shareholders to defer recognizing these amounts as income and therefore defer the tax liability. Section 965(h) only permits a deferral of the payment of that liability if the shareholder elects to do so.

Thus, the memorandum explains that an overpayment under section 6402(a) does not exist with respect to a 2017 income tax liability:

> *… unless and until the entire liability is fully paid, including any amount of that liability that is subject to an election to pay that income tax liability in installments under section 965(h). Absent an overpayment of the entire tax liability for the 2017 tax period, the [IRS] cannot issue a credit or refund under section 6402(a) with respect to the 2017 tax period.*

The memorandum notes that there may be taxpayers that made elections under section 965(h) to pay in installments, and that made estimated tax payments with respect to their

2017 income tax liability before enactment of the new law. Also, it notes that those taxpayers that remitted more than the sum of the portion of their 2017 income tax liability not subject to payment in installments and their first installment payment of their section 965(h) net tax liability may make an election under section 965(h) to defer payment of the net tax liability under section 965(h)(6) and to pay the tax in installments.

In such instances, the IRS will apply any excess amount to the next successive annual installment due in 2019, and to the extent such excess exceeds the amount of that installment due, then to the next such successive annual installment until the excess amount has been fully applied.

The IRS will not refund any excess installment payment to the taxpayer until there is an overpayment of the entire liability. The memorandum concludes that because there is no overpayment under section 6402 until the entire 2017 tax liability is paid—including all of the installments of the deferred payment—the IRS's offset refund bypass procedures will not apply.

**Observation**

It is noteworthy that the Chief Counsel memorandum discusses taxpayers that have **made** (note the use of the past tense) an election under section 965(h) to pay the transfer tax in installments, and appears to treat the 2017 tax liability relating to the section 965 tax as if it had already been assessed, which typically occurs following the filing of a return.

Although FAQ14 indicates that the IRS will not refund or credit amounts in excess of tax that would be due with respect to the current year's installment payment following an election under section 965(h), many taxpayers—including those requesting extensions of the due date of their 2017 returns—have not yet filed their 2017 return which allows assessment of the tax. Nor have they made the section 965(h) election as specifically directed by the statute, initial IRS guidance, and the recently proposed section 965 regulations, and required to be made by attaching a statement to the return.

Accordingly, the analysis in the memorandum does not address the common situation of taxpayers that have not yet filed their 2017 returns, and as a result have not yet self-assessed a section 965 liability or elected section 965(h) treatment for such a liability. A tax liability is not established until the IRS assesses the tax (i.e., makes the required formal bookkeeping entry under section 6203). In other words, the memorandum does not discuss the authority of the IRS to withhold overpaid estimated taxes paid before an actual tax liability being established; it simply assumes an actual liability that does not yet exist.

As a result, despite the Chief Counsel memorandum, it remains unclear what authority the IRS relied upon for the practice described in FAQ 14 of applying amounts against section 965 tax liabilities that have not yet been assessed.

*Calculating section 965 amounts, elections available for 2017 returns: IRS Publication 5292*

The IRS has posted Publication 5292, "How to Calculate Section 965 Amounts and Elections Available to Taxpayers" with respect to the transition tax imposed under section 965. **Publication 5292** [PDF 1.4 MB], as posted with a date of April 6, 2018:

- Defines certain terms for purposes of section 965 determinations
- Identifies taxpayers that may be required to report section 965 amounts
- States section 965 amounts are to be reported on 2017 tax returns
- Notes that under certain circumstances, taxpayers may need to report section 965 amounts on 2016 tax returns
- Includes a "workbook" to assist in calculating section 965 amounts

## Rules relating to passive and mobile income

### GILTI (global intangible low-tax income)

The new law generally retained the existing subpart F regime that applies to passive income and related-party sales, but created a new, broad, class of income—"global intangible low-taxed income" (GILTI).

GILTI is deemed repatriated in the year earned and, thus, is subject to immediate taxation. GILTI income is effectively taxed at a reduced rate while subpart F income is taxed at the full U.S. rate. In general, GILTI is the excess of all of the U.S. corporation's net income over a deemed return on the CFC's tangible assets (10% of depreciated tax basis).

*Proposed regulations*

**Proposed regulations** [PDF 389 KB] (REG-104390-18) relating to the GILTI provisions were initially released by the Treasury and IRS on September 13, 2018, and were formally published in the Federal Register on October 10, 2018. According to an **IRS release**, the proposed regulations describe new reporting rules requiring the filing of Form 8992, *U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI),* but do not include foreign tax credit computational rules relating to GILTI (these rules are to be addressed separately in the future).

The due date for written comments on the proposed regulations was November 26, 2018.

The following discussion provides initial impressions and observations about the proposed regulations drawn from a KPMG report issued on October 12, 2018.

**Overview**

The proposed GILTI regulations were shorter than many anticipated because Treasury and the IRS limited the scope to address primarily the calculation of the GILTI inclusion amount.

Among those things not addressed in the proposed regulations are:

- Rules relating to the section 250 deduction.
- Foreign tax credits, including rules under sections 904 and 960(d). However, the preamble clarifies an outstanding issue by indicating that "[i]t is anticipated that the proposed regulations relating to foreign tax credits will provide rules for assigning the section 78 gross-up attributable to foreign taxes deemed paid under section 960(d) to the separate category described in section 904(d)(1)(A)."
- Interaction with interest limitation rules under section 163(j) or with hybrid instruments under section 267A (although these issues, along with the dividends received deduction under section 245A, are specifically identified in the preamble as the subject of future guidance).
- Previously taxed income under section 959 or basis adjustments under section 961.
- The interactions of the section 962 election (which generally allows individual shareholders to elect the benefit of corporate rates and indirect foreign tax credits at the cost of a second level of U.S. tax when previously taxed earnings are eventually distributed) and the GILTI regime. In particular, no guidance was provided as to whether the section 250 deduction would be available in computing the hypothetical corporate tax under section 962(a)(1).

**The basics**

The GILTI inclusion amount is a formulaic shareholder-level determination described through a series of defined terms. The proposed regulations add more than 20 new defined terms that feed into the calculation. As with the section 965 regulations (which had a large number of defined terms), the trend seems to be to provide rules through definitions.

Net CFC tested income is computed at the U.S. shareholder level, using section 951(a)(2) to determine the pro rata share of a CFC's tested income, tested loss, qualified business asset investment (QBAI), and interest items. The proposed regulations also modify the pro rata share rules in Prop. Reg. section 1.951-1(e), affecting both subpart F and GILTI inclusion calculations.

In a welcome piece of guidance, the proposed regulations aggregate and then allocate consolidated group members' GILTI items (such as tested income, tested loss, and QBAI)

to members in proportion to their share of the group's tested income. This has the effect of allowing tested losses or QBAI attributable to CFCs owned by one consolidated group member to offset tested income attributable to CFCs owned by another member of the group. The guidance stops short, however, of mandating that all GILTI computations are done as if members of a consolidated group were a single shareholder.

The proposed regulations provide guidance for the CFC-level computations that was absent from the statute itself. In particular, the proposed regulations generally determine income and loss by reference to the section 952 regulations (the existing rules that provide taxable income for subpart F purposes). It is important to recall, however, that unlike subpart F income which is ultimately governed by earnings and profits, all computations related to the computation of tested income of a CFC are driven by taxable income concepts. Because the information currently gathered for Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations,* is earnings and profit (E&P) driven, taxpayers as a practical matter may generally need to start with E&P and then make appropriate adjustments to get to taxable income. Some examples of necessary adjustments—items which are treated differently for taxable income and E&P purposes—include:

- Fines, bribes and other illegal payments
- Meals and entertainment, luxury automobiles, etc.
- Capital losses disallowed
- Tax-exempt income and related expenses
- Section 267 losses disallowed
- Amortization
- COD income (under section 312(l)) (cancellation of indebtedness)
- Installment sales (under section 312(n)(5))
- Charitable contributions

Importantly, the proposed regulations confirm that there is not a general high-tax exception for GILTI for non-subpart F income. Thus, the high-tax exception remains very limited—it includes only subpart F income that is actually excluded from subpart F under the subpart F high-tax exception when a taxpayer makes a section 954(b)(4) election.

Similarly, the proposed regulations confirm the statutory structure that results in the absence of any QBAI benefit for a tested loss CFC. The proposed regulations define tangible property for QBAI purposes by reference to sections 167 and 168. The preamble

explains that this was meant to be helpful in determining when tangible property is eligible to be QBAI.

Adjusted basis is determined using section 168(g)'s alternative depreciation system (ADS) rules for QBAI purposes, regardless of whether a different method is used for another Code section. For property placed in service before the new law, the basis is calculated as if ADS had applied from the date placed in service. Unfortunately, this appears to mean that the vast majority of companies will need to recompute basis for QBAI purposes.

There is new guidance on the specified interest expense amount. At a high level, QBAI is reduced for interest paid to third parties, related U.S. parties, or related CFCs when the amount is included in the recipient CFC's subpart F income. As a practical matter, there was no prior guidance on how to determine when interest expense and tested income or loss are attributable to the appropriate interest income. Treasury and the IRS rejected a tracing approach as too burdensome and instead provided that the specified interest expense is determined under a netting approach.

In another nice piece of computational guidance, the foreign currency exchange rate to use for translating amounts for GILTI purposes is the average exchange rate for the CFC's year. This is the same rate methodology that applies for translating subpart F inclusions.

**The wrinkles**

Compared to the relatively straightforward approach provided in the basic rules above, the proposed regulations also add some less straightforward anti-abuse rules. In particular:

- There are interesting issues in the pre-GILTI anti-abuse period for tested income and tested loss.

- There are calculation quirks in the application of sections 163(j) and 267, QBAI quirks, and issues with domestic partnerships.

*Sections 163(j) and 267*

There is some ambiguity in the preamble as to whether section 163(j) will apply for GILTI purposes. Unless and until there is a follow-on regulation that states that section 163(j) does not apply, it will apply for CFC tested income and tested loss, and less explicitly for computing specified interest expense. The preamble signals that Treasury and the IRS may be willing to reconsider this. It is an open question where they will come out, but absent more guidance, it seems that section 163(j) would apply until further notice.

Section 267(a)(3)(B) is a rule that disallows a deduction for a payment to a related person if the deduction isn't taken into account for U.S. tax purposes. Under the proposed regulations, items—including OID, notwithstanding section 163(e)(3)(B)(i)—are treated as included in income of U.S. person when taken into account for tested income or tested

loss purposes. This helpful rule significantly limits application of section 267(a)(3)(B) to CFC-to-CFC payments. It could also apply to accruals of royalties outbound from the U.S. in certain circumstances.

*Preferred stock and dual use property*

Generally, a U.S. shareholder takes into account a CFC's QBAI based on its pro rata share of the CFC's tested income. A limitation applies for preferred shareholders when QBAI exceeds 10 times the tested income of the CFC, in which case the excess QBAI gets allocated to common stock. This is a favorable rule.

Instead of following regulations under section 861, the proposed regulations create a stand-alone rule for allocating income from dual use property—Prop. Reg. section 1.951A-3(d). Among other provisions, the QBAI "dual use" property rule is expanded to include property that does not produce any income, another taxpayer favorable rule from a GILTI perspective.

*Partnership QBAI*

The proposed regulations also attempt to simplify things for QBAI held through a partnership. The QBAI computations occur generally at the partnership level by allocating property to income at the partnership level, and similarly the quarterly tests are done at the partnership level. Prop. Reg. section 1.951A-3(g). The quarterly test rules are more detailed than in the section 956 quarterly test regime.

The treatment of domestic partnerships is one of the most interesting wrinkles in the proposed regulations. The proposed GILTI regulations take a hybrid aggregate/entity approach to domestic partnerships that are U.S. shareholders of a CFC. A partnership that is a U.S. shareholder of a CFC will do its own GILTI computations as a U.S. shareholder. U.S. partnerships are required to furnish information to partners for GILTI inclusion or, as relevant, pro rata share of CFC-tested items.

It remains to be seen whether the proposed regulations' hybrid view of partnerships is a foreshadowing of what Treasury and the IRS might do in the section 163(j) context. It seems clear that the application of section 163(j) to a partnership produces drastically different results when the partners are corporations versus when partners are individuals.

**The headaches**

Other provisions in the proposed regulations are hard to understand, hard to apply, and potentially present traps.

*Anti-abuse rules*

The proposed regulations contain three separate anti-abuse rules.

- The first applies solely with basis created as a result of certain transactions occurring during the transition period between January 1, 2018, and the beginning of a CFC's first tax year to which section 951A applies.

- The second applies to any transactions which generate QBAI from an asset that is held "temporarily."

- The third—and potentially most broadly reaching—anti-abuse rule arises in the context of the more general pro rata share rules under section 951, and would apply to any transaction entered into with a principal purpose of the avoidance of federal income tax.

*Transition rule*

As noted above, a transition period anti-abuse rule applies to transfers of assets that create amortizable or depreciable basis during the "donut" period—the period between January 1, 2018, when section 245A first springs into being as a way to get foreign earnings home tax-free, and the end of the transferor CFC's first tax year ending in 2018, when GILTI first applies to the CFC.

Under this rule, if an asset already held by a CFC is transferred to another CFC in a manner that increases its basis, then the incremental basis may be ignored for GILTI purposes. Unlike the other anti-abuse rules provided by the proposed regulations, it is a per se rule and not a principal purpose test. As a result, taxpayers will need to carefully review their CFC-to-CFC transactions. The deduction or loss attributable to a stepped-up basis is disqualified for purposes of determining tested income/loss, to the extent gain creating stepped-up basis is not subject to U.S. tax.

Notably, the rule is only a GILTI rule. If a CFC is buying property and getting a stepped-up basis for subpart F purposes—the asset is used to produce subpart F income and depreciation is allocable against subpart F income—this rule does not apply.

*"Temporary" QBAI rule*

Another anti-abuse rule involves "temporarily held" QBAI under Prop. Reg. section 1.951A-3(h)(1).

Under this provision, ownership of property would be disregarded for QBAI computation purposes when a CFC holds property temporarily, but for over at least one quarter end. As generally stated, this rule requires a "bad purpose"—that is, that the property be acquired with a principal purpose of reducing the GILTI inclusion. However, the rule applies on a per se basis if property is held for less than 12 months and over at least one quarter end, regardless of principal purpose.

Again, this will require taxpayers to carefully review transactions to determine if there are ordinary course transactions that might inadvertently be caught by this "anti-abuse"

provision. In addition, it is important to note that the "temporarily held" rule applies on CFC-by-CFC basis—it doesn't look to the U.S. shareholders even though QBAI itself is ultimately a U.S. shareholder level computation. Given the complications and unclear policy underpinnings, one can only hope that this rule will be revisited when the proposed regulations are taken final.

*Pro rata share anti-abuse rule*

The broadest and potentially most significant of the anti-abuse rules is contained in Prop. Reg. section 1.951-1(e)(6). Although contained within the subsection of the proposed regulation that addresses a U.S. shareholder's pro rata share of subpart F income or GILTI, the condition that triggers this rule is **any** transaction or arrangement that is part of a plan with a principal purpose to avoid federal income taxation. Thus, it seems that the rule can be invoked even if the potential avoidance is not directly tied to subpart F income or GILTI.

The consequence of falling within the rule is that any transactions or arrangements made pursuant to the plan are disregarded for purposes of determining the pro rata share of subpart F income or GILTI items. The formulation of the rule leads to remarkable ambiguity and confusion.

- If the avoidance in question does not involve the amount of a U.S. shareholder's pro rata share (but rather, for instance, amount or basket of foreign tax credits available to the U.S. shareholder), then why is it appropriate to disregard the transaction for purposes of computing the pro rata share?

- Further, even if the avoidance does involve subpart F or GILTI more directly, does the rule only operate on the amount of earnings and profits otherwise subject to allocation under Prop. Reg. section 1.951-1(e) and only among the persons who are otherwise U.S. shareholders owning stock of the CFC within the meaning of section 958(a) as of the last day of the CFC's tax year, or can the rule change the amounts of earnings and profits and/or identities of section 958(a) shareholders?

There are no examples in the proposed regulations, and the preamble doesn't discuss or provide any context for the rule.

*Tested loss basis reduction*

Another unique and complex rule (although not in this case styled as an anti-abuse rule) contained in the proposed regulations is Prop. Reg. section 1.951A-6(e)'s tested loss basis reduction that prevents double use of deductions. Under this rule, a suspense account is created with respect to stock of a CFC the tested loss of which offsets tested income of another CFC. Special rules allow for recapture of the suspense account when the same CFC's tested income is offset by tested loss of another CFC and for the tiering (but non-duplication) of the suspense account.

Interestingly, there is neither direct statutory authority for this rule nor even hints of it in the legislative history—in contrast to the legislative history's explicit discussion of similar considerations for the sharing of deficits under section 965(b). Against this backdrop, it seems particularly odd that the GILTI basis reduction is mandatory and operates on a deferred basis whereas the corresponding rule in Prop. Reg. section 1.965(2)(f) is elective but operates immediately.

It is also noteworthy that the basis reduction rules operate any time that tested losses offset tested income, even if there is no net tax benefit to the U.S. shareholder (because, for example, the tested income was subject to a sufficient rate of foreign tax to be fully sheltered under section 960).

*Special rules for allocations of tested loss*

Tested losses generally are allocated only to common stock, but they would be allocated to preferred stock in two situations:

- When preferred stock has accrued but unpaid dividends that exceed E&P, and
- When common stock has no liquidation value.

The rules would not seem to affect situations in which all the common and preferred stock is underneath one U.S. shareholder or one consolidated group. But to the extent there is externally held common or preferred stock within a group, it could create a major complication.

Under Prop. Reg. section 1.951A-3(f), QBAI is reduced when a CFC has a short tax year, generally to reflect the portion of the tax year during which the CFC held the property. This rule's mechanical application is likely to create more GILTI considerations in M&A transactions.

### *GILTI reporting forms*

In August 2018, the IRS posted draft versions of two forms with respect to GILTI reporting for 2018.

- **Form 8992** [PDF 133 KB], *Global Intangible Low-Taxed Income (GILTI)*
- Form 8993, Section 250 Deduction for Foreign Derived Intangible Income (FDII) and Global Intangible Low-Taxed Income (GILTI)

These draft versions reflected a "watermark" date of August 22, 2018, However, in September 2018, the IRS re-posted the **draft version of Form 8993** [PDF 93 KB] as well **draft instructions for Form 8992** [PDF 184 KB]; these postings reflect a "watermark" date of September 20, 2018. Subsequently, the IRS posted **draft instructions for Form 8993** [PDF 176 KB], with a watermark date of October, 19, 2018.

The draft forms, as well as the draft instructions, include cautionary language that they are not to be used for filing purposes, and are subject to change and to OMB approval before being officially released.

### GILTI and FDII

Very generally, the new law allows a U.S. corporation a deduction equal to 37.5% of its "foreign-derived intangible income" (FDII). The deduction for FDII is limited when the "global intangible low-taxed income" (GILTI) inclusion (including the section 78 gross-up for foreign taxes attributable to the GILTI inclusion) and the FDII exceed the corporation's taxable income, determined without regard to the GILTI and FDII deductions.

*Section 250 deductions for FDII and GILTI: Proposed regulations*

On December 14, 2018, OMB's Office of Information and Regulatory Affairs (OIRA) acknowledged receipt of proposed regulations from the Treasury as guidance under section 250 concerning the deductions for "foreign-derived intangible income" (FDII) and "global intangible low-taxed income" (GILTI).

## Limit deduction of certain related-party amounts in hybrid transactions or with hybrid entities

The new law disallows a deduction for any disqualified related-party amount paid or accrued pursuant to a hybrid transaction, or by, or to, a hybrid entity. Generally:

- A disqualified related-party amount is any interest or royalty paid or accrued to a related party if (1) there is no corresponding income inclusion to the related party under local tax law or (2) such related party is allowed a deduction with respect to the payment under local tax law.

- A disqualified related-party amount does not include any payment to the extent such payment is included in the gross income of a U.S. shareholder under section 951(a) (i.e., a "subpart F" inclusion).

- A related party for these purposes is determined by applying the rules of section 954(d)(3) to the payor (as opposed to the CFC referred to in such section).

- A hybrid transaction is any transaction, series of transactions, agreement, or instrument under which one or more payments are treated as interest or royalties for federal income tax purposes but are not so treated for purposes of the tax law of the foreign country of which the entity is resident or is subject to tax.

- A hybrid entity is one that is treated as fiscally transparent for federal income tax purposes (e.g., a disregarded entity or partnership) but not for purposes of the foreign country of which the entity is resident or is subject to tax (hybrid entity), or an entity

that is treated as fiscally transparent for foreign tax law purposes but not for federal income tax purposes (reverse hybrid entity).

The new law also grants the Secretary authority to issue regulations or other guidance necessary or appropriate to carry out the purposes of the provision and sets forth a broad list of issues such guidance may address. Such guidance may provide rules for the following:

- Denying deductions for conduit arrangements that involve a hybrid transaction or a hybrid entity
- Applying the provision to branches or domestic entities
- Applying the provision to certain structured transactions
- Denying some or all of a deduction claimed for an interest or a royalty payment that, as a result of the hybrid transaction or entity, is included in the recipient's income under a preferential tax regime of the country of residence of the recipient and has the effect of reducing the country's generally applicable statutory tax rate by at least 25%
- Denying a deduction claimed for an interest or a royalty payment if such amount is subject to a participation exemption system or other system that provides for the exclusion of a substantial portion of such amount
- Determining the tax residence of a foreign entity if the entity is otherwise considered a resident of more than one country or of no country
- Exceptions to the provision's general rule to (1) cases in which the disqualified related-party amount is taxed under the laws of a foreign country other than the country of which the related party is a resident for tax purposes, and (2) other cases that the Secretary determines do not present a risk of eroding the U.S. income tax base
- Requirements for record keeping and information reporting in addition to any requirements imposed by section 6038A

## Proposed regulations

Proposed regulations concerning the hybrid dividends and payments provision under the new law were published in the Federal Register on December 28, 2018. It was indicated that comments and requests for a public hearing would be due by February 26, 2019. Read the **proposed regulations** [PDF 379 KB] as published in the Federal Register.

The following discussion and observations are drawn from a KPMG report issued on December 21, 2018, regarding the proposed regulations as released for publication in the Federal Register.

**Section 245A(e)**

New section 245A(e) denies the benefit of the section 245A dividends received deduction (DRD) to certain "hybrid dividends," thus treating such items as taxable at ordinary rates. This treatment also applies to "tiered dividends" between controlled foreign corporations (CFCs), by treating the dividend as subpart F income in the recipient CFC. The proposed regulations address the following key points:

- **Connection between foreign tax benefit and the dividends**: U.S. shareholders would be required to maintain a "hybrid deduction account" with respect to each share of CFC hybrid stock that tracks the amount of foreign deduction (arising in years after December 31, 2017) associated with the CFC's earnings as an unfavorable tax attribute. Successor and reorganization rules similar to those contained in the section 959 PTEP (previously taxed earnings and profits) rules would also be included and would substantially restrict taxpayers' ability to restructure or recapitalize the hybrid stock in a manner that removes the section 245A(e) "taint."

- **Definition of hybrid deduction**: The proposed regulations would define a "hybrid deduction" as a deduction or "other tax benefit (such as an exemption, exclusion, or credit, to the extent equivalent to a deduction)." The legislative text in section 245A(e) disallows a dividend received deduction to the extent that the CFC payor is entitled to a deduction or "other tax benefit" under local law. There was some question prior to the issuance of the proposed regulations what Congress had in mind when it referred to "other tax benefits." The example used in the proposed regulations to illustrate what might be included in this category is a refund to a shareholder of taxes paid by a CFC on the earnings that fund the distribution—whether through an actual refund or with a credit.

  **KPMG observation**: The definition of hybrid deduction in the proposed regulations remains sufficiently broad to capture other arrangements that may not, on their face, involve a deduction under foreign law, so care should be taken to analyze the foreign tax treatment of any distribution out of section 245A eligible earnings.

- **Application to PTEP distributions**: The proposed regulations would confirm that section 245A(e) does not apply to distributions of previously taxed earnings and profits (PTEP) to U.S. shareholders, nor to distributions of PTEP between CFCs (which arguably could have been the result because section 959(b) does not literally exclude the distribution from being a dividend at the recipient CFC level). The proposed regulations also would treat certain amounts treated as a dividends under section 1248 as hybrid dividends.

- **Tiered dividends**: The proposed regulations would provide that a subpart F inclusion may result from an actual distribution of non-PTEP E&P between CFCs, as well as to gain that is recharacterized under section 964(e). Also included would be coordinating rules on the effect of the inclusion on the CFCs' and U.S. shareholders' E&P to ensure

that the dividend income is actually included as subpart F income by the U.S. shareholder.

- **Anti-abuse rule**: In similar form to the other proposed regulations that have been issued in connection with the new law, the proposed regulations would contain an anti-avoidance rule, which is broadly drafted to the allow the IRS to make "appropriate adjustments … if a transaction or arrangement is undertaken with a principal purpose of avoiding the purpose of this section."

- **Effective date**: The regulations, if finalized prior to the "18-month rule" contained in Code section 7805(b), would be effective for distributions made after December 31, 2017.

**Section 267A**

New Code section 267A disallows a deduction for any "disqualified related-party amount" paid or accrued pursuant to a "hybrid transaction" or by, or to, a "hybrid entity."

The statute provides the Secretary with expansive regulatory authority to carry out the purposes of section 267A.

The General Explanation of Public Law 115-97 (JCS-1-18) prepared by the Joint Committee on Taxation and released on December 20, 2018 (the "blue book"), contains a summary of the statute, but particularly emphasizes the broad regulatory authority granted to Treasury to issue regulations or other guidance to not only implement the statute but to also "carry out the purposes" of the provision. Specifically, the blue book states that Treasury has the authority to address the "overly broad or under-inclusive application of this provision" and provides examples of such over-breadth and under-inclusiveness. Examples provided in the blue book as potentially not being caught by the legislative text are branches (to which they devote a lengthy footnote but are otherwise not mentioned in the statute itself) and reverse hybrids, which (as discussed in more detail below), appear to have been inadvertently omitted from the definition of hybrid entities in the statute. An example of an overly broad application of the statute is a type of hybrid instrument that is primarily targeted and sold to tax-exempt domestic entities but may also be acquired by persons who benefit from the hybridity in their respective jurisdictions.

The proposed regulations take the broad grant of regulatory authority seriously. They would broaden the reach of section 267A, as contemplated by the drafters of the statute, to encompass transactions—such as branch payments and reverse hybrids—that appeared to escape a literal reading of the statute. They would even expand the scope of section 267A to include the long-term deferral of inclusions as a prohibited hybridity. In fact, and interestingly, the proposed regulations would adopt an entirely new lexicon of defined terms, not otherwise contained in the statutory language, while not ignoring the defined terms specifically provided for in the statute—such as the definition of "disqualified related party amount," as described above. Yet at the same time, the

Treasury exercises a bit of regulatory restraint by not applying the proposed regulations to areas otherwise within its delegated authority, such as preferential tax regimes.

The following features of the proposed regulations are noteworthy:

- **U.S. outbound structures now generally unaffected by section 267**: The section 267A statutory provision is seemingly broad in reach, generally disallowing interest and royalty expense deductions for CFCs and U.S. entities alike to the extent such payments would constitute disqualified related-party amounts pursuant to a hybrid transaction or by, or to, a hybrid entity. Under the statute, an exception applied to exclude from the definition of disqualified related-party amounts certain related-party interest and royalty payments to the extent such payment would be taken into account as subpart F income by a U.S. shareholder. However, no similar exception was provided to the extent such payment would be included directly in the income of a U.S. person or U.S taxable branch or deemed included under section 951A. The broad application of section 267A to situations in which a payment is taken into account under section 951A, or otherwise directly included in a U.S. taxpayer's income, would effectively result in double taxation because the amount would be included in the U.S. shareholder's taxable income directly and indirectly as GILTI. Accordingly, the proposed regulations would provide that interest and royalty payments are not subject to disallowance under section 267A to the extent that: (1) the U.S. tax resident or U.S. taxable branch would take such payment into account in its gross income; or (2) the U.S. shareholder would include such item in its gross income under subpart F or take such item into account under section 951A. As a result, the preamble to the proposed regulations explains that the population of taxpayers affected by section 267A will seldom include U.S.-based companies, since those companies are taxed under section 951A and subpart F.

- **Payments resulting in deduction / non-inclusion ("D/NI") broadly targeted**: The proposed regulations would generally disallow a deduction for certain interest and royalty payments ("specified payments") only if the specified payment results in a D/NI outcome. Notably, the proposed regulations would not target double-deduction outcomes under section 267A. The proposed regulations would interpret section 267A(b)(1)(B) as referring only to dividends received deductions and other items directly related to the receipt of the specified payment (which the proposed regulations view as a form of D/NI rather than as a double-deduction) and would not broaden the scope to encompass deductible payments made as part of an overall arrangement of which the specified payment was only a part. Thus, the proposed rules would apply to a specified payment only if such payment would constitute a: (1) "disqualified hybrid amount" (i.e., D/NI resulting from a hybrid or branch arrangement); (2)) "disqualified imported mismatch" (i.e., importation of an offshore hybrid or branch arrangement); or (3) payments pursuant to a principal purpose transaction entered into to avoid the application of section 267A and resulting in a D/NI outcome. However, double-deduction outcomes are targeted by the proposed regulations using tools other than section 267A in the proposed changes to the DCL rules, discussed in more detail below.

**KPMG observation**: Although the limited scope of section 267A as implemented by the proposed regulations as applying only to D/NI outcomes would be narrower than the anti-hybrid rules contained in Action 2 of the OECD's base erosion and profit sharing (BEPS) initiative and adopted by some countries in various forms, the proposed regulations would otherwise implement rules that are similar in approach to the BEPS initiative, including the imported mismatch rule.

- **Timing differences**: Specified payments that result in "long term" D/NI timing differences would also be included within the scope of section 267A, apparently on the basis that a long-term accrual without taxation is deemed to be hybridity, as "payment" is defined in the proposed regulations to include "accrual" and non-taxation until payment is considered a form of exclusion). A deferral benefit is considered to be long-term if there is no corresponding inclusion after 36-months from the year in which the related-party payor received a deduction. Timing differences resolved within the 36-month period are considered insignificant, and therefore, the associated deduction will not be subject to disallowance under section 267A.

- **Linkage to hybridity generally required**: The proposed regulations would not disallow a deduction for an interest or royalty payment made in connection with a hybrid transaction or to a hybrid entity, as those terms are defined in the proposed regulations, if the foreign country's law would otherwise exclude the income from tax under a "generally applicable" provision of the local tax law. Examples provided of such generally applicable provisions are depreciation deductions and net operating losses and back-to-back financing. Further, regimes with preferential tax rates not based on hybridity are not subject to the proposed regulations.

**KPMG observation:** Based on the broad language in the statute, there was some concern that the payment of a royalty by a foreign entity owned by a CFC that is disregarded for U.S. tax purposes to a related U.S. company could result in the disallowance of the deduction because the payment would be eligible for the deduction for foreign derived intangible income (FDII) provided in section 250. Because the section 250 deduction is allowed to the U.S. taxpayer, regardless of whether it is paid by a hybrid entity, it does not appear to be linked to the hybridity, and therefore not subject to disallowance under the proposed regulations. Even if such linkage were deemed to exist, the proposed rules would seemingly allow a deduction for such payment because the U.S. taxpayer would include the entire amount of such item in its gross income, even if such U.S. taxpayer also received a corresponding section 250 deduction (read the discussion above regarding curtailed application of section 267A to U.S. outbound structures).

- **Treatment of reverse hybrids**: The legislative text of section 267A could be read to exclude reverse hybrids from the definition of a hybrid entity because the statute defines a hybrid entity as an entity treated as being fiscally transparent in the country in which such entity is tax resident or otherwise subject to tax. Invariably, a reverse hybrid entity is neither subject to tax nor a tax resident under the laws of a jurisdiction

in which it is treated as fiscally transparent. As such, it seemed that a technical reading of the section 267A statutory definition of a hybrid entity would necessarily exclude reverse hybrid entities. As discussed above, the blue book acknowledges that the statutory language may be under-inclusive as it relates to reverse hybrids, so it is not surprising that the proposed regulations would capture them. Specifically, the proposed regulations would define a reverse hybrid entity for purposes section 267A as an entity that: (1) is fiscally transparent under the tax law of the country in which it is established; and (2) is not fiscally transparent under the tax law of an "investor" determined on an investor-by-investor basis, and generally subject such an entity to section 267A. This definition is different from the definition of reverse hybrid used in the current section 894 regulations.

**KPMG observation**: Technically, payments to a reverse hybrid present D/NI potential because the payor to a reverse hybrid would likely be entitled to a deduction, while there is no inclusion by a taxpaying entity either in the jurisdiction where the entity is formed or in the jurisdiction where the investor is resident. Notwithstanding the existence of such D/NI potential, it is worth observing that interest and royalty payments from U.S. persons to non-U.S. reverse hybrids generally are already ineligible for reduced rates of withholding tax under applicable U.S. income tax treaties. Arguably, the rationale for applying section 267A to reverse hybrid entities is less compelling, since the US tax base erosion potential is less evident in the reverse hybrid context.

- **Definition of interest broadly defined / definition for royalty based on U.S. tax treaty**: The proposed regulations would provide an expansive definition of interest, substantially similar to the definition proposed in the section 163(j) proposed regulations and the standard applied in Reg. section 1.861-9T. The proposed regulations would also provide a definition for royalties, which is based on the definition incorporated in the Article 12 of the 2006 U.S. Model Income Tax Treaty.

- **Category of persons subject to section 267A / treatment of partnerships**: The section 267A statutory language does not limit the application of section 267A to any particular category of persons. The proposed regulations would narrow the scope of section 267A to apply only to deductions of "specified parties." The preamble explains that a specified party means any (1) U.S. tax resident, (2) CFC for which one or more US shareholders directly or indirectly own 10% of the CFC stock, and (3) U.S. taxable branches. Notably, the proposed regulations would provide that partnerships would be excluded from the definition of a "specified party," but partners of a partnership may be a specified party, thereby treating a partnership as an aggregate of its partners for purposes of section 267A.

- **Coordination / overlap with other U.S. tax provisions**: The proposed regulations would provide that section 267A would generally apply after the application of other U.S. federal tax provisions that affect the deductibility of interest and royalties, unless another provision of the Code explicitly provides otherwise.

**KPMG observation**: Read in isolation, this coordination rule seems to suggest that the interest disallowance rule under section 163(j) would apply before section 267A. This is somewhat inconsistent with a similar coordination rule contained in the section 163(j) proposed regulations, which would apply section 163(j) after other interest limitation / deferral provisions in the Code. Neither the section 163(j) proposed regulations nor the section 267A proposed regulations cross-references each other, so it is still unclear which provision should be applied first. It is also unclear how this coordination rule should be applied in the context of the base erosion alternative tax (BEAT) regime under section 59A. The BEAT regime may also effectively disallow a deduction for interest or royalty payments made to foreign related parties, but does so through the mechanism of the modified taxable income calculation, and it is unclear whether such calculation would be done prior the application section 267A or after.

- **Effective date generally retroactive to tax years beginning after December 31, 2017**: The section 267A proposed regulations generally would apply to tax years beginning after December 31, 2017, citing section 7805(b) as the authority for their retroactive application This retroactive effective date appears to apply only to those provisions that are interpreting the operative provisions of the statute, and not the provisions implementing Treasury's regulatory authority contained in section 267A(e). The proposed regulations that rely on the authority granted in section 267A(e) would be effective for tax years beginning on or after the date the proposed regulations are published in the Federal Register. Notably, and perhaps in recognition of the advancing calendar, the preamble also addresses the possibility that the proposed regulations may not be finalized within the 18-month window prescribed by section 7085(b), by providing that Treasury and the IRS generally expect that any provision of the proposed regulations that is finalized after June 22, 2019 (the date when the 18-month window expires) would apply to tax years ending on or after the date the proposed regulations are filed with the Federal Register.

- **Information reporting requirement**: The proposed regulations would provide that disallowed payments under section 267A and hybrid dividends / tiered hybrid dividends under section 245A must be reported in accordance with sections 6038 and 6038A.

**Changes to dual consolidated loss (DCL) rules**

The proposed regulations propose to amend the section 1503(d) DCL rules to cover certain double deduction structures. As proposed to be amended, they would require taxpayers to treat domestic reverse hybrid (DRH) entities as dual resident corporations that are subject to the DCL rules as a pre-condition to electing corporate status for the entity under the "check-the-box" regulations.

- **Consent requirement**: To prevent the possibility of such losses of such "consenting domestic corporations" becoming "stranded" if their shareholders' country of tax residence imposes shareholder-level anti-double deduction restrictions, the "Mirror Legislation" restriction in the DCL rules would not apply. The proposed regulations

expressly declined, however, to modify application of the Mirror Legislation rule to U.S.-owned "separate units," which leaves taxpayers still needing to assess the overlapping application of the DCL rules with foreign countries' anti-double deduction rules.

- **Request for comment**: Finally, the proposed regulations acknowledge that the current DCL regulations' exclusion of "disregarded" payments from the DCL calculation may facilitate undesirable D/NI and double deduction outcomes, and request comments on their treatment.

## Modifications relating to foreign tax credit system

The new law repealed the deemed paid foreign tax credit under Code section 902 and retained but modified the deemed paid foreign tax credit under section 960 of the Code. Section 902 deemed a U.S. corporate shareholder of a 10%-owned foreign corporation to have paid a portion of the foreign corporation's foreign income taxes when it received or was deemed to receive a dividend from that foreign corporation. Section 960 of the Code provided a similar deemed paid credit for subpart F inclusions. Under the new law, the allowable credit under section 960 is based on current-year taxes attributable to subpart F income rather than the "pooling" approach that applied under sections 902 and 960.

The new law also provides rules applicable to foreign taxes attributable to distributions of previously taxed income (PTI), including from a lower-tier to an upper-tier CFC. These statutory rules are not explained in any further detail, but appear to allow foreign taxes as credits under section 960 in the year the PTI is distributed. The new law grants the Treasury Secretary authority to promulgate regulations and guidance such that the amended section 960 credit would, as under pre-enactment law, be computed separately for each category or "basket" of income under Code section 904(d).

The new law makes conforming amendments to other Code provisions to reflect the repeal of Code section 902, including amending Code section 78 to treat the "gross-up" for deemed paid taxes as a dividend.

The repeal of section 902 may have significant consequences for domestic corporations eligible to claim section 902 deemed paid credits with respect to dividends from 10%-owned foreign corporations that are not CFCs because foreign income taxes paid or accrued by such corporations can no longer be claimed as foreign tax credits. Moreover, the change from the pooling regime to a current-year foreign tax regime may also significantly affect the foreign tax credit calculation, as the pooling regime served to blend effective foreign tax rates that may differ from year to year due to U.S. and foreign timing differences and rate changes.

## Proposed regulations relating to sections 78, 864, 901, 904, and 960, as amended

On November 28, 2018, the Treasury released proposed regulations relating to sections 78, 864, 901, 904, and 960, as amended by the new law. The regulations were filed with the Federal Register on December 4, 2018, and were published on December 7, 2018 (**REG-105600-18**). It was indicated that comments and requests for public hearings are due by February 5, 2019. (Read a related IRS release: **IR-2018-235**.)

The following initial impressions and observations about the proposed regulation are drawn from a KPMG report published on November 30, 2018; the KPMG report was based on the text of the proposed regulations as published on the IRS webpage on November 28, 2018. Read the **KPMG report**.

### Effective dates and reliance

Different effective date rules are provided for different provisions of the proposed regulations but generally fall into three categories—(1) tax years beginning after December 31, 2017, (2) tax years ending after the date on which the proposed regulations were filed with the Federal Register (that is, December 4, 2018), or (3) tax years which meet both of those criteria. For a summary of the effective dates of the proposed rules see the table in Appendix A of the November 28, 2018 **KPMG report**.

Significantly, taxpayers are not entitled to rely on the proposed regulations as having the force of law.

### Background

As indicated above, the new law involved substantial changes to the foreign tax credit ("FTC") regime under section 904 of the Code. It added two new categories of income (GILTI inclusions and foreign branch income) to section 904(d), thereby doubling the number of statutory FTC "baskets" from two to four. Furthermore, each of these new categories involves a class of income that can be earned only by an actual U.S. taxpayer and not a controlled foreign corporation ("CFC"). The new law also provided that dividends qualifying under section 245A (and stock producing such dividends), and deductions allocated and apportioned thereto, should be disregarded for certain purposes under section 904(d).

As a result of the statutory changes, significant regulatory changes needed to be made to the operation of the "look-through" rules of section 904(d)(3). Additionally, the proposed regulations would amend the existing expense allocation rules of the section 861 regulations. These changes relate primarily to GILTI, and while perhaps not going as far as some commentators had hoped, may provide some relief from expense allocation in the computation of the GILTI FTC limitation.

In addition to changing the rules under section 904(d), the new law entirely repealed section 902 and its "pooling" mechanism for imputing foreign taxes paid by a CFC to its U.S. shareholders upon a dividend or subpart F inclusion. Deemed paid credits are now

governed solely by section 960 which applies an “attributable to” standard rather than pooling. The proposed regulations contain detailed rules implementing this new regime, which generally associate taxes with items of income using a combination of the existing regulations under section 904 and grouping rules that exist under subpart F.

Finally, the proposed regulations include a number of provisions that are unrelated to the new law but address longstanding rules and results that the government apparently viewed as problematic.

**Section 960**

As amended by the new law, section 960 is now the only provision that allows a corporate U.S. shareholder to claim a deemed paid credit with respect to taxes paid by its CFCs. Taxes are deemed paid by a corporate U.S. shareholder to the extent they are attributable to subpart F inclusions and GILTI inclusions. Section 960 also provides rules that treat foreign taxes imposed on a distribution of “previously taxed earnings and profits” (“PTEP” under the proposed rules–perhaps signaling a more general and somewhat ironic break from the colloquial section 959 term “PTI”) as deemed paid by the U.S. shareholder or upper tier CFC. In effect, amended section 960 entirely replaces the pooling regime of former section 902.

The proposed regulations under section 960 generally would provide two sets of computational rules, one for determining deemed paid taxes attributable to subpart F and GILTI inclusions based on current year CFC taxes, and the other for calculating deemed paid taxes attributable to PTI distributions based on current and prior year CFC taxes. The proposed regulations would provide a multi-step process for computing the deemed paid credit for subpart F and GILTI inclusions for each CFC in a chain of ownership, calculated first for the lowest tier CFC and then repeated for each CFC up the chain. The process generally would calculate deemed paid taxes by dividing a CFC’s income into tested income, various subcategories of subpart F income, and residual income (which is neither subpart F income nor tested income).

*Grouping of income*

Under the proposed rules, a CFC’s income for its current U.S. tax year (other than gross income relating to a PTEP distribution (discussed below)) and taxes for its current year would be assigned to a section 904 category (for CFCs, generally either the general limitation or the passive limitation category). Income and taxes then would be further assigned to an “income group” within a section 904 category or to a “PTEP group” (discussed below). “Income groups” would consist of the subpart F income groups, the tested income group, and the residual income group.

The subpart F income groups would comprise several separate income groups including, most significantly, separate groups for each separate “item” of foreign base company income identified under section 1 .954-1(c)(1)(iii).

*Allocation and apportionment of expenses and foreign taxes*

Deductions would be allocated and apportioned to the various income groups (under section 861 rules) to arrive at the net income (or loss) within each income group. Likewise, current year taxes would be allocated to the groups under the principles of proposed section 1.904-6. Current year taxes would be limited to the taxes paid or accrued by the CFC during its current U.S. tax year, even when a portion of the CFC's foreign tax year to which the taxes relate does not overlap with its U.S. tax year. As a result, when a CFC has different tax years for U.S. and foreign purposes, the CFC's "current year" taxes for a particular U.S. tax year could be based in part on foreign taxes imposed on income earned by the CFC in a different U.S. tax year. The proposed rules provide that current year taxes for these purposes would include subsequently redetermined foreign income taxes that "relate back" to the current year under section 905(c), which was revised by the new law. Only current year taxes allocated to a specific income group would be deemed paid with respect to an income inclusion (for example, under sections 951(a) or 951A(a)) that is sourced from the income group. Current year taxes that are assigned to the residual group would not be deemed paid, and thus, would be lost.

**KPMG observation:** An example of a subpart F income group is foreign base company sales income, which could include income earned from sales by separate qualified business units (QBUs) of the CFC located in various foreign jurisdictions. Under these rules, sales by separate QBUs would be aggregated into a single group, rather than segregating such income into multiple income groups based on the location of the sale or identity of the QBU conducting such sale.

**KPMG observation:** These grouping rules will be of much more significance going forward than they have been in the past. In particular, grouping was of very limited relevance in determining if an item of subpart F income qualified for the high-tax exception of section 954(b)(4) because the determination was ultimately driven by the pooling regime of old section 902. Under the proposed section 960 rules, the association of taxes with a particular group of subpart F income would directly determine whether that group qualifies for the high-tax exception.

**KPMG observation:** The proposed rules would assign current year taxes that are attributable to a "base difference," as determined under proposed section 1.904-6(a)(1)(iv), to the residual income group. The effect of this assignment is that any taxes incurred as a result of a base difference would not be eligible to be claimed as a deemed paid credit under section 960. The proposed regulations would "clarify" that base differences arise only in the limited circumstance of a foreign tax imposed on a <u>type</u> of item that does not constitute income under federal income tax principles, such as a gift or insurance proceeds.

**KPMG observation:** A taxpayer would be able to claim a section 960 credit only to the extent there is current year income in the income group to which current year taxes are attributed. Thus, taxes could be stranded when a CFC has a different U.S. and foreign

tax year, or when there is a timing difference under foreign law. For example, assume a CFC with an 11/30 year-end for U.S. tax purposes, but a 12/31 year-end for local country purposes, engages in an extraordinary transaction in June of Year 1 that generates subpart F income in a non-recurring income group. The CFC would accrue the local taxes imposed on the transaction on 12/31 of Year 1, which would be within the CFC's 11/30 Year 2 tax year. Although foreign taxes would be assigned to the non-recurring subpart F income group, because the extraordinary subpart F income to which the taxes relate was taken into account in the U.S. shareholder's gross income as a subpart F inclusion in Year 1, there may not be any income in the relevant income group in Year 2 to permit the U.S. shareholder to claim a deemed paid credit for such taxes. Consequently, the only way to claim the credits would be to generate gross income in the same subpart F income group in the 11/30 Year 2 tax year.

*Previously taxed earnings and profits*

The proposed rules set forth a separate set of mechanical rules that would apply to CFC taxes attributable to PTEP. These rules would determine the amount of deemed paid taxes that a U.S. shareholder would take into account when it receives a PTEP distribution, based on attributable taxes paid or accrued by either the distributing CFC or a lower-tier CFC in a current or prior year. The creditability of taxes paid or accrued on PTEP distributed through tiers of CFCs is an area that lacked specific guidance prior to the change in law, and requires rules distinct from those applicable to subpart F and GILTI inclusions, which only give rise to credits for current year taxes.

The proposed rules would track PTEP on an annual basis based on the separate limitation category assigned to the inclusion that generated the PTEP. Within each annual layer for each separate limitation category, PTEP would be further assigned to one of ten "PTEP groups," based on the underlying subpart F, GILTI, or section 956 inclusion that generated the PTEP (taking into account reclassifications of PTEP from section 959(c)(2) to section 959(c)(1)). For example, PTEP attributable to GILTI inclusions would be assigned to a PTEP group separate from PTEP attributable to subpart F inclusions, which would be tracked in three distinct PTEP groups (with two separate PTEP groups related to section 965 mandatory repatriation inclusions).

The proposed rules do not provide ordering rules for determining the PTEP group from which a distribution is made, although the preamble states that Treasury and the IRS anticipate addressing ordering rules in future guidance under section 959. The preamble also notes that the ten PTEP groups could change based on future section 959 guidance. Proposed rules under section 959 are expected to be issued in early 2019.

**KPMG observation:** Prior to the change in law, PTEP generally has been classified in only two categories, often referred to as "(c)(1) PTI" and "(c)(2) PTI." After the change in law, additional subgroups are necessary, due in part to different substantive rules that can apply to distributions of the various PTEP groups for foreign tax credit purposes, including reductions in creditable taxes attributable to PTEP groups related to mandatory repatriation inclusions, as well as the lack of carryforwards or carrybacks for PTEP groups related to GILTI inclusions assigned to the GILTI category.

Consistent with the statute, the proposed rules do not haircut creditable taxes on GILTI PTEP distributions, even though taxes attributable to GILTI inclusions are subject to a 20% reduction.

*Section 956*

The proposed rules would eliminate the ability to claim deemed paid credits for section 956 inclusions. Proposed rules under section 956 published in early November would limit the ability of corporate taxpayers to include amounts in income under section 956, while the proposed rule under section 960 would deny foreign tax credits in the limited cases in which the corporation has a section 956 inclusion.

**Foreign tax credit limitation—Basket rules**

The actual regulatory changes required under section 904 to accommodate the new category of income for GILTI inclusions were relatively modest given that the category is simply defined as the amount of income included under section 951A (plus, in a regulatory clarification that had been widely foretold, the amount of section 78 gross-up attributable to such inclusions). In contrast, the rules added to address foreign branch income are much more elaborate. In addition, substantial changes were made to the "look-through" rules under section 1.904-5 to bring the provisions in line with statutory changes made as part of the new law (and other legislation since the regulations were last updated).

*Foreign branch basket and income*

Prior to the enactment of the new law, the fact that foreign source income was earned through a foreign branch was generally irrelevant to the computation of a U.S. person's foreign tax credit limitation. Such income, along with the associated taxes, was assigned to the general category or passive category depending upon the nature of the income that was earned. The new law establishes a new foreign tax credit limitation category for foreign branch income, generally effective for tax years beginning after 2017. The statute defines foreign branch income (subject to an exclusion for passive category income) as "business profits … attributable to 1 or more qualified business units (as defined in section 989(a)) in 1 or more foreign countries." The foreign branch category is maintained on an aggregate foreign branch basis–that is, there are not separate categories for separate foreign branches or foreign jurisdictions.

Significantly, foreign branch income, defined by cross reference to the new foreign tax credit category, is excluded from income that is eligible to be treated as foreign-derived intangible income (FDII) under section 250(b)(3)(A).

*Definition of a foreign branch*

The proposed rules define a foreign branch by reference to the section 989 regulations, with modifications, such that a foreign branch must carry on a trade or business outside

the United States and maintain a separate set of books and records. Thus, activities undertaken within the United States would be excluded when determining whether activities rise to the level of a trade or business outside the United States.

Under section 1.989(a)-1(c), for activities to constitute a trade or business, they "must ordinarily include the collection of income and payment of expenses." This requirement created the possibility that a branch that does not earn any regarded income is not a QBU under section 989, regardless of the level of activity within the branch (for example, a maquiladora). In contrast, the proposed rules provide that, for purposes of determining whether this test is met in the context of section 904, disregarded transactions **are** taken into account and may give rise to a trade or business for this purpose.

**KPMG observation**: The decision to provide a rule taking into account disregarded transactions in determining whether the trade or business test is met for purposes of the foreign tax credit rules represents a departure from the current regulations under section 989. Accordingly, a branch that does not earn any regarded income (for example, because all of its transactions are with its owner) may constitute a foreign branch for purposes of the foreign tax credit limitation and section 250, but might not be treated as a QBU for purposes of section 987, which applies the definition in the section 989 regulations.

Notably, the foreign branch definition would not import the section 989 regulations' per se QBU rule for partnerships, but rather would provide that if a partnership's activities constitute a trade or business conducted outside the United States, then those activities will constitute a foreign branch even if the partnership does not maintain books and records for the trade or business that are separate from the partnership's books and records. Activities that constitute a permanent establishment in a foreign country under a bilateral U.S. income tax treaty would be presumed to constitute a trade or business conducted outside the United States.

*Foreign branch gross income—The basics*

Under the new law, foreign branch category income is limited to the income of a U.S. person attributable to foreign branches held directly or indirectly (via disregarded entities, partnerships, or other pass-through entities) by such U.S. person. Foreign persons (including CFCs) cannot have foreign branch income. The proposed rules would define a U.S. person for this purpose to exclude pass-through entities (for example, partnerships). As such, foreign branch category income would be determined at the U.S. corporate / individual level, applying an aggregate theory for partnerships. Generally, the proposed rules would attribute gross income to a foreign branch to the extent such gross income is reflected on the foreign branch's separate books and records, but would exclude the following:

- Income attributable to activities carried out in the United States.

- Income relating to stock held by the foreign branch, such as dividends, CFC and passive foreign investment company (PFIC) inclusions (for example, sections 951(a), 951A(a), and 1293(a)), and gain from the disposition of such stock (unless the stock is dealer property).

- Income from the sale of interests in entities that are treated as pass-throughs or disregarded for U.S. federal tax purposes, except in the case of a disposition of a partnership interest that is in the ordinary course of the foreign branch owner's trade or business. The ordinary course standard is deemed satisfied if there is at least 10% ownership of the entity and the owner and the entity are in the same or related businesses.

- Income or payments reflected (or not reflected) on the books and records if "a principal purpose" of recording (or not recording) the item is tax avoidance and the books and records do not reflect the substance of the transaction. For this purpose, a foreign branch's related party interest income (other than certain financial services income) is presumed to be excluded from foreign branch category income.

**KPMG observation**: These exclusions from foreign branch category income, and in particular the presumption for related party interest, seem motivated by a concern that taxpayers may try to artificially shift mobile, low-taxed income into an otherwise high-taxed foreign branch category, resulting in cross-crediting that would be contrary to the purpose underlying the enactment of the branch category.

*Foreign branch gross income—Disregarded payments*

In addition to respecting disregarded transactions in determining the existence of a branch, the proposed rules would generally take such transactions into account for purposes of determining the amount of gross income attributable to a branch. The preamble explains this rule as necessary for an accurate reflection of the gross income attributable to a branch, noting that this determination also governs the income that qualifies as FDII. The proposed rules generally would provide that gross income attributable to a foreign branch must be adjusted for otherwise disregarded payments between a foreign branch and its owner or between two foreign branches owned by the same owner if the payment would be deductible or capitalized if it were regarded for federal income tax purposes. The proposed rules would not treat such disregarded transactions as "regarded." Accordingly, such payments would continue to have no effect on the source, character, or total amount of the U.S. person's gross income. Instead, they are merely used to allocate that existing gross income between the foreign branch owner and the foreign branch. As a general matter, to determine the geographic source and character of an amount that is reallocated as a result of a disregarded payment, the principles of section 861 are applied to determine the gross income against which the disregarded payment would have been allocated if it were a regarded payment.

For example, a payment made by a foreign branch to its foreign branch owner (such as a disregarded royalty payment) may result in a downward adjustment to the gross income

attributable to the foreign branch and an increase in the general category gross income of its owner. If a hypothetical regarded royalty would have been allocable against foreign source income of the branch, then the reallocation will be of the branch's foreign source income to the general category income of the owner.

**KPMG observation**: In this example, the ability to reallocate some of the foreign branch income to be general category income may give rise to a FDII benefit. The disregarded royalty itself cannot qualify for FDII because it is not regarded as such for U.S. purposes. However, if the foreign branch used the licensed IP to export products, a portion of the regarded gross income from the export sales would potentially be deduction eligible income as it would no longer be disqualified foreign branch income. This result makes sense from a policy perspective because the U.S. person retained ownership of foreign use IP in the United States.

**KPMG observation:** This rule may result in U.S. source gross income being reallocated from the general category to the foreign branch category, in particular in situations where the U.S. owner makes disregarded payments to the branch. In addition, if the U.S. source income is properly subject to foreign tax (as may likely be the case since it is reflected on the books and records of a foreign branch), it may be eligible to be treated as foreign source income under the terms of an income tax treaty, in which case the resourced income would be subject to a separate foreign tax credit limitation for income resourced under a tax treaty. See section 904(d)(6).

In the case of otherwise disregarded transfers of intangible property to or from a foreign branch (regardless of any consideration exchanged) the proposed rules would also require the application of the principles under sections 367(d) and 482 to re-determine the appropriate allocation of income between the foreign branch and the foreign branch owner.

Certain disregarded payments, including certain interest and interest equivalents, would be excluded and thus not taken into account for purposes of determining the amount of gross income attributable to a foreign branch.

> **KPMG observation:** The foreign branch disregarded payment rules are among the most remarkable provisions in the proposed regulations package. They are notable for their complexity in creating a "virtual" company to determine the appropriate amount of income in the foreign branch. Such complexity may in some ways be justified by the importance of the foreign branch and its income in determining what income can qualify as "foreign derived deduction eligible income" that gives rise to the section 250 deduction.

*Treatment of financial services income*

The proposed rules provide that financial services income would be treated as foreign branch income to the extent attributable to a foreign branch, rather than automatically defaulting to the general category.

*Allocation and apportionment of taxes to the foreign branch category*

The proposed rules provide special provisions for allocating and apportioning foreign taxes related to disregarded payments to or from a foreign branch. In the case of disregarded payments or transfers that result in an adjustment to the gross income attributable to a foreign branch, a corresponding adjustment is required to allocate associated foreign taxes in the same manner as the reallocated foreign income to which such foreign taxes relate. For example, in the case of a disregarded royalty payment from a foreign branch to its owner that resulted in a reallocation of income from the foreign branch category to the general category, any foreign tax imposed solely by reason of that payment (for example, withholding taxes on the royalty) would be allocated to the general category. However, foreign tax imposed on disregarded payments from a foreign branch owner to a foreign branch that **would not** result in a reallocation of gross income would be allocated and apportioned to the foreign branch category. For other disregarded payments from the foreign branch to the foreign owner, the foreign tax imposed by reason of such payments would be allocated and apportioned to a separate category based on the nature of the item under general tax principles. For example, a remittance of an appreciated asset from a foreign branch to its owner that results in taxable gain under foreign law would be allocated and apportioned to the separate category to which such taxable asset gain would be allocable if the asset were sold in a recognition transaction.

Withholding tax imposed by a foreign jurisdiction upon a remittance from a foreign branch is attributable to a timing difference in the taxation of the income out of which the remittance is made, and is allocated and apportioned to the separate category or categories to which a section 987 gain or loss would be assigned under section 1.987-6(b).

**Foreign tax credit limitation—Look-through rules**

The proposed rules would modify existing “look-through” rules that apply to certain payments from CFCs to their U.S. shareholders and certain related parties. In keeping with section 904(d)(3), which was amended in 2004 but not revised by the new law, the proposed rules would apply look-through principles only to payments allocable to passive income; all other payments would be assigned to a separate category other than the passive category under the general rules of section 1.904-4. Under proposed section 1.904-4, amounts are assigned to the GILTI category only to the extent such amounts are included in income under section 951A. Importantly, a look-through rule was not provided to treat interest, rents or royalties paid by a CFC and which reduce tested income (that would otherwise be includible as GILTI) as GILTI category income.

**KPMG observation:** Numerous commentators had suggested that interest, rent, and royalty payments made to U.S. shareholders by CFCs should be characterized as GILTI category income to the extent attributable to tested income taxable under section 951A. Such a look-through rule would have increased the amount of limitation in the GILTI category FTC calculation, which would have been welcome relief to many corporations that have excess GILTI category taxes and nonetheless owe residual U.S. tax on GILTI

inclusions due to the effect of expense allocation on their FTC capacity in the GILTI category. Treasury and the IRS apparently determined either that they lacked the statutory authority to provide such rules and/or that such rules were inconsistent with the policies that led to very restrictive treatment (for example, the lack of carry-forwards) of taxes attributable to GILTI.

The modified look-through rules would apply to payments of dividends, interest, rents, and royalties from a CFC to its U.S. shareholder, as well as subpart F and GILTI inclusions. Consistent with the statute, the proposed rules would provide that dividends, interest, rents, and royalties received by a U.S. shareholder from a CFC would be excluded from the passive category unless the look-through rules provide otherwise. Again, such income that would be excluded from passive category income is assigned to another separate category under the rules of section 1.904-4. In most cases, such income would be assigned to the general category or the foreign branch income category. However, unlike under prior law, such amounts would not automatically be assigned to the general category.

*Interest*. Under existing rules that would remain unchanged, related person interest is first allocated by a CFC to passive foreign personal holding company income and characterized by the recipient accordingly. Remaining related person interest is proportionally allocated by the payor to separate categories other than passive. This treatment would not be altered under the proposed rules. Interest received by a U.S. shareholder from a CFC that is not characterized as passive category income under the look-through rules would be characterized under section 1.904-4.

*Rents and royalties*. Rents and royalties received by a U.S. shareholder from a CFC would be passive category income to the extent allocated to passive income of the CFC under the expense allocation and apportionment rules. Remaining rents and royalties would be characterized under section 1.904-4.

*Dividends*. Dividends from a CFC to a U.S. shareholder would generally be treated as passive category in proportion to the passive category E&P of the CFC to the total E&P of the CFC. The proposed rules would provide that a dividend from a CFC would not be attributable to passive category income to the extent the underlying income was subject to a rate of foreign tax in excess of 90% of the maximum U.S. rate under section 11.

**KPMG observation:** Due to the enactment of section 245A and its accompanying disallowance of foreign taxes, look-through for dividends would be of very limited significance.

*Subpart F income.* Subpart F inclusions would be treated as passive category income to the extent attributable to passive income received or accrued by the CFC. Remaining amounts would be treated as general category income or as otherwise prescribed under section 1.904-4.

*GILTI inclusions*. GILTI inclusions would similarly be treated as passive category income to the extent attributable to passive income received or accrued by the CFC. Remaining amounts are treated as GILTI category income or as otherwise prescribed under section 1.904-4.

*Application to payments from partnerships.* Payments of interest, rents, or royalties from a partnership to a 10% or greater partner acting in a non-partner capacity would generally be characterized under section 1.904-4 except to the extent they are attributable to passive category income of the partnership. Such attribution would be done under the principles of the section 861 regulations' expense allocation and apportionment rules by treating the partnership as a foreign corporation. This rule also applies to partnership payments made to a member of such a 10% partner's controlled group.

*Extension of look-through rules*. Consistent with the existing rules, the proposed rules would apply the look-through rules where an entity to which the look-through rules apply makes a payment to certain related entities to which the look through rules also apply.

**Foreign tax credit limitation—Transition rules**

As described above, the new law added two new additional section 904 income categories, or "baskets," for foreign branch income and GILTI income. The new law did not, however, provide explicit transition rules to address carryovers of FTC attributes from pre- to post-reform years, and vice versa. Such attributes include foreign tax credit carryovers under section 904(c), as well as overall foreign loss (OFL), overall domestic loss (ODL), and separate limitation loss (SLL) accounts that were created and "basketed" based upon the pre-reform categories.

The proposed regulations provide a relatively narrow set of transition rules addressing this issue. Specifically, taxpayers may elect, but are not required, to treat a portion of their pre-2018 general category FTC carryforwards as foreign branch category taxes to the extent the taxes would have been so allocated if they had arisen in a post-reform year. The proposed regulations contemplate that taxpayers who make this election must "roll back" to pre-reform years the complex computation and reallocation methods for determining the amount of foreign branch income and taxes in order to characterize the taxes, but the preamble requests comments on whether a simplified alternative method would be appropriate. If such election is made, other pre-2018 general category tax attributes such as OFLs and ODLs would be re-basketed to the foreign branch category in the same proportion as carryover FTCs are. Thus, if the taxpayer does not make the election discussed above, or has no FTC carryover attribute, there is no reallocation of the loss account attributes, regardless of the extent to which the taxpayer's prior general category losses were attributable to foreign branch activities. In addition, taxpayers that generate excess foreign branch credits in their first post-reform year are entitled to carry

those taxes back to their last pre-reform year, and upon doing so the taxes are re-basketed as general category.

**KPMG observation:** The decision to permit through election, but not require, re-basketing between general and foreign branch attributes will be welcome news to many taxpayers, as is the confirmation that 2018 excess foreign branch category taxes would be useable in the general category when carried back to 2017. Earlier in the year there had been some speculation that the government was considering whether to require re-basketing of a portion of general category attributes into the GILTI category, but happily for taxpayers the proposed regulations do not take such a draconian approach.

**Expense allocation**

The general framework of the current expense allocation and apportionment rules under section 861 was retained but was revised to take into account the new GILTI category and the addition of section 904(b)(4) (which disregards certain income and expenses in calculating the various FTC limitations). In a favorable change for domestic corporations, and based in part on language in the legislative history, the proposed rules would treat the portion of a GILTI inclusion that is offset by a section 250 deduction (as adjusted for the section 250 taxable income limitation) and a portion of the CFC stock giving rise to such portion of the GILTI inclusion as, respectively, exempt income and an exempt asset. As a result, section 864(e)(3) and the proposed rules would ignore such income and such asset for purposes of allocating and apportioning deductions. This would reduce the amount of expenses that are allocated and apportioned to the GILTI category, thereby generally making GILTI FTCs easier to claim.

Exempt income and assets also would include a portion of a domestic corporation's gross FDII and assets that produce gross income included in FDII, respectively. The portion of the asset that produces FDII that is treated as exempt is equal to the product of the value of the assets that produce gross income included in FDII and a fraction equal to the FDII deduction over FDII income.

**KPMG observation:** This formula appears to generally treat 37.5% of the "FDII producing assets" as exempt assets. The proposed regulations do not, however, provide a methodology for identifying the assets (or the portion of the assets) that produce FDII. It would be reasonable to expect the allocation rule to focus more narrowly on assets that produce "foreign derived deduction eligible income" as that is the income that is intended to be benefited by the section 250 deduction. Nevertheless, the proposed rules are unclear. Treating FDII assets as exempt assets would generally be expected to counteract some of the benefit of the GILTI rules, and could on a given taxpayer's facts, actually result in more of a taxpayer's interest expense being allocated against GILTI than would occur without these rules.

Subject to the foregoing change, interest expense generally continues to be allocated and apportioned under the asset method as required by section 864(e). As provided in the new law, taxpayers may no longer use the fair market value method for valuing assets

and must instead use the tax book value method or the alternative tax book value method for their first tax year beginning after December 31, 2017. Approval of the Commissioner would not be required for taxpayers currently on the fair market value method to change to one of the two allowable methods for that first tax year. Because the value of assets used for purposes of the assets method is an average of the beginning year and ending year value and the fair market value method would no longer be allowed, an elective transition rule would allow taxpayers to use as the beginning of year value the recomputed value as of the end of the taxpayer's first quarter in the first year the new method was used. Helpfully (and in contrast to the wording of current rules) the tax book value of an asset is specifically described as the adjusted basis of the asset.

It also is currently unclear how the allocation and apportionment of expenses would work for purposes of calculating the section 250 deduction related to FDII. The proposed regulations specifically provide, however, that the tax exempt rule does not apply for that purpose.

*Treatment of CFC stock*

The rules for characterizing CFC stock (located in proposed section 1.861-13) continue to look through to the assets or gross income of CFCs; however, the current rules would be significantly revised, mainly to ensure that a portion of the stock of a CFC will be characterized as a GILTI category asset if the taxpayer has a GILTI inclusion from such CFC (something the current rules would fail to do because CFCs do not themselves earn GILTI income).

Such rules would also characterize a portion of the stock of a CFC (or 10% owned foreign corporation) as stock that could give rise to a section 245A dividend for purposes of applying section 904(b)(4), which excludes expenses allocated and apportioned to such portion from the FTC limitation for each basket. As a result, interest expense apportioned to this grouping would not reduce general, passive, or (importantly) GILTI basket income; a taxpayer favorable result because the amount of foreign source taxable income in each of these baskets would be higher. However, section 904(b)(4) also requires that such expenses be added back to worldwide taxable income. Because worldwide taxable income is the denominator of the FTC limitation fraction, this adjustment would unfavorably take back some of the benefit of disregarding expenses allocated to section 245A dividends in the numerator of the FTC limitation fraction.

*Special rules for section 965*

Absent a special rule, the application of section 965 and the proposed rules thereunder would cause an uneconomic increase in the tax book value of the stock of specified foreign corporations where a deficit of one specified foreign corporation was used to offset the untaxed earnings of another specified foreign corporation. This is because section 965(b)(4)(B) creates a net increase in the aggregate E&P of the two corporations without any change in net asset basis or net stock basis. For example, if a taxpayer did not make the basis adjustment election, the basis in the stock of a taxpayer's E&P deficit foreign

corporation would not be reduced and, in any case, such corporation's E&P would be increased to the extent that the corporation's specified deficit was utilized to offset deferred foreign income. As a result, the tax book value of the corporation's stock (which is generally reduced by deficits) would be higher even though, economically, the entity's value has not changed. If a basis election was made, the tax book value of the stock of an E&P deficit foreign corporation may not be distorted because such election would cause a reduction in the basis of the corporation's stock equal to the increase in its E&P; however, the corresponding basis increase in the stock of a deferred foreign income corporation could cause that corporation's tax book value to be distorted.

To correct for these uneconomic effects and solely for purposes of valuing the stock of a CFC or 10% owned foreign corporation, the proposed rules would treat the taxpayer as having elected to apply the basis adjustment rule if it had not done so. Any increase in the basis of the stock that results from the elected application or deemed application of the basis adjustment rule is treated as a section 961 increase that is excluded from the tax book value of the stock.

The proposed rules contain several proposed rules regarding the effect of taxpayers making the section 965(n) election to waive the use of carryover, carryback, or current-year net operating losses (NOLs) against their net 965 income inclusion. Specifically, the proposed rules would prevent an electing taxpayer's net section 965 inclusion from being "walled off" or un-reduced by allocated and apportioned expenses for section 904 limitation purposes. The proposed rules would instead require that taxpayers treat the NOL that is not absorbed because of the section 965(n) election as being comprised of a proportionate amount of deductions in each of the respective limitation categories (including deductions allocated to U.S. source income). As a result, any electing taxpayer with expenses allocated or apportioned to foreign source income would have to treat those expenses as partially absorbed against the net section 965 inclusion for FTC limitation purposes, thus yielding a less than 100% section 904 capacity.

**KPMG observation:** Numerous taxpayers have already filed their 2017 calendar year returns reflecting a section 965(n) election, and may have determined their section 904 limitation in a manner different than the "clarification" set forth in the proposed regulation. Such taxpayers would now have to perform a more detailed analysis to implement the new guidance and consider the effects on their 2018 return reporting, section 965(h) installment payments, and the potential need to file an amended 2017 return.

*Other expense allocation issues*

The proposed rules would amended a number of provisions that the government appears to believe led to inappropriate results. Included in these provisions are rules providing for an exclusion of hybrid stock from the definition of related group indebtedness in the current CFC netting rules. The proposed regulations also would amend the treatment of interest (and interest equivalents including guaranteed payments) between partnerships and their partners or other related parties. Under current regulations, those payments fall within the look-through rules, but the deductions are allocated and apportioned at the

partner level under section 1.861-9(e)(2). As a result, purely internal transactions can result in reallocations of net income from one foreign tax credit category to another. Under the proposed regulations, these amounts will be directly netted against each other to avoid any overall impact on foreign tax credit capacity.

The proposed rules would not address (but request comments with respect to) the allocation and apportionment of many other expenses, including R&D, stewardship, and G&A expenses.

**Section 78**

Prior to amendment by the new law, section 78 provided that if a domestic corporation elects to take a foreign tax credit then the amount of taxes deemed paid by the domestic corporation shall be treated as a dividend received by the taxpayer (a "section 78 gross-up") for all purposes of the Code, except with respect to section 245. The new law amended section 78 to exclude the section 78 gross-up from dividend treatment for purposes of section 245A, effective for tax years of foreign corporations beginning after December 31, 2017 and for tax years of U.S. shareholders in which or with which such tax years end. Section 245A applies to distributions of foreign source E&P from a 10% owned foreign corporation to its corporate U.S. shareholder made after December 31, 2017 and, as a result under the Code, a section 78 gross-up from a 10% owned foreign corporation with a fiscal year ending in 2018 may qualify for a section 245A DRD. The proposed rules provide that a section 78 gross-up is not treated as a dividend for purposes of section 245A and would make such exclusion effective for section 78 gross-ups with respect to dividends received after December 31, 2017.

**KPMG observation:** While the mismatch between the effective date of new section 78 and section 245A appears to be an unintended drafting error, it is unclear whether a regulation alone can change the apparent result under the statute or if a legislative technical correction is needed instead.

## BEAT (base erosion and anti-abuse tax)

### Proposed regulations

On December 13, 2018, the Treasury and IRS released proposed regulations (REG 104259-18) under new section 59A. The proposed regulations were filed with the Federal Register on December 17, 2018, and were published in the Federal Register on December, 21, 2018 (**83 FR 65956**) [PDF 397]. The preamble to the proposed rules includes over 20 requests for comment. It was indicated that any comments or requests for a public hearing are due by February 19, 2019.

The following discussion is drawn from a **KPMG report** dated December 17, 2018, on the proposed regulations as initially released on December 13, 2018. See **Insurance section** of this supplement for observations from another KPMG report on insurance issues.

**Effective dates and reliance**

The proposed rules generally are proposed to apply to taxable years beginning after December 31, 2017, citing the authority for regulations issued within 18 months of the date of the enactment of a new statute to apply retroactively to the effective date of the statutory provision to which the regulation relates. Notably, and perhaps in recognition of the advancing calendar, the preamble also addresses the possibility of the proposed rules not being finalized within the 18-month window, by providing that Treasury and the IRS generally expect that any provision of the proposed regulations that is finalized after June 22, 2019, would apply to taxable years ending on or after the date the proposed regulations are filed with the Federal Register.

The proposed regulations were filed with the Federal Register, on December 17, 2018. This would allow the proposed regulations to apply to taxpayer years ending on December 31, 2018. It is also noteworthy, however, that the preamble does not discuss the impact of section 1503(a), which generally requires that any special consolidated return rules must be adopted by the un-extended due date of the return in order to retroactively apply.

Prior to finalization, taxpayers are permitted to rely on the proposed regulations for years beginning after December 31, 2017, provided the taxpayer and all related parties consistently apply the proposed regulations for all such taxable years that end before the regulations are finalized. Significantly, this phrasing suggests that changes between proposed and final regulations may be made fully retroactive.

**Background**

New section 59A imposes an addition to tax (the “base erosion and anti-abuse tax” or “BEAT”) that targets certain deductions or similar tax benefits (“base erosion tax benefits”) attributable to “base erosion payments” made to foreign related parties by certain “applicable taxpayers.” An applicable taxpayer is a corporation (other than an S corporation, a regulated investment company, or a real estate investment trust) that has average annual gross receipts of at least $500 million for the 3-taxable-year period ending with the preceding taxable year, and has a “base erosion percentage” (generally the ratio of base erosion tax benefits over the aggregate deductions (with limited exceptions) allowable to the taxpayer during the taxable year) in excess of 3%. The base erosion percentage threshold is dropped to 2% in the case of taxpayers that are members of affiliated groups containing a bank or registered securities dealer.

The BEAT acts as a minimum tax that applies to the extent that a tentative BEAT calculated on “modified taxable income” exceeds regular tax liability. For these purposes, modified taxable income generally is calculated like taxable income, but with no deduction allowed for (i) “base erosion tax benefits” attributable to base erosion payments to foreign related parties, or (ii) a portion of the net operating loss (“NOL”) deduction allowed during the taxable year. In addition, the tentative BEAT is calculated without giving any benefit for credits, whereas the regular tax liability to which this amount is compared generally is

calculated after taking into account the effect of credits, including the foreign tax credit, with only limited exceptions for taxable years beginning before 2026 for the R&D credit and certain section 38 credits. The lack of a foreign tax credit under the BEAT makes it imperative for many taxpayers to keep their base erosion percentage below the applicable threshold.

The BEAT applies at a 5% rate for taxable years beginning in 2018, 10% for taxable years beginning in 2019 through 2025, and 12.5% for taxable years beginning in 2026 or later. The rate is one percent higher for any taxpayer that is a member of an affiliated group that includes a bank or registered securities dealer.

**Overview**

The proposed BEAT regulations provide guidance on a wide range of issues, including which taxpayers will be subject to section 59A (including guidance on how to determine gross receipts and base erosion percentage); the scope of what is included as a base erosion payment and a base erosion tax benefit; and the method for calculating modified taxable income and the base erosion minimum tax amount. The proposed rules also provide guidance on reporting requirements, the application to consolidated groups and partnerships, and the interaction with the interest expense limitation under section 163(j). The following features of the proposed rules, which are discussed in greater detail below, appear particularly noteworthy:

- **Application of section 15.** The proposed regulations provide that for taxable years beginning after January 1, 2018, section 15 will apply to any taxpayer using a taxable year other than the calendar year. The reference to section 15 is unclear. It at least implies that the section 15 blended rate regime applies to fiscal year filers for tax years beginning in 2018 and taking into account the change in the BEAT rate from 5% to 10%. Thus, for example, if section 15 applies to an 11/30 taxpayer, the resulting blended BEAT rate would be 9.58% for the tax year end 11/30/19. As noted in more detail below, this result is not completely clear from the proposed regulations themselves, and appears inconsistent with the structure of the BEAT statute.

- **Add-back approach for modified taxable income ("MTI") calculation.** The BEAT statute could be read to contemplate a full recalculation of taxable income in order to arrive at MTI. The proposed rules provide instead that MTI is computed by starting from taxable income or loss as computed for regular income tax purposes, and then simply adding back any gross base erosion tax benefits and the base erosion percentage of the NOL deduction allowed under section 172 for the tax year. This means, for example, that the amount of interest allowed under section 163(j) would not be redetermined to take into account any increase to MTI.

- **Treatment of NOLs for BEAT purposes.** The proposed rules provide that the base erosion percentage applicable to NOLs for purposes of the MTI calculation is the percentage associated with the "vintage" year in which the NOL was incurred, rather than the base erosion percentage associated with the year in which the NOL is applied

to reduce taxable income. This has the effect of treating the base erosion percentage of an NOL that arose in a taxable years beginning before January 1, 2018, as zero. In addition, with respect to pre-2018 NOLs, the proposed rules would limit the amount of the NOL that can be taken into account for BEAT purposes to the amount that is necessary to reduce regular taxable income to zero ($0). Thus, while a current year loss would result in negative taxable income as a starting point for the MTI calculation, an NOL would not reduce taxable income below zero for that purpose.

- **Broad scope of "amounts paid or accrued."** The proposed rules provide that an "amount paid or accrued" for purposes of defining a base erosion payment subject to the BEAT is not limited to cash payments, and would also include amounts paid or accrued using any other form of consideration including property, stock or the assumption of a liability. The preamble to the proposed rules notes that no exception is provided for transactions eligible for nonrecognition treatment.

- **Services cost method ("SCM") exception.** The proposed rules provide that the exception for services that are eligible to be priced using the services cost method under section 1.482-9(b), but for the business judgment rule in section 1.482-9(b)(5), is available even when a mark-up is charged; in such case, only the portion of the payment exceeding the total services cost will not be eligible for the exception. The proposed rules provide books and records requirements that apply for purposes of the SCM exception.

- **Aggregation rule.** The BEAT statute provides for an aggregation rule treating members of the same controlled group as a single person for purposes of determining whether a taxpayer is an applicable taxpayer and what base erosion percentage will apply to that taxpayer. The proposed rules clarify that the aggregation rule will exclude foreign members of the controlled group except to the extent that they are subject to U.S. income taxation on their net income. The proposed rules also provide rules for calculating gross receipts and the base erosion percentage of an aggregate group, including rules for an aggregate group that includes taxpayers with different tax years.

- **ECI exception.** The proposed rules provide an exception from the scope of base erosion payments for amounts that are subject to tax on a net basis in the United States because they are treated as effectively connected with a trade or business or as profits attributable to a permanent establishment under a U.S. tax treaty.

- **Interaction with section 163(j).** The proposed rules reverse the rule announced in Notice 2018-28 for section 163(j) carryforwards from pre-effective date tax years. The proposed rules provide that such interest would not constitute a base erosion payment when allowed. The proposed rules also provide detailed rules regarding the interaction with section 163(j), including how to classify the remaining interest for which deductions are allowed when section 163(j) applies (e.g., as paid to related or unrelated, U.S. or foreign, persons).

- **Qualified derivative payments.** The proposed rules narrow the BEAT statute's broad definition of derivatives by removing securities lending transactions, sale-repurchase transactions, and substantially similar transactions from the scope of derivatives covered by the exception. The proposed rules also include reporting requirements that apply with respect to QDPs, and address the effect of noncompliance.

- **Allocation of expenses.** The proposed rules provide that a foreign corporation with interest or other expenses allocable to effectively connected income will be treated as making base erosion payments to the extent the expense results from a payment or accrual to a foreign related party. In the case of interest, the proposed rules provide that the allocation would depend on the interest expense allocation method otherwise used by the taxpayer. Notably, in the case of a taxpayer relying on a tax treaty method that would recognize payments between a branch and a foreign home office for purposes of determining taxable profits, such payments would be treated as subject to the BEAT even though they are not otherwise recognized for U.S. tax purposes.

- **Aggregate approach to partnerships.** The proposed rules generally adopt an aggregate approach for characterizing payments made to or by a partnership. That is, payments made by a partnership with corporate partners generally would be treated as made by those corporate partners. Consistent with this aggregate approach, whether a recipient of a payment is a foreign related person would also be determined at the partner level. The proposed rules also provide a new exception that would disregard allocations of base erosion tax benefits to de minimis partners.

**Reporting requirements**

The new law amended section 6038A to authorize regulations requiring reporting by corporations that are applicable taxpayers for BEAT purposes. The proposed rules identify information that will be required to be reported, along with the time and manner for such reporting. The proposed rules also provide that the IRS may require certain additional information reporting via forms or form instructions.

**Anti-abuse rule**

Section 59A(i) provides Treasury and the IRS with extremely broad anti-abuse authority, which raises significant questions about how taxpayers would be permitted to manage their BEAT liability. The proposed rules provide a number of specific anti-abuse rules addressing relatively narrow factual situations. In addition, the proposed rules provide more general anti-abuse rules focused on transactions, plans, or arrangements with a principal purpose of: (1) avoiding or reducing base erosion payments through the use of intermediaries; (2) increasing the deductions taken into account for purposes of the denominator of the base erosion percentage; and (3) avoiding the rules applicable to banks and registered securities dealers.

**Applicable taxpayer**

*In general*

Section 59A applies to certain sizable taxpayer groups, for which so-called U.S. base erosion payments comprise a specified percentage of their deductible payments ("applicable taxpayers"). As stated above, section 59A(e) defines an applicable taxpayer as a corporation (other than a regulated investment company ("RIC"), real estate investment trust ("REIT"), or S corporation) or, as discussed further below, a controlled group of corporations that has both average annual gross receipts of at least $500 million for the three preceding taxable years (the "Gross Receipts Test"), and a base erosion percentage for the taxable year in excess of the applicable threshold (the "Base Erosion Percentage Test"). The proposed rules would expand the aggregation rules and provide operating rules for applying the Gross Receipts and Base Erosion Percentage Tests. The proposed rules also would provide rules applying the Applicable Taxpayer requirements in the partnership context.

*Aggregation rules*

For purposes of determining applicable taxpayer status, section 59A(e)(3) adopts a modified version of the section 1563(a) group rules, applying a 50% ownership threshold, to treat an "aggregate group" of corporations as one taxpayer. Once the aggregate group is determined, the proposed rules would require each taxpayer that is a member of the aggregate group to determine its gross receipts and base erosion percentage as of the end of its taxable year. To do so, each member must take into account the gross receipts and base erosion tax benefits of all of the members of the aggregate group. For these purposes, the proposed rules would eliminate payments between members of the aggregate group, so that a deductible intragroup payment would generate neither additional gross receipts nor tested deductions. As discussed further below, the proposed rules broadly take an aggregate approach to partnerships, and test partners' distributive shares of partnership items (gross receipts, deductions, etc.) at the partner level.

The proposed rules generally would exclude foreign corporations from the aggregate group, except with regard to transactions related to income that is, or is treated as, income effectively connected with the conduct of U.S. trade or business ("ECI"). If a foreign corporation qualifies for the benefits of a tax treaty, only transactions related to the net taxable income of a U.S. permanent establishment are taken into account.

**KPMG observation:** Under the proposed rules, all payments between domestic members of an aggregate group would be disregarded for purposes of the Gross Receipts and Base Erosion Percentage Tests. Note that this rule is applied on a transaction-by-transaction basis. Because foreign corporations are treated as members of the aggregate group only to the extent transactions are treated as giving rise to ECI (or included in determining net income under a treaty), the same foreign corporation may be considered a member of an aggregate group with respect to one transaction but not another. For example, assume that a foreign corporation (Foreign Parent) that is not located in a treaty

jurisdiction wholly owns U.S. Subsidiary, and also has a U.S. trade or business subject to U.S. federal income tax on its net income. U.S. Subsidiary makes two deductible payments to Foreign Parent – one that is included in Foreign Parent's ECI and one that is not. Foreign Parent would be considered part of the aggregate group with respect to the ECI-related payment and, therefore, the payment would be disregarded in determining applicable taxpayer status. However, Foreign Parent would not be part of the aggregate group with respect to the non-ECI payment, and that payment would be taken into account for purposes of the Gross Receipts and Base Erosion Percentage Tests.

**KPMG observation:** Foreign financial institutions frequently conduct their U.S. business though both a U.S. branch of the foreign bank and a consolidated group of corporations that are generally required to be organized under a single U.S. entity. It is customary for frequent payments to be made between the U.S. branch and the members of the consolidated group, and there was a concern the ECI-related payments would be included in both the Gross Receipts and Base Erosion Percentage Tests. The proposed rules' aggregate approach should be welcome news for these institutions.

Notably, for aggregate groups that include members that are separate taxpayers (e.g., different U.S. consolidated groups) with different taxable years, the proposed rules would require each separate taxpayer to apply the Gross Receipts and Base Erosion Percentage Tests based on the aggregate group's data but computed with respect to the separate taxpayer's individual taxable year. That is, the proposed rules do *not* take the more common approach of referring to the taxable years of other taxpayers that end with or within the taxable year of the relevant taxpayer.

**KPMG observation:** These rules could cause aggregate group members with different taxable years to reach very different results with respect to their base erosion percentages and average annual gross receipts. The preamble states that the approach in the proposed rules is intended to provide certainty for taxpayers and to avoid the complexity of using a single taxable year for an aggregate group, yet this approach could create significant data collection and systems challenges for groups with numerous, separate U.S. taxpayers. The preamble appears to acknowledge these potential challenges by stating that taxpayers may use a reasonable method to determine the gross receipts and base erosion percentage information of members with different taxable years. This language does not, however, appear in the actual text of the proposed rules.

The regulations also would provide a transition rule for groups with members that have fiscal years beginning before January 1, 2018 and ending in 2018. The rule provides that each taxpayer must determine the scope of pre-effective date payments by using its own taxable year for all members of the taxpayer's aggregate group. Thus, a fiscal year taxpayer would only take into account amounts paid or accrued by the aggregate group during its first year in which section 59A is effective. Correlatively, a calendar year group member must take into account amounts paid or accrued by fiscal year group members during all of 2018, even if a portion of those amounts are pre-effective date payments with respect to those fiscal year members.

*Partnership transactions*

Partnerships are not themselves included as applicable taxpayers or members of an aggregate group. Instead, the proposed rules generally would take an aggregate approach to partnerships and apply section 59A at the partner level for purposes of determining whether a corporate partner is an applicable taxpayer.

For purposes of applying the Gross Receipts Test, a U.S. corporate partner in a partnership would take into account its distributive share of the partnership's gross receipts (if necessary, through tiers of partnerships). A foreign corporate partner would do the same, but take into account only its distributive share of items related to ECI (or, in the treaty context, to net taxable income).

For purposes of applying the Base Erosion Percentage Test, a partner in a partnership generally is treated as having paid or accrued its allocable share of amounts paid or accrued by the partnership. The determination of whether a payment by a partnership is made to a related foreign person is determined by reference to its partners. Similarly, for purposes of characterizing a payment made to a partnership, the payor is treated as having paid an amount to each partner, based on that partner's allocable share of partnership income.

The proposed rules would provide a de minimis exception for purposes of determining the amount of a partner's base erosion tax benefits – but not for purposes of determining the partner's gross receipts. Under the exception, a partner would not be required to take into account its distributive share of any of the partnership's potential base erosion tax benefits for the taxable year if all three of the following requirements are satisfied: (i) the partner's interest in the partnership represents less than 10% of the capital and profits of the partnership at all times during the taxable year; (ii) the partner is allocated less than 10% of each partnership item of income, gain, loss, deduction, and credit for the taxable year; and (iii) the partner's interest in the partnership has a fair market value of less than $25 million on the last day of the partner's taxable year, determined using a reasonable method.

**KPMG observation:** The statute does not specifically address the treatment of partnerships. However, U.S. partnerships generally are treated as U.S. persons and foreign partnerships generally are treated as foreign persons for U.S. federal income tax purposes. As a result, a literal application of the statute could have produced BEAT liability on payments entirely within the U.S. tax system, and conversely could have ignored payments which were functionally outbound deductions to related parties. By taking an aggregate approach, the proposed rules would prevent the existence of a partnership (foreign or domestic) from producing different results than would have arisen had the partners entered into the transaction directly.

*Gross receipts test*

The proposed rules include a number of rules for purposes of applying the Gross Receipts Test, i.e., determining whether the average annual gross receipts of the aggregate group (with reference to that taxpayer's taxable period) for the prior three-taxable-year period are at least $500 million.

First, the proposed rules reference section 1.448-1T(f)(2)(iv) for the general definition of gross receipts. The gross receipts of a consolidated group are determined by aggregating the gross receipts of all of the members of the consolidated group (but eliminating intra-group payments). Consistent with the rule noted above, a foreign corporation's gross receipts include only gross receipts that are included in determining ECI or, under an applicable tax treaty, in net taxable income attributable to a U.S. permanent establishment. For any corporation that is subject to tax under subchapter L (or any corporation that would be subject to tax under subchapter L if that corporation were a domestic corporation), gross receipts are reduced by return premiums, but are not reduced by any reinsurance premiums paid or accrued.

The proposed rules also provide operating rules for a variety of extraordinary events (such as mergers) occurring during the three year testing period. In the context of a section 381(a) transaction in which the taxpayer was the acquiring corporation, the proposed rules would apply the gross receipts test by including any predecessor to the taxpayer (the "predecessor rule"). In addition, any taxpayer with a taxable year of less than 12 months is required to annualize its gross receipts from the short period (the "annualization rule"). Finally, any taxpayer not in existence for the entire three-year testing period must determine its average annual gross receipts for the period that it was in existence, taking into account the annualization rule (the "short testing period rule").

**KPMG observation:** Although the proposed rules do not clearly provide an ordering protocol among the three special rules, it seems reasonable to apply the predecessor rule first, then to apply the annualization rule, and finally to apply the short testing period rule. Consequently, the data for predecessor and successor corporations are first combined, and annualization would only apply if there is any remaining short year during the testing period. If the taxpayer still has fewer than three prior taxable years in the testing period, the average annual gross receipts are calculated only with respect to those years the taxpayer was in (or, under the annualization rule, is treated as in) existence.

**Base erosion percentage test**

*Base erosion percentage threshold*

Under section 59A(e), a taxpayer generally satisfies the Base Erosion Percentage Test if the taxpayer has a base erosion percentage (calculated under the aggregation rules discussed above) of three percent or more.

As a general matter, an aggregate group that includes a member of an affiliated group (as defined in section 1504(a)(1)) that includes a domestic bank or a registered securities dealer is subject to a two percent threshold. The proposed rules would include a de minimis exception that turns off the lower, two percent threshold for a taxable year if the total gross receipts of the aggregate group that are attributable to the bank or the registered securities dealer represent less than two percent of the total gross receipts of the aggregate group. The de minimis rule applies to a consolidated group, if there is no aggregate group.

**KPMG observation:** This rule likely will provide welcome relief for groups that primarily conduct a non-financial services business but own a small bank within their affiliated group. For example, a number of large retailers own small banks that provide limited banking services to their customers (e.g., credit card services). Further, taxpayers otherwise subject to the three percent threshold may not be negatively impacted if they acquire a target group that includes a small bank or registered securities dealer.

The proposed rules also would clarify that only corporations satisfying the requirements of section 581 are treated as a "bank". Among other requirements, section 581 provides that a bank must be incorporated and doing business under the laws of the United States (including laws related to the District of Columbia) or any state. Therefore, foreign financial institutions that only operate in the United States through a U.S. branch would not be treated as a bank for these purposes.

*Base erosion percentage calculation*

Under section 59A(c)(4), a taxpayer's base erosion percentage for a taxable year is calculated using the following fraction (with all referenced amounts arising during the taxable year) –

- The aggregate amount of base erosion tax benefits (the "numerator"), divided by
- An amount (the "denominator") equal to:
  - The aggregate amount of the taxpayer's allowable deductions as well as certain base erosion tax benefits arising from reductions to gross income (described below);
  - Reduced by
    - Deductions allowed under sections 172 (NOLs), 245A (participation exemption), or 250 (FDII and GILTI);
    - Deductions for payments for services that qualify for the SCM Exception; and
    - Deductions for payments that qualify for the QDP Exception.

As referenced above, certain reductions from gross income qualify as base erosion tax benefits. Those base erosion tax benefits–certain premiums or other consideration paid to a foreign related party for reinsurance, and reductions of gross income arising from payments to certain expatriated entities–are included in both the numerator and the denominator.

The proposed rules provide several taxpayer-favorable rules for calculating the base erosion percentage. The proposed rules would clarify that the numerator does not include deductible payments to related foreign persons that qualify for one of the exceptions to the definition of a base erosion payment. In addition, the proposed rules would include in the denominator an amount paid to a related foreign person that is not a member of the aggregate group if the payment qualifies for the ECI Exception and the payment also qualifies for either the QDP Exception, TLAC Exception, or SCM Exception (all discussed further below). The preamble to the proposed rules also confirms that a deduction allowed under section 965(c) is included in the denominator, as it is not one of the categories of deductions specifically excluded from the denominator under the statute.

On the other hand, the proposed rules also would expand the list of items that are excluded from the denominator of the fraction to include: (i) any exchange loss from a section 988 transaction; (ii) any amounts that qualify for the TLAC Exception discussed below; and (iii) any deduction not allowed in determining taxable income for the taxable year.

Finally, the proposed rules would require a scaled inclusion of base erosion tax benefits related to payments subject to U.S. withholding tax. A base erosion tax benefit is not included in the numerator if the payment was subject to withholding tax under sections 871 or 881 (as non-ECI FDAP) and withholding has occurred. Full withholding (i.e., at the statutory rate) results in elimination of the full amount of the base erosion tax benefits from the numerator. Partial withholding, i.e., under an applicable income tax treaty, results in elimination of a proportionate amount of the base erosion tax benefits from the numerator. For example, a 10% withholding tax – imposition of 1/3 of the statutory withholding tax rate – eliminates 1/3 of the base erosion tax benefit from the numerator.

*Mark-to-market deductions*

The proposed rules would provide specific rules for determining the amount of deductions that are included in the denominator that arise from mark-to-market transactions (e.g., contracts that are marked-to-market under sections 475 and 1256). For any position with respect to which the taxpayer (or a member of the aggregate group) uses mark-to-market tax accounting for U.S. federal income tax purposes, the taxpayer must determine its gain or loss with respect to that position by combining all items of income, gain, loss, or deduction arising with respect to the position during the taxable year. If the combination of these items results in a net loss, the taxpayer would include the net loss in the denominator, unless the QDP Exception applies.

**KPMG observation:** The proposed rules clarify the treatment of contracts subject to mark-to-market tax accounting. Taxpayers' systems may track these positions differently, particularly taxpayers that are not generally mark-to-market taxpayers (e.g., corporations that apply mark-to-market to hedging transactions). Additional flexibility in calculating income or loss from mark-to-market positions may be helpful.

**KPMG observation:** The proposed rules do not provide further clarity as to how to define a "transaction" that is marked-to-market for federal income tax purposes. Presumably, the determination should be made for each contract (e.g., ISDA confirmation, trade ticket).

**KPMG observation:** As discussed above, section 988 exchange losses from a section 988 transaction would be excluded from the denominator. Many foreign currency derivative contracts are marked-to-market for tax purposes (e.g., certain foreign currency forward contracts that are subject to section 1256 and derivatives referencing foreign currency that are subject to section 475). The losses on these contracts may qualify as section 988 exchange losses and would therefore need to be excluded from the denominator. This result is inconsistent with the statutory treatment of payments on other mark-to-market derivatives, which are only excluded from the denominator to the extent of the exclusion from the numerator. It is unclear why Treasury and the IRS provided this disparate treatment for section 988 losses, and in the preamble, the government requested comments on the treatment of section 988 losses in the denominator of the base erosion percentage calculation.

### Base erosion payments

The BEAT statute defines a base erosion payment to include payments or accruals by a taxpayer to a foreign related party that fall into one of four categories: (i) payments for which a deduction is allowable; (ii) payments made in connection with the acquisition from the foreign related party of depreciable or amortizable property; (iii) premiums or other consideration paid for reinsurance, and (iv) certain payments with respect to a surrogate foreign corporation or its expanded affiliated group that result in a reduction of the taxpayer's gross receipts. Specifically excluded from this definition, however, are qualified derivative payments, as well as certain payments that would otherwise qualify for the service cost method (without regard to the so called "business judgment rule" in section 1.482-9(b)(5)).

The proposed rules provide operating rules for determining whether an amount is a base erosion payment, provide guidance on the scope of the statutory exceptions already in place, and add several new exceptions from the definition of base erosion payment.

### Operating rules

As a preliminary matter, the proposed rules take an expansive view of the circumstances in which a base erosion payment may arise. In particular, Treasury clarified the types of consideration that may be treated as an "amount paid or accrued" to include not only payments made in cash and property, but also stock or the assumption of a liability. The

preamble further notes that in some cases, a non-cash payment to a foreign party may meet the definition of a base erosion payment in the context of a transaction that qualifies under certain non-recognition provisions of the Code. The preamble lists as examples of such transactions a domestic corporation's acquisition of depreciable assets from a foreign related party in an exchange described in section 351, a liquidation described in section 332, and a reorganization described in section 368. The preamble notes that no specific exception is provided for transactions eligible for nonrecognition treatment, and includes a fairly extensive discussion of why Treasury and the IRS believe that to be the correct result, emphasizing that the statutory definition of a base erosion payment that results in the acquisition of depreciable or amortizable assets in exchange for a payment or accrual to a foreign related party is based on the amount of imported basis in the asset, which applies equally to carryover basis in a nonrecognition transaction. Although asserting the existence of a "payment" by the shareholder in a liquidation of its subsidiary, the preamble does acknowledge that the receipt of property by the shareholder in a non-liquidating distribution under section 301 is not a "payment" for BEAT purposes.

The preamble also suggests that, with respect to the first category of base erosion payments, a transfer of property to a foreign related party may constitute a base erosion payment if the transfer results in a deductible loss. The preamble requests comments on the appropriate treatment of non-cash consideration.

**KPMG observation:** In light of this broad view of what constitutes a base erosion payment, taxpayers should carefully consider the BEAT implications of internal restructurings resulting in inbound transfers of depreciable or amortizable property, including those involving only stock consideration. Taxpayers should also consider the BEAT implications of outbound sales or other transfers of assets to related parties that may result in a loss for U.S. tax purposes.

The proposed rules also provide that a taxpayer should determine its base erosion payments on a gross basis, regardless of any contractual right to settle obligations by offsetting amounts owed by one party against obligations owed to it by the other party. The preamble notes, however, that where generally applicable U.S. tax law would allow the computation of deductions on a net basis, the proposed rules do not change that result. The preamble further notes that other existing general tax principles that may impact deductibility or that may exclude an item from gross income because it is beneficially owned by a different person generally will have consequences for Section 59A as well as for other provisions of the Code.

**KPMG observation:** Given the higher stakes under the BEAT on the classification of related party payments, now is a good time for taxpayers to revisit their existing arrangements with foreign related parties to determine which amounts are appropriately treated as deductions as opposed to other forms of transactions (such as partnerships, agency, or co-ownership of assets or income streams), taking into account the underlying contractual agreements and the application of general U.S. tax law principles for attribution of gross income. Taxpayers should also ensure that they consistently take into

account the effect that positions taken with respect to the BEAT have for general income tax purposes.

**KPMG observation:** The application of these rules in the context of cost-sharing arrangements under section 1.482-7 may be of particular interest to many taxpayers. The cost-sharing regulations provide that certain payments ("CST Payments") from one participant to another are treated as reducing the recipient's deductions for amounts it has paid (rather than being gross income to the recipient). This raises two related questions – first whether the related party payor should therefore be treated as directly making the payments for which the recipient's deductions are reduced (for example under a deemed agency treatment), and second whether a similar treatment should apply for all expenses incurred pursuant to the cost-sharing arrangement (i.e., disaggregation) rather than just for CST Payments made between the parties. In public comments last week [i.e., in mid-December 2018], a Treasury official indicated that the cost-sharing regulations should not be read so broadly as to create that kind of deemed transaction in either context. Rather, the CST Payment should be respected as a deductible payment made to the recipient of the CST Payment and only in the amount of the CST Payment. All other amounts incurred in connection with the cost-sharing arrangement should be treated as payments by the participant that actually incurred the amounts and paid to the person actually receiving the amounts.

The proposed rules provide rules for foreign taxpayers with a U.S. trade or business or a permanent establishment to determine the amount of base erosion payments allocable against their effectively connected income or business profits. These rules distinguish between foreign taxpayers that calculate their taxable income by applying U.S. expense allocation rules and those that rely on a treaty to apply a method of expense allocation that differs from U.S. domestic tax rules (e.g. by allocating costs to the permanent establishment based on its assets used, risks assumed, and functions performed).

With respect to foreign taxpayers applying U.S. expense allocation rules, the proposed rules generally follow the approach in the current regulations for interest (section 1.882-5) and other deductions (section 1.882-4) incurred by a foreign person in the conduct of its U.S. trade or business. Any payments that are paid to a related foreign person that are allocated against the foreign corporation's ECI are generally treated as base erosion payments subject to an applicable exception. With respect to interest expense, the proposed rules provide detailed rules that differ in approach depending on whether a taxpayer uses the adjusted U.S. booked liabilities (AUSBL) method or the separate currency pools method under section 1.882-5. In general, a taxpayer will have base erosion payments based on the identity of the recipient of interest that is directly allocated to ECI (or that is paid with respect to U.S. booked liabilities for AUSBL taxpayers). Any remaining interest expense will be treated as base erosion payments in accordance with the ratio of the average worldwide liabilities due to foreign related parties over average total worldwide liabilities.

With regard to foreign taxpayers relying on an income tax treaty to attribute interest and other deductions on the basis of assets used, risks assumed, and functions performed,

the proposed rules generally recognize amounts that are treated as deductible payments between the permanent establishment and the foreign corporation's home office or another branch of the foreign corporation for purposes of calculating attributable profit— referred to as internal dealings— as base erosion payments.

**KPMG observation:** Treating otherwise disregarded amounts between a U.S. branch and other parts of the same entity as payments to a related person stands in stark contrast to the allocation rule that applies to taxpayers applying section 1.882-5, which appears intended to limit base erosion payments to the U.S. branch's share of interest expense that the foreign corporation in fact pays to other persons that are foreign related parties.

As noted above, the proposed rules adopt an aggregate view of partnerships for purposes of identifying base erosion payments. In addition, the proposed rules provide rules deeming there to be base erosion payments in the case of certain payments to other "domestic passthrough" entities, including trusts, REITs, and RICs, that are owned in whole or in part by foreign related parties. An additional anti-abuse rule addresses certain transfers of depreciable or amortizable property between related parties.

**KPMG observation:** The rules addressing non-partnership domestic passthrough entities and transfers of property to related taxpayers appear to be intended to prevent taxpayers from converting base erosion payments into non-base erosion payments by using U.S. entities or entities that are not "applicable taxpayers" to "cleanse" the payments without giving up tax benefits.

*Exceptions*

The proposed rules clarify several questions related to certain exceptions to the definition of base erosion payment and also add several new exceptions.

- **SCM Exception:** The proposed rules clarify that outbound payments with respect to services that are otherwise eligible for the services cost method exception (without regard to the business judgment rule) (the "SCM exception") would not be disqualified by the fact that a mark-up is charged on such payment. Instead, the cost component of the payment would continue to qualify for the SCM exception while the amount charged as a mark-up generally would constitute a base erosion payment. Helpfully, the proposed rules would confirm that an election to use the services cost method and the satisfaction of other reporting requirements relevant to the services cost method are not required to meet the SCM exception. However, the taxpayer would be required to maintain adequate books and records from which the IRS could verify the total amount of the payment and the total costs of the services.

- **QDP Exception:** The proposed rules also include guidance on the scope of the exception for qualified derivative payments (the "QDP exception"), including guidance on the associated reporting requirements. First, the contract pursuant to which the payment is made must constitute a "derivative" under the BEAT statute. The proposed rules provide that, because of their similarity to a secured loan, a sale-repurchase

agreement and a securities lending transaction would not be treated as derivatives for purposes of the QDP exception. Treasury requests comments on whether excluding these transactions was appropriate. The proposed rules also would provide that ADRs and certain insurance contracts are not derivatives.

- Second, by its terms, the QDP exception only applies when the taxpayer satisfies certain reporting requirements, which raised concern among taxpayers that the misreporting of one derivative payment could forfeit the QDP exception for all derivative payments. Helpfully, the proposed rules would clarify that, if a taxpayer satisfies the reporting requirements for some, but not all, of its derivative payments, those payments that met the reporting requirements would continue to satisfy the QDP exception. In contrast to the general applicability date of the proposed rules, the reporting requirements for the QDP exception (section 1.6038A-2(b)(7)(ix)) are proposed to be effective for taxable years beginning one year after the final regulations are published in the Federal Register. Prior to that date, the reporting requirement will be treated as satisfied only to the extent the taxpayer reports the aggregate amount of qualified derivative payments on IRS Form 8991.

**KPMG observation**: Eliminating the risk of a "cliff effect" if a taxpayer fails to satisfy the reporting requirements for some derivative contracts is welcome relief, along with the delayed effective date for the full reporting requirements. Further, excluding sale-repurchase transactions from the definition of a derivative is consistent with existing law that treats the arrangements as a secured borrowing. However, excluding securities lending transactions from the definition of a derivative is surprising given that the economics of a securities lending transaction, especially for the borrower of the security, closely resembles other derivative contracts (e.g., taking the short position on a total return swap).

In addition to the clarifications to the SCM and QDP exceptions, the proposed rules would add several new exceptions to the definition of base erosion payment.

- **ECI exception:** Most notably, the proposed rules would add an exception for outbound payments that are included in the foreign related corporation's income as ECI and subject to U.S. tax (the "ECI exception"). Notably, the ECI exception only applies to the extent that the taxpayer receives a withholding certificate from the foreign related corporation. Similarly, outbound payments made to a foreign corporation that determines its U.S. taxable income under an applicable U.S. treaty also are not included in the definition of base erosion payment to the extent such amounts are taken into account by the foreign corporation in determining its U.S. taxable income.

- **TLAC exception:** The proposed rules would add an exception for certain global systemically important banking organizations ("GSIB"s) that are required under U.S. law to issue a certain amount of TLAC securities to minimize the risk of insolvency (the "TLAC exception"). In particular, payments made on TLAC securities by a domestic intermediate holding company of a foreign GSIB to a related foreign party are excluded from the definition of base erosion payment. This exception is only

available, however, to the extent of the amount of TLAC securities that are required by U.S. law. Notably, since the relevant U.S. laws associated with the TLAC exception only apply to domestic institutions, foreign corporations would not be entitled to avail themselves of the TLAC exception even when they are subject to similar solvency requirements in their home country. Comments were requested on whether a similar exception should apply to foreign corporations.

- **Exception for section 988 losses:** The proposed rules exclude from the definition of base erosion payment exchange losses with respect to section 988 transactions. This exclusion applies to all types of section 988 transactions, including physical currency, currency forwards and derivatives, and nonfunctional currency debt instruments. As noted above, such losses are also excluded from the denominator in calculating the base erosion percentage.

Finally, consistent with the statute, the proposed rules also would exclude from the definition of base erosion payment any amounts paid or accrued in taxable years prior to January 1, 2018. Contrary to the position set forth in Notice 2018-28, 2018-16 I.R.B. 492, the proposed rules also would exclude from the definition of base erosion payment disallowed interest under section 163(j) that is carried over from a pre-tax reform year (i.e., prior to January 1, 2018) to a post-tax reform year (i.e., after January 1, 2018).

*Base erosion tax benefits*

Under the BEAT statute, base erosion tax benefits generally refer to the deductions allowed for the taxable year with respect to base erosion payments. They generally include (i) deductions allowed from deductible payments to foreign corporations, (ii) deductions allowed for depreciation and amortization resulting from the acquisition of property from a related foreign corporation, (iii) reductions in gross amounts of premiums attributable to certain reinsurance payments, and (iii) reductions in gross receipts attributable to payments to surrogate foreign corporations. The amount of base erosion tax benefits is used to determine both the base erosion percentage (discussed above) and modified taxable income (discussed below). The proposed rules provide two clarifications for taxpayers computing their base erosion tax benefits.

First, consistent with the ECI exception and the statute, the proposed rules reduce the amount of the base erosion tax benefit associated with deductible payments made to a foreign related party to zero when full U.S. withholding tax is imposed on such payment. In the event the U.S. withholding tax is reduced under an applicable treaty, the amount of the base erosion tax benefit is similarly reduced (but not to zero) to the extent of the withholding taxes paid.

**KPMG observation:** The BEAT statute explicitly provided such proportionate treatment for base erosion payments subject to U.S. withholding tax for purposes of determining modified taxable income, but not for purposes of determining the base erosion percentage. The proposed rules would provide consistent treatment of payments subject to withholding tax for both purposes.

Second, the proposed rules would clarify the treatment of interest payments when section 163(j) applies. For purposes of computing a taxpayer's base erosion tax benefits, the statute prescribes a taxpayer unfavorable stacking rule that treats the interest that is limited under section 163(j) as attributable first to any interest paid to unrelated parties, with the result that an increased portion of the interest that is allowed is treated as paid to related parties and potentially subject to the BEAT. Notably, there was an ambiguity left by the statute regarding how the allowed interest should be allocated between foreign related parties and domestic related parties. The proposed rules would clarify this ambiguity by providing for an allocation between foreign related parties and domestic related parties in proportion to the interest actually paid to each. The proposed rules also would provide guidance on the treatment of the excess interest carried over into future years.

**Modified taxable income**

*The basics*

The BEAT imposes an additional tax on an Applicable Taxpayer equal to the base erosion minimum tax amount ("BEMTA"). An Applicable Taxpayer's BEMTA is the excess of the applicable percentage of its modified taxable income ("MTI") over its regular tax liability, with certain adjustments. The statute defines MTI as taxable income computed for the taxable year under Chapter 1 "determined without regard to" any (i) base erosion tax benefits and (ii) the base erosion percentage of any NOL deduction allowed under section 172 for the taxable year.

The proposed rule interprets the statutory phrase "without regard to" as simply requiring the identified amounts to be added back to taxable income. This simple add-back approach begins with taxable income as computed for regular tax purposes as the starting point, which means that taxable income might be less than zero if current year deductions exceed gross income (but see the discussion below regarding the special rule for pre-2018 NOL carryforwards). Taxable income as so computed is then adjusted by adding back the gross base erosion tax benefits and the base erosion percentage of the NOL deduction allowed under section 172. Thus, under the proposed rule the MTI formula is:

- MTI = taxable income + base erosion tax benefits + (base erosion percentage x NOLs).

Unlike the Applicable Taxpayer and Base Erosion Percentage determinations, an Applicable Taxpayer's MTI and BEMTA amounts are determined on a taxpayer-by-taxpayer basis, rather than on the basis of the aggregate group. The proposed rules clarify that domestic corporations that join in filing a U.S. consolidated return are treated as a single taxpayer.

*Adoption of the add-back approach and rejection of a more dynamic recomputation approach*

The proposed rules adopt an "add-back" approach for computing MTI, rather than the recomputation approach that appears to be a more literal construction of the statutory language ("determined without regard to"). In contrast to the simplified "add-back" approach, a full redetermination of taxable income without regard to the disallowed deductions would also take into account the indirect effects of disallowing those deductions (such as an increased section 163(j) limitation or increased capacity to absorb an NOL carryover). In rejecting this approach**,** Treasury and the IRS explained that the recomputation approach would create significant complexity that would require separate BEAT-specific attributes to be determined and tracked in a manner similar to attributes under the alternative minimum tax (AMT) regime that was repealed as part of the Act. Thus, it appears to be the view of Treasury and the IRS that the omission of this architecture from section 59A suggests that Congress did not intend for the BEAT to create a separate tax base akin to AMT but, rather, intended to rely instead on the general Code definition of taxable income with limited "static" addbacks for the disallowed amounts.

**KPMG observation:** Both an add-back approach and various iterations of a recomputation approach seem to be reasonable interpretations of the statutory language. Treasury and the IRS's decision to use the "add-back" approach for computing MTI is consistent with the approach they took in the proposed rules under section 163(j) for computing adjusted taxable income ("ATI"). The relevant statutory language in sections 59A and 163(j) use the same "without regard to" formulation for making the applicable computations, which is also not dissimilar from the pre-Act definition of alternative minimum taxable income under the AMT ("taxable income . . . determined with the adjustments. . . ."), which allowed for a recomputation of taxable income.

The adoption of the add-back approach provides the virtue of simplicity but may result in more BEAT liability in certain situations. In particular, taxpayers with significant attributes that are limited by their taxable income, such as NOLs and interest expense deductions, would seem to be adversely affected by the proposed adoption of the "add-back" approach. Although the proposed rules decline to incorporate the recomputation approach, the preamble explicitly invites comments on the practical effects of an alternative recomputation-based approach, which suggests that it remains possible that final regulations could be drafted to allow taxpayers to apply a recomputation-based alternative to derive MTI.

*Treatment of net operating losses*

The proposed rules would clarify the effect of NOLs in computing MTI. First, the proposed rules provide that an excess amount of NOL deduction cannot reduce taxable income below zero for determining the starting point for computing MTI. That is, a deduction for a pre-2018 NOL (which is not subject to the new limitation of 80% of taxable income) would be taken into account for purposes of the MTI starting point only to the extent of the amount of taxable income prior to the NOL deduction, with the result that an NOL carryover cannot cause MTI to become negative. Similarly, to compute the add-back for the NOL, the base erosion percentage of the NOL would be applied to the same amount

that was used to reduce taxable income in computing the MTI starting point. Accordingly, the add-back would be determined by taking into account the 80% of taxable income limitation for post-2017 NOLs under new section 172(a) and the "no negatives" limitation described above.

The proposed rules include an example illustrating this point (section 1.59A-4(c), Example 1). In Example 1, a domestic corporation ("*DC*") during its 2020 tax year has gross income of $100x, a deduction of $80x that is not a base erosion tax benefit, and a deduction of $70x that is a base erosion tax benefit. In addition, DC has a $400x NOL carryforward that arose in 2016. The analysis states that DC's starting point for computing MTI is ($50x), which is the excess of DC's current year deductions over DC's current year gross income. Because DC's taxable income without regard to its pre-2018 NOL carryforwards does not exceed $0x, DC does not take into account any of its pre-2018 NOL carryforward for purposes of computing its MTI or the addback for NOL deductions. DC's add-back amount therefore consists of the $70x base erosion tax benefit and the $0x NOL. Accordingly, DC's MTI for 2020 is $20x, which is computed as (i) ($50x) (DC's regular taxable income) plus (ii) $70x (DC's base erosion tax benefit) and (iii) $0x NOL.

Second, the proposed rules provide that the base erosion percentage of an NOL is the base erosion percentage of the Applicable Taxpayer in the year in which the loss arose (defined in the preamble as the "*vintage year*"), rather than the base erosion percentage of the year in which the NOL is applied to reduce taxable income. If the Applicable Taxpayer is a part of an aggregate group, the base erosion percentage is the aggregate group's base erosion percentage for the year in which the NOL arose, even though the Applicable Taxpayer's NOL is not determined by reference to the aggregate group. Consistent with the vintage year approach, the base erosion percentage for NOLs that arose in tax years beginning before January 1, 2018 is 0, because the BEAT does not apply to tax years beginning before January 1, 2018. The preamble explains that the "vintage year" approach is the preferred method because it provides greater certainty as to the portion of an NOL that will have to be added back, since the percentage used to determine the NOL add-back would be fixed in the year the NOL arose.

The proposed rules include an example illustrating the vintage year-approach (section 1.59A-4(c), Example 2). In Example 2, the facts are the same as in Example 1, except that DC's gross income in 2020 is $500x. The analysis states that DC's MTI starting point is $0x, which is equal to (i) DC's $500x gross income less the sum of (ii)(a) $150x current year deductions and (b) $350x allowable NOL deduction. Because the NOL used in 2020 arose in DC's tax year beginning prior to January 1, 2018, the applicable base erosion percentage is 0. DC's add-back amount is $70x (the base erosion tax benefit amount) plus $0x (the base erosion percentage of the NOL). Accordingly, DC's MTI for 2020 is $70x, which is computed as (i) $0x (DC's regular taxable income) plus (ii) $70x (DC's base erosion tax benefit) plus (iii) $0x (DC's base erosion percentage NOLs).

**KPMG observation:** Treasury's and the IRS's decision to exclude pre-2018 NOLs as an add-back item for purposes of computing MTI is a taxpayer favorable resolution to a vexing BEAT transition issue. This approach also is consistent with Treasury's

unexpected decision in the BEAT proposed rules to exclude pre-2018 section 163(j) interest expense carryforwards from the definition of base erosion payments. The tax benefit from excluding pre-2018 NOLs as an add-back item, however, may be at least partially offset for some taxpayers by the floor that prevents NOLs from reducing the MTI starting point below zero.

**KPMG observation:** The vintage year approach to computing the base erosion percentage of an NOL will require taxpayers to track separately the base erosion percentage of NOLs based on the year in which the NOLs arose. Applicable Taxpayers that are part of an aggregate group will have to track the base erosion percentages by reference to the aggregate group.

**KPMG observation:** None of the examples in the BEAT proposed rules considers the application of the vintage year method to post-2017 NOLs. To illustrate this scenario, assume the same facts as in Example 2, except that the NOLs arose in 2019. Assume also that DC's 2019 base erosion percentage is the same as the percentage in 2020, 46.7% (.467 = 70x/150x). Under these facts, DC's MTI starting point is $70x because its allowable NOL deduction is limited to 80% of taxable income (350 X .80 = 280). Thus, DC's taxable income is $70x (350 – 280 = 70). DC's add-back amount consists of the $70x of base erosion tax benefit and $130.76x, which is the base erosion percentage of its allowable $280x NOL (280 X .467 = 130.76). Accordingly, DC's MTI for 2020 is $270.76x, which is computed as (i) $70x (DC's regular taxable income) plus (ii) $70x (DC's base erosion tax benefit) plus (iii) $130.76x (DC's base erosion percentage of its NOL).

**Base erosion minimum tax amount**

*The basics*

An Applicable Taxpayer's BEMTA for a particular tax year equals the excess of (1) (i) the applicable tax rate for the taxable year (the "BEAT Rate") x (ii) MTI <u>over</u> (2) the taxpayer's adjusted regular tax liability. An Applicable Taxpayer's adjusted regular tax liability generally is equal to its regular tax liability, reduced by certain credits allowed against regular tax liability (but not below zero). Credits that reduce regular tax liability for these purposes cause an offsetting increase in BEMTA; credits that do not reduce regular tax liability for these purposes do not cause such an increase in BEMTA.

For tax years beginning after December 31, 2017 and beginning before January 1, 2026, the following credits do not reduce regular tax liability for BEMTA purposes: (1) the credit allowed under section 38 for the taxable year that is properly allocable to the research credit; (2) a portion equal to 80% of the lesser of (a) the applicable section 38 credits (the low housing credit under section 42(a), the renewable electricity production credit under section 45(a), the investment credit under section 46, but only to the extent properly allocable to the energy credit under section 48), or (b) the BEMTA (determined without regard to the amounts in (2)(a); and (3) credits under section 33 and 37. Number (2) requires parallel computations.

For tax years beginning after December 31, 2025, the only credits that do not reduce regular tax liability are credits under sections 33 and 37.

*BEAT rate*

For taxpayers other than certain banks and securities dealers, the BEAT Rates are:

- 5%, for taxable years beginning in calendar year 2018
- 10%, for taxable years beginning in calendar year 2019 through taxable years beginning before January 1, 2026
- 12.5%, for taxable years beginning after calendar year 2025.

For a taxpayer that is a member of an affiliated group that includes a bank or a registered securities dealer, these rates are increased by one percentage point to 6%, 11%, and 13.5%, respectively.

Notably, the proposed rules address the application of the above BEAT Rate schedule to fiscal year taxpayers. Specifically, the proposed rules provide that for taxable years beginning after January 1, 2018, section 15 will apply to any taxpayer using a taxable year other than the calendar year. This appears intended to require fiscal year taxpayers to use a blended rate for their tax years, other than any tax year that includes January 1, 2018, by applying a prorated percentage of the number of days prior to and subsequent to the last day of the calendar year within such taxpayer's tax year. Under this approach, for an 11/30 year-end taxpayer, for example, the BEAT rate would be 9.58%, calculated as follows:

- BEMTA = (i) 5% x 31/365 plus (ii) 10% x 334/365 = 9.58%

Fiscal year taxpayers would remain exempt from the BEAT regime in respect of their tax year beginning before January 1, 2018.

**KPMG observation**: The intent of this rule appears to be to ensure that while non-calendar year end taxpayers benefit from the delayed onset of the BEAT regime in respect of the tax year ending in 2018, the benefits afforded to fiscal year taxpayers would be reduced for tax years beginning after December 31, 2017 because the proposed rule would effectively impose a blended rate for the BEAT Rate transition years (i.e., the 2018-2019 and 2025-2026 tax years). This approach is difficult to reconcile with the statutory language in section 59A(b)(1)(A), which treats 10% as the default rate, but states that a 5% rate would apply to a taxpayer's MTI for the taxable year "in the case of taxable years beginning in calendar year 2018"). The approach of explicitly carving out taxable years beginning in calendar year 2018 from the otherwise effective tax rate of 10% does not fit well with the mechanics of section 15. Further, it appears that the BEAT rate mechanism is intended to start at a low rate to allow taxpayer's time to adapt to the tax. As a result, it

is unclear whether the statute permits section 15 to apply to the BEAT for fiscal tax years beginning in 2018.

**Application of BEAT to consolidated groups**

In addition to confirming that BEAT itself is computed on a consolidated group basis, the proposed regulations contain intricate rules for the co-ordination of the BEAT rules with the proposed section 163(j) regulations for a consolidated group. In general, to the extent a consolidated group's business interest expense ("BIE") is allowed as a deduction in a taxable year, it is classified first as from BIE paid/accrued to a foreign related party and a domestic related party, on a *pro rata* basis, with any remaining BIE deductions treated as BIE paid/accrued to an unrelated party. Under complex rules, this allocation is done on a consolidated basis, and a member's current year BIE can be classified (and thus treated) as (i) domestic-related current year BIE, (ii) foreign-related current year BIE, or (iii) both, regardless of whether the member actually incurred BIE on debt owed to a domestic or foreign related party. These classification rules apply on a year-by-year basis, and the classification of BIE as foreign related party BIE or domestic related party BIE (or if neither, as unrelated party BIE) effectively persists with the BIE, even if it becomes part of a section 163(j) disallowed BIE carryforward.

When a member departs a group, the member's disallowed BIE carryforwards retain their allocated status (*i.e.*, as having been paid/accrued to a domestic or foreign related party or to an unrelated party). Similarly, if a member's assets are acquired in a section 381(a) transaction (such as a tax-free section 368(a)(1) asset reorganization or section 332 subsidiary liquidation), the member's disallowed BIE carryforwards are inherited and retain their allocated status. This retained status is taken into account in determining an acquiring group's base erosion tax benefit when the disallowed BIE carryovers are absorbed in the acquiring group.

The proposed regulations would also add the consolidated group's liability for the BEAT tax to the list of taxes in section 1.1502-2, which would confirm that each entity that is a member of a consolidated group during any portion of a consolidated return year is severally liable for the group's BEAT tax for that year.

**Treatment of reinsurance premiums**

The proposed rules follow the statute in confirming that premiums and other consideration paid or accrued by an insurance company to a foreign related person for reinsurance generally would be base erosion payments and base erosion tax benefits notwithstanding that such amounts are adjustments to gross income and therefore do not give rise to deductions under the Code. As a consequence, the regulations would include these amounts in both the numerator and denominator of the base erosion percentage and in gross receipts for purposes of the applicable taxpayer test. The regulations also clarify that return premium paid by an insurance company to a foreign related party is a reduction to gross receipts.

**KPMG observation:** The preamble to the proposed rules addresses comments made by the insurance industry regarding the calculation of gross income, primarily by requesting additional comments. While the proposed rules specify that taxpayers may not net receipts and payments for purposes of the BEAT in a manner different than allowed under general tax rules (even when the parties have a right of setoff against each other and the amounts are settled on a net basis), the preamble requests that taxpayers comment on whether there should be a distinction between reinsurance contracts with netting and other commercial contracts. This request seems to be referring to modified co-insurance and funds withheld insurance arrangements, but could be meant more broadly. The preamble also acknowledges that for purposes other than section 59A, the Code describes payments of claims for losses incurred made by insurance companies that are not life insurance companies as both reductions of gross receipts and as deductions against gross income. The question of whether a non-life insurance company is free to treat the payments as one or the other for purposes of characterizing the payments as base erosion payments under section 59A has been widely debated. While requesting comments on the appropriate treatment of the claims payments in general, but failing to insist that claims payments be treated as deductions, the proposed rules and preamble can be read as signaling recognition (at least pending future guidance) of the position that payments of claims to related foreign persons are not base erosion payments. The preamble also requests comments on whether life insurance companies should obtain the same treatment of claims payments as non-life insurance companies.

**KPMG observation:** The preamble confirms that entities making the section 953(d) election would be treated as domestic corporations for purposes of section 59A. Thus, insurance companies that wish to avoid BEAT may consider electing section 953(d) treatment. However, once the 953(d) election is made, the insurance company would no longer be able to enjoy a reduced effective tax rate in a lower-tax jurisdiction (or to enjoy a lower U.S. tax rate under the Global Intangible Low-Taxed Income rules) and any losses in the electing company would be subject to the dual consolidated loss rules. Thus, insurance companies would need to weigh the benefit of avoiding BEAT against the tax consequences of making the election.

### Interaction between business interest expense limitation and BEAT: Notice 2018-28

See discussion of **Notice 2018-28** [PDF 183 KB] in Interest Expense Limitation section of this report, above. The notice generally states that regulations will address the interaction of section 163(j) with the BEAT. In particular, the notice indicates that regulations (1) will provide that business interest carried forward from a tax year beginning before January 1, 2018, will be subject to section 59A (the BEAT) in the same manner as interest paid or accrued in a tax year beginning after December 31, 2017, and (2) will clarify how the BEAT will apply to that interest. Notice 2018-28 thus effectively provides that such interest will not be grandfathered for BEAT purposes despite being paid prior to the effective date of section 59A.

### Reporting: Draft version of Form 8991

The IRS has posted a draft version of **Form 8991** [PDF 162 KB], *Tax on Base Erosion Payments of Taxpayers With Substantial Gross Receipts.* The draft has a "watermark" date of September 5, 2018, and includes cautionary language indicating that it is not to be used for filing purposes and is subject to change and to OMB approval before being officially released.

## Previously taxed earnings and profits

### Intent to issue proposed regulations: Notice 2019-01

The IRS on December 14, 2018, released an advance version of **Notice 2019-01** [PDF 85 KB] that provides guidance on the treatment of "previously taxed earnings and profits" or PTEP (colloquially referred to as PTI). The notice announces that Treasury and the IRS intend to issue proposed regulations under sections 959 and 961 that will take into account various changes made by the new law and will withdraw the existing proposed regulations.

The observations and initial impressions below are drawn from a KPMG report issued on December 17, 2018.

**Overview**

Although the general PTEP rules were not directly modified by the new law, the existing PTEP regulations need to be revised to reflect the additional types of PTEP created under the new law, including PTEP from the mandatory repatriation rules and "global intangible low-tax income" (GILTI) inclusions. In addition, revised guidance on PTEP distributions is needed due to statutory changes—including revisions to the foreign tax credit (FTC) regime—that resulted in different operative rules applying to distributions of different types of PTEP.

Notice 2019-01 does not contain a comprehensive discussion of the rules expected to be included in the forthcoming PTEP regulations. Rather, the notice focuses on a narrow set of issues related to the new law, including guidance on the methodology to determine the order in which PTEP is distributed, and the associated tracking of PTEP required to comply with this methodology.

**Section 3.01: Annual accounts and PTEP groups**

Section 3.01 of Notice 2019-01 generally describes the rules that taxpayers would need to follow in tracking their PTEP accounts. As set forth in the notice, for each of their separate section 904 separate limitation categories ("baskets"), taxpayers would need to maintain PTEP in an annual account, and segregate the annual account into 16 PTEP groups. The 16 PTEP groups would correspond to the underlying statutory rule that

created the PTEP, and would reflect the reclassification of PTEP from section 959(c)(2) to section 959(c)(1) that occurs in connection with section 956.

Read **descriptions of the 16 PTEP groups** [PDF 118 KB]

Once PTEP is assigned to an annual account and PTEP group in an initial year, it would be maintained in that account as it is distributed or reclassified in subsequent years. In total, there would be nine groups of section 959(c)(1) PTEP and seven groups of section 959(c)(2) PTEP, which include the 10 PTEP groups described in the recently issued proposed FTC regulations (Prop. Reg. section 1.960-3(c)(2)) and six additional groups. A number of these PTEP groups would be relatively uncommon, due to the limited circumstances in which the rule that creates the PTEP would apply or because current law no longer contains the rule that creates the PTEP group.

The forthcoming regulations are expected to include rules that would address the transition from maintaining PTEP under the existing rules, which require the maintenance of fewer PTEP groups, to the new 16 PTEP groups. As described in Notice 2019-01, PTEP assigned to a PTEP group prior to the publication of the regulations generally would remain in that PTEP group, other than PTEP attributable to section 965(a) or section 965(b), which would need to be separately maintained in its relevant PTEP group.

Notice 2019-01 generally discusses the interaction of the PTEP rules described in the notice with the recently issued proposed FTC regulations that provide guidance on the application of the deemed paid FTC rules to PTEP distributions. As noted above, the PTEP groups would be maintained separately for each basket, generally consistent with the proposed FTC regulations. As a result, an annual layer of a particular PTEP group may be maintained in more than one basket. In order to apply the PTEP ordering rules that apply to a PTEP distribution (discussed in the next section of this report), the regulations are expected to include a rule that would treat a distribution of earnings and profits (E&P) from a PTEP group that includes amounts in multiple baskets as a pro rata distribution from each basket. Notice 2019-01 also states that the proposed FTC rules will be coordinated with the PTEP rules, consistent with statements in the preamble to the FTC regulations that acknowledge an intention for the PTEP groups in the proposed FTC regulations to be consistent with the PTEP groups ultimately included in PTEP regulations.

Notice 2019-01 generally describes an expected rule that would address the application of the basis reduction rules to PTEP distributions. The notice states that the regulations are expected to confirm that a distribution from a PTEP group would reduce a shareholder's stock basis under section 961(b), regardless of how the basis was created. As an example, Notice 2019-01 states that a distribution from a PTEP group would reduce basis created under section 961(a) even if that PTEP group did not create the basis. Thus, a distribution of section 965(b) PTEP would reduce a shareholder's stock basis even though there was not an underlying increase in a shareholder's basis associated with that PTEP.

Notice 2019-01 also describes rules that would apply for purposes of determining foreign currency exchange gain or loss on PTEP distributions. The forthcoming regulations are expected to require each annual PTEP account to be maintained on a separate dollar basis. As a result, the basis pooling rules in Notice 88-71 would no longer apply. Under a transition rule described in Notice 2019-01, shareholders that currently are using the pooling method would be permitted to transition to the annual method by using the blended dollar basis as a single annual PTEP account, assigned to the last tax year before the regulations are applicable. Further, shareholders that maintained aggregate dollar basis pools for section 959(c)(1) PTEP or section 959(c)(2) PTEP would be permitted to assign an average dollar basis to the PTEP in each annual account, provided that the taxpayer maintained annual accounts for section 959(c)(1) PTEP and section 959(c)(2) PTEP.

Notice 2019-01 generally describes the requirement to maintain, for each basket, 16 PTEP groups in annual accounts as necessary to precisely apply the FTC and section 986 foreign currency rules, but also acknowledges the complexity associated with the maintenance of so many PTEP groups. Notice 2019-01 states that Treasury and the IRS are weighing the administrative and compliance concerns raised by the complexity against the need for precise compliance with the rules, and have requested comments on simplifying the rules including by consolidating PTEP groups, or grouping accounts into multi-year accounts.

**Section 3.02: Ordering rules**

Notice 2019-01 provides that the forthcoming regulations will clarify that a controlled foreign corporation (CFC) can distribute PTEP only to the extent it has current or accumulated E&P. Thus, a CFC that does not have current or accumulated E&P that otherwise would support a section 316 dividend would not be able to distribute PTEP, even if it has PTEP accounts. This rule would address an issue that existed prior to the change in law, but that is amplified under the new law because of the greater potential for PTEP accounts to exceed E&P.

Notice 2019-01 describes ordering rules that would apply when a CFC with E&P distributes PTEP, which determine the PTEP group from which the PTEP is distributed. Subject to a special priority rule, a “last in, first out” (LIFO) approach would apply to PTEP distributions, first to section 959(c)(1), and then to section 959(c)(2) PTEP. As a result, subject to the special priority rule, current year section 959(c)(1) PTEP would be distributed first, followed by prior year section 959(c)(1) PTEP, beginning with the most recent prior year. Next, subject to the special priority rule, current year section 959(c)(2) PTI would be distributed, followed by prior year section 959(c)(2) PTEP, beginning with the most recent prior year.

As described in Notice 2019-01, a special priority rule would apply to distributions of PTEP attributable to a section 965(a) inclusion and PTEP created under section 965(b), which are each maintained in separate PTEP groups within section 959(c)(1) PTEP and section 959(c)(2) PTEP. Under this rule, in applying the ordering rules to distributions of section

959(c)(1) PTEP, distributions would be treated as first coming from the section 965(a) PTEP group, followed by the section 965(b) PTEP group. After these PTEP groups are exhausted, the LIFO approach would apply on a pro rata basis to the PTEP groups in each annual layer of section 959(c)(1) PTEP. Next, the same approach would apply to section 959(c)(2) PTEP. After all of the section 959(c)(2) is distributed, then section 959(c)(3) E&P would be distributed.

The special priority rule and LIFO rules also would apply when PTEP is reclassified from section 959(c)(2) PTEP to section 959(c)(1) PTEP. As a result—with respect to each of section 959(c)(1) PTEP and section 959(c)(2) PTEP—PTEP related to section 965 would be distributed first, regardless of whether there are more current annual layers of PTEP. Notice 2019-01 justifies the special priority rule as reducing the administrative burden of maintaining PTEP accounts because it would result in a quicker reduction in the number of PTEP accounts by exhausting the section 965 PTEP groups sooner than under a LIFO approach.

**Section 3.03: Inclusions in excess of earnings and profits**

Under the new law, PTEP for a current year can exceed current year E&P. For example, the amount of GILTI PTEP can exceed E&P because a U.S. shareholder's GILTI inclusion allocated to a CFC is not limited by the CFC's E&P. In addition, the amount of PTEP from a subpart F inclusion can exceed E&P under a GILTI-subpart F coordination rule that increases the E&P of a tested loss CFC for purposes of applying the current year E&P limitation rule in calculating a CFC's subpart F income.

Notice 2019-01 states that section 959(c)(1) PTEP, section 959(c)(2) PTEP, and section 959(c)(3) E&P must equal the CFC's E&P. Under the rules described in the notice, to the extent that a CFC has PTEP in a year that exceeds E&P, the excess amount would reduce section 959(c)(3) E&P, including below zero. In addition, a current year E&P deficit would reduce only section 959(c)(3) E&P. As a result, under the forthcoming regulations, a CFC could have a negative section 959(c)(3) E&P amount, which is generally consistent with Rev. Rul. 86-131.

**Section 4: Applicability date**

The rules described in Notice 2019-01 are expected to apply to tax years of U.S. shareholders that end after December 14, 2018. Prior to issuance of the regulations, shareholders can rely on the rules described in Notice 2019-01, provided the shareholder and all related persons consistently apply the rules to all foreign corporations, beginning with the tax year that includes the tax year end of any foreign corporation to which section 965 applied.

**Section 5: Request for comments**

Notice 2019-01 includes a separate section that requests comments on a number of specific issues, which are due by February 12, 2019. Included in this section is a request

for guidance on the application of section 961(c) basis for purposes of determining tested income for GILTI purposes, as well as a request relating to an election that would allow for multi-year GILTI PTEP accounts.

## International changes, in general: Forms and instructions

In December of 2018, a final version of Form 5471 for 2018 was posted on the IRS website. Also, the IRS has provided a draft version of instructions for Form 5471 for 2018.

- Read **Form 5471** [PDF 218 KB], *Information Return of U.S. Persons With Respect To Certain Foreign Corporations*

- Read the **draft version of the instructions** [PDF 511 KB] for Form 5471 for 2018

The draft instructions reflect a "watermark" date of December 12, 2018, and include cautionary language that these instructions are not to be relied upon for filing purposes and are subject to change and to OMB approval before being officially released.

The draft instructions note, under the "What's New" section, that because of measures added to the Code by the new law, Form 5471 has been amended to reflect new reporting requirements for certain taxpayers in tax years beginning after 2017.

## KPMG reports and articles on international issues

### Application to cost component of services with markup component

Tom Wessel, Manal Corwin, Ron Dabrowski, Danielle Rolfes, and Michael Plowgian of KPMG wrote an article analyzing the new BEAT and its exception for certain amounts paid for services ("BEAT SCM exception"): ***A Response to an Off-BEAT Analysis*** [PDF 701 KB]. The article was published in Tax Notes on Feb. 12, 2018.

The article analyzes the relevant statutory and regulatory provisions, the omission of the "business judgment rule" from the BEAT SCM exception, the legislative history, and relevant policy considerations. The authors conclude that the statutory language providing for the BEAT SCM exception is unambiguous and necessarily contemplates that marked-up services can qualify for the exception.

### U.S. tax reform considerations for multinational services companies

Read an article by Tom Zollo, Mike Moore, Anjit Bajwa, and Tom Chamberlin of KPMG on ***U.S. Tax Reform Considerations for Multinational Services Companies*** [PDF 255 KB], in Tax Notes International on April 30, 2018.

The article reviews some provisions of the new law and observes how multinational service companies (MSCs) may be affected. The authors note that MSCs use relatively fewer fixed assets than other enterprises; often operate throughout the world, including

in less-developed countries with unorthodox tax systems and limited treaty networks; tend to be globally integrated; and contract with customers locally for services that may be delivered in several countries through an extensive web of intercompany transactions. These facts present several opportunities and challenges under the revised U.S. tax system.

The article analyzes how the new law has shifted the U.S. international tax paradigm. It explains that the new law requires MSCs to consider whether changes to their existing intercompany and third-party arrangements are appropriate to manage their tax liabilities under the new U.S. regime and the emerging international rules being developed in response to the BEPS project.

The authors indicate that this review should begin with a fresh look at the functions, assets, and risks that determine the MSC's profits. The operating model selected should, as required by BEPS, align the intercompany commercial arrangements and profit allocation to the MSC's value-adding activities. Within that constraint, the MSC should reconsider its legal structure and contractual arrangements with the new tax regime in mind. Finally, because the interaction of the new rules is complex, the MSC should carefully model the resulting tax consequences under various reasonably foreseeable operating outcomes.

### Transfer pricing in the age of tax reform

Shifts in the tax environment have placed sharper focus on how multinational entities structure and price their intercompany transactions. Specifically, U.S. tax reform has created new international tax and transfer pricing planning opportunities for taxpayers to consider in reducing their tax burden.

A July 2018 report by Sherif Assef of KPMG, ***Transfer pricing in the age of tax reform***, considers how multinational entities (especially small to midsized ones) can take a fresh look at their transfer pricing policies to avail themselves of new planning opportunities arising from U.S. tax reform.

### Section 965(n) and the nebulous NOL waive-off election

Read an article by Douglas Holland and Ron Dabrowski of KPMG, ***Deciphering the Nebulous NOL Waive-Off Election*** [PDF 1 MB], in Tax Notes on June 18, 2018.

The article considers interpretive and policy questions raised by new section 965(n), which allows taxpayers to forgo use of their losses against the mandatory repatriation income inclusion required by new section 965(a). Among other things, the article examines the use of the election to forgo or waive absorption of current-year losses, as well as carryover or carryback losses, against the mandatory repatriation income inclusion; the effect of the election on the taxpayer's broader foreign tax credit (FTC) limitation; the intersection of section 965(n)(1) and the FTC rules; and procedural matters concerning the election.

### Mandatory repatriation considerations for insurance companies

For a discussion of mandatory repatriation considerations for insurance companies, see the **Insurance section** of this supplement.

## Businesses engaged in research and development

The new law retained the research credit without modification, but made a variety of other changes that are relevant to businesses engaged in research and development (R&D) activities.

### R&D considerations relating to tax reform: KPMG report

Read a March 2018 report by Michael S. Brossmer, Edward J. Jankun, Tyrone Montague, Jaime Park, Ross Reiter, and Scott Vance of KPMG, ***Tax Reform: And the Winner Is ... R&D*** [PDF 121 KB].

The article explains that tax reform changed the playing field for taxpayers engaged in research and development (R&D) activities. As a result, there are new and modified provisions of the tax law for taxpayers engaged in R&D activities to consider—whether or not the taxpayers claimed the R&D tax credit in the past. Among other things, the article highlights the significance of the following new law provisions to businesses engaged in R&D:

- Reduction in the corporate tax rate and effect of section 280C (calendar year corporations have a net R&D credit of 79% of gross credit starting in 2018 vs. 65% of gross credit for 2017)

- AMT repeal for corporations, which makes more taxpayers eligible to use the credit

- Modified net operating loss (NOL) deduction, which can cause corporations with NOLs arising after 2017 to have regular tax liability that can potentially be offset by the R&D credit

- Section 174 research and experimental expenditures (there will be required capitalization, including for software development for tax years beginning after December 31, 2021—five-year amortization if the research is conducted in the United States and 15-year amortization if the research is conducted outside of the United States)

- Orphan drug credit (ODC) and section 280C(b)(3) (credit rate reduced from 50% to 25% of qualified human clinical testing expenses paid or incurred in tax years beginning after December 31, 2017 and new election under section 280C(b)(3) to claim a reduced ODC in lieu of reducing section 174 amounts by the amount of the ODC)

- International considerations (e.g., mandatory repatriation may increase taxes that can be offset by the R&D credit)

# Insurance

## Section 163(j) business interest limitation: Potential implications of proposed regulations

For possible insurance industry implications of the proposed regulations relating to section 163(j), read the discussion of those regulations **earlier in this supplement**.

## BEAT: Provisions in proposed regulations applicable to insurance companies

As discussed earlier in this supplement, the Treasury and IRS on December 13, 2018, released proposed regulations on the new BEAT. The proposed regulations were published in the Federal Register on December 21, 2018.

On December 19, 2018, KPMG issued a report on provisions in the proposed regulations applicable to insurance companies, based on the proposed regulations as initially released on December 13, 2018. The observations below are drawn from that report.

**Background on section 59A**

New section 59A imposes an addition to tax (the "base erosion and anti-abuse tax" or "BEAT") that targets certain deductions or similar tax benefits ("base erosion tax benefits") attributable to "base erosion payments" made to foreign related parties by certain "applicable taxpayers."

An applicable taxpayer is a corporation (other than an S corporation, a regulated investment company, or a real estate investment trust) that is a member of a group of related corporations (an aggregate group) that has average annual gross receipts of at least $500 million for the three-tax-year period ending with the preceding tax year, and has a "base erosion percentage" (generally the ratio of base erosion tax benefits over the aggregate deductions (with limited exceptions) allowable to the taxpayer during the tax year) in excess of 3%. The base erosion percentage threshold is dropped to 2% in the case of an aggregate group that includes an affiliated group containing a bank or registered securities dealer.

**Treatment of an affiliated group that includes a bank or registered securities dealer**

Consistent with the Internal Revenue Code, for an aggregate group that includes an affiliated group containing a bank or a registered securities dealer (i.e., broker-dealer), the proposed regulations lower the threshold base erosion percentage for purposes of determining whether a taxpayer is an applicable taxpayer from 3% to 2%, and increases the BEAT tax rate for members of the affiliated group by one percentage point. However,

the regulations provide that the lower 2% threshold will not apply for a tax year if the total gross receipts of the aggregate group that are attributable to the bank or registered securities dealer represent less than 2% of the total gross receipts of the aggregate group.

This can be a welcome provision for insurance groups, which often include broker-dealers with limited activity and revenue that is not a significant percentage of the gross receipts of the aggregate group. Less welcome is an anti-abuse rule that provides that transactions or arrangements among related parties with a principal purpose of avoiding rules applicable to banks or registered securities dealers are disregarded. This anti-abuse rule could potentially be applied to companies that have moved to deconsolidate their broker-dealers in order to avoid the lower 2% threshold or to benefit from the lower BEAT tax rate.

**Treatment of claim losses**

The preamble acknowledges that, for purposes other than section 59A, the Code describes payments of claims for losses incurred made by non-life insurance companies as both reductions of gross receipts and as deductions against gross income. The question of whether a non-life insurance company is free to treat the payments as one or the other for purposes of characterizing the payments as base erosion payments under section 59A has been widely debated.

While requesting comments on the appropriate treatment of the claims payments in general, but failing to insist that claims payments be treated as deductions, the proposed regulations and preamble can be read as signaling recognition (at least pending future guidance) of the position that payments of non-life insurance claims to related foreign persons are not base erosion payments. Presumably, a company will be required to apply its treatment of claims payments consistently for the qualification fraction and the calculation of modified taxable income. The preamble also requests comments on whether life insurance companies should obtain the same treatment of claims payments as non-life insurance companies.

**Offsetting reinsurance payments**

Another question that has been widely discussed is the calculation of the BEAT with respect to reinsurance transactions that have offsetting payments between the ceding company and the reinsurance company. While the proposed regulations specify that taxpayers may not net receipts and payments for purposes of the BEAT in a manner different than allowed under general tax rules (even when the parties have a right of setoff against each other and the amounts are settled on a net basis), the preamble requests that taxpayers comment on whether there should be a distinction between reinsurance contracts with netting and other commercial contracts.

This request seems to be referring to modified co-insurance and funds withheld insurance arrangements, but could be meant more broadly.

**Group members with different tax years**

An aggregate group that includes more than one U.S. consolidated group, or that includes stand-alone entities, may in some cases have companies that are on different tax years. The proposed regulations require aggregate group members with different tax years to determine gross receipts and the base erosion percentage on an aggregate basis (i.e., taking into account the results of all members of the aggregate group) but with respect to each entity's individual tax year. This means that gross receipts and base erosion percentage would have to be determined for all entities in the group on both a calendar year and a fiscal year basis. As a result, two members of the same aggregate group could have different gross receipts and base erosion percentages. Taxpayers are allowed to use a reasonable method to determine the gross receipts, numerator and denominator numbers for members of the aggregate group that do not have the same tax year.

Depending on what methods are considered reasonable, this approach might be practicable for non-insurance companies, it may be burdensome for insurance companies, particularly relating to reserve calculations.

**Treatment of base erosion payments to U.S. branch of a foreign entity**

As expected, the proposed regulations exclude from treatment as base erosion payments amounts paid to a foreign related party that are subject to U.S. income taxation as effectively connected income (ECI) of a U.S. branch, or income attributable to a permanent establishment under an applicable U.S. tax treaty.

However, when the income of the foreign corporation that is allocated to the U.S. branch is computed under the business profits article of the treaty on the basis of functions performed, assets used, and risks assumed, and not on the basis of U.S. expense allocation principles, the proposed regulations would treat any deductions attributable to amounts paid or deemed paid by the permanent establishment to its home office or another branch of the same entity as fully subject to BEAT to the extent that they would otherwise qualify as BEAT payments.

Any foreign corporation with a U.S. branch would need to examine its methodology for allocation of expenses to determine if the allocation gives rise to deemed base erosion payments.

**Net operating loss rules**

The proposed rules clarify the effect of net operating losses (NOLs) in computing modified taxable income (MTI).

First, the proposed rules provide that an NOL carryover deduction cannot reduce taxable income below zero for determining the starting point for computing MTI. That is, a deduction for a pre-2018 NOL (which is not subject to the new limitation of 80% of taxable income) would be taken into account for purposes of the MTI starting point only to the

extent of the amount of taxable income prior to the NOL deduction, with the result that an NOL carryover cannot cause MTI to become negative. Similarly, to compute the add-back for the NOL, the base erosion percentage of the NOL would be applied to the same amount that was used to reduce taxable income in computing the MTI starting point. Accordingly, the add-back would be determined by taking into account the 80% of taxable income limitation for post-2017 NOLs under new section 172(a) and the "no negatives" limitation described above.

The preamble discussion, the proposed regulations, and examples in the proposed regulations emphasize the impact of loss carryforward on the BEAT calculation of MTI. However, these provisions also apply to the carryback of non-life insurance companies. Consequently, under the proposed regulations, whenever a property and casualty company has a loss carryback, the insurer recalculates its BEAT for the carryback year to account for the impact of the loss carryback. This would add complexity to the insurer's carryback calculations.

**Calculation of MTI for a life / non-life consolidated group**

The proposed regulations clarify that MTI and base erosion minimum tax amount are determined for a consolidated group as if it were a single taxpayer. The proposed regulations also clarify that taxpayers with net losses in the current year have negative taxable income as a starting point for calculating MTI. This is in contrast with the treatment under the proposed regulations of net operating loss carryovers discussed above, which for purposes of MTI, cannot reduce taxable income to below zero.

Questions remain, however, regarding how current year losses apply in life / non-life consolidated groups. In calculating life / non-life consolidated taxable income, non-life subgroup net losses can generally offset only life subgroup income to the extent of the lesser of 35% of the non-life losses or 35% of the life subgroup income. In addition the regulations governing life / non-life consolidation state that each subgroup's taxable income cannot be reduced below zero by the subgroup's current-year losses. Thus, even when the non-life subgroup has current year losses significantly in excess of income in the life subgroup, a strict "consolidated" approach would disadvantage life / non-life groups by calculating modified taxable income based on the consolidated taxable income of the group as a whole.

## Modification of discounting rules for insurance companies: Proposed regulations

On November 5, 2018, the Treasury and IRS released to the Federal Register proposed regulations regarding the new rules for discounting insurance companies' unpaid losses and estimated salvage recoverable for federal income tax purposes. The **proposed regulations** (REG-103163-18) [PDF 211 KB] are in the November 7, 2018, edition of the Federal Register. Comments are due by December 7, 2018.

The discussion below is drawn from a *TaxNewsFlash* issued on November 6, 2018.

**Background**

Section 846 of the Code requires property and casualty (P&C) insurance companies to discount their unpaid losses and estimated salvage recoverable. This section also provides rules for discounting the unearned premiums of title insurance companies under section 832 and the unpaid losses of life insurance companies under sections 805(a)(1) and 807(c)(2). [For the sake of brevity, the following discussion refers to the unpaid losses of P&C insurance companies.]

The new law:

- Modified section 846 to change the definition of the applicable interest rate to be used
- Amended the computational rules for determining loss payment patterns under section 846(d)
- Repealed the election under former section 846(e) to use the taxpayer's own historical loss payment pattern rather than the pattern published by the IRS for purposes of discounting its reserves

These changes were effective for tax years beginning after December 31, 2017.

**Proposed regulations**

The proposed regulations, as released on November 5, 2018, implement the recent legislative changes to the Code and make other technical improvements to the derivation and use of discount factors.

**Modification of applicable rate of interest used to discount unpaid losses**

Prior to the enactment of the new law, section 846 required taxpayers to use an "annual rate" based on the applicable mid-term federal rate, as defined in section 1274(d). For years beginning after 2017, under the new law, the annual rate for any calendar year is determined by the IRS based on the corporate bond yield curve, as defined by section 430(h)(2)(D)(i) but by substituting "60-month period" for "24-month period" therein. The corporate bond yield curve is published on a monthly basis by Treasury and consists of spot interest rates for each stated time to maturity.

The preamble to the proposed regulations notes that revised section 846(c)(2) does not specify how the Treasury Secretary is to determine the annual rate for any calendar year based on the corporate bond yield curve. Consequently, to implement the changes made by the new law, the proposed regulations adopt an annual discount rate equal to the average of the corporate bond yield curve's monthly spot rates with times to maturity of not more than 17.5 years, computed using the most recent 60-month period ending before the beginning of the calendar year for which the determination is made. The preamble

notes that the 17.5-year maturity range was selected to compute the annual rate in order to minimize the differences in aggregate taxable income that inherently result from applying a single discount rate for a given accident year versus the direct application of the corporate bond yield curve separately to each accident year.

This maturity range determination was made after an analysis of aggregate data reported on annual statements filed for 2015—the most recent year for which published aggregate data was available. Since section 846(c)(2) does not specify how the annual rate for a given calendar year is to be determined based on the corporate bond yield curve, the Treasury and the IRS considered multiple alternatives in an effort to match as closely as possible the yield curve from insurance companies' investments in bonds used to fund the undiscounted losses to be incurred in the future. As part of this process, the Treasury and the IRS also considered other methods, including using a variable maturity range, applying two rates (one for short-tail lines, and one for long-tail), applying a different annual rate for each line of business, or directly applying the corporate bond yield curve.

Given the variety of options, the Treasury and IRS have invited commentators to suggest alternative methods, along with the legal basis for the suggested methods and explanations of how the suggested methods more clearly reflect income.

**Modification of computational rules for loss payment patterns**

Under section 846(d)(1), the Treasury Secretary determines a loss payment pattern for each line of business by reference to the historical aggregate loss payment data applicable to that line of business for each determination year (i.e., the calendar year 1987 and each fifth calendar year thereafter). These loss payment patterns are determined using the most recently published aggregate data reported on insurance companies' annual statements, as filed with the National Association of Insurance Commissioners (NAIC).

Prior to the new law's enactment, for short-tail lines of business, losses unpaid at the end of the first year following the accident year were treated as paid equally in the second and third years following the accident year. For long-tail lines of business, unpaid losses remaining after 10 years were treated as paid in the 10th year following the accident year, with an available extension provided certain conditions were met.

The new law did not modify the loss payment pattern for short-tail lines of business, but it provided for an extension of the 10-year long-tail payment period for a maximum of 14 additional years if the amount of losses that would have been treated as paid in the 10th year after the accident year exceeds the average of the loss payments treated as paid in the seventh, eighth, and ninth years after the accident year.

The new law also repealed sections 846(d)(3)(E) through 846(d)(3)(G) of the Code, which provided rules for situations in which annual statement data was available for longer periods after the accident year than the periods otherwise assumed under section 846;

special rules for determining payment patterns for the international and reinsurance lines of business; and guidance for addressing negative loss payment patterns.

The preamble to the proposed regulations attempts to fill the void left by the repeal of the rules designed to address negative loss payment patterns by proposing a “smoothing” mechanism, and the proposed regulations themselves grant the Treasury and IRS the authority to adopt such an approach. The preamble details this proposed approach, which provides steps to include payment amounts from adjacent years and calculate an average if the payment amount for a given year is negative, and compares the proposed mechanisms to other approaches suggested by previous commenters.

The preamble also recognizes that the new law’s repeal of section 846(d)(3)(E) leaves no specific rules for determining the loss payment patterns for non-proportional reinsurance and international lines of business extending beyond three calendar years beyond the accident year, since these lines are not included in the list of long-tail lines set forth in section 846(d)(3)(A)(ii). The Treasury and IRS have requested comments regarding the length of the loss payment patterns for these lines, and the legal basis for limiting the payment patterns for these lines to three calendar years following the accident year versus extending the payment patterns beyond those years.

**Repeal of historical loss payment pattern election**

Prior to the new law’s enactment, taxpayers were permitted to elect under section 846(e) to use their own historical loss payment patterns with respect to all lines of business rather than the industry-wide pattern determined by the IRS, providing certain requirements were met. The new law repealed this election, and the proposed regulations do not provide any mechanism to replace it. The final tax year available for companies to elect to use their own historical company payment pattern was 2017.

**Transition rule**

The transition rule set forth in new law section 13523(e) provides that, for the first tax year beginning after December 31, 2017, the unpaid losses and expenses unpaid (as defined in section 832(b)(5) and (6)) at the end of the preceding tax year, and the unpaid losses (as defined in sections 805(a)(1) and 807(c)(2)) at the end of the preceding tax year, are determined as if the amendments made by section 13523 of the new law had applied to such unpaid losses and expenses unpaid in the preceding tax year and by using the interest rate and loss payment patterns applicable to accident years ending with calendar year 2018. Any adjustment resulting from this transition rule is taken into account ratably in such first tax year and the seven succeeding tax years.

For subsequent tax years, such amendments are applied with respect to unpaid losses and expenses unpaid for accident years ending with or before calendar year 2018 by using the interest rate and loss payment patterns applicable to accident years ending with calendar year 2018. The preamble describes this transition rule, but neither the preamble

nor the proposed regulations modify or provide new information regarding the transition rule.

**Other considerations**

Other notable items include:

- The preamble explains the proposal to discontinue the "composite method" for discounting unpaid losses relating to accident years not separately reported on the NAIC annual statement by requiring taxpayers to compute discounted unpaid losses with respect to that year using the discount factor published by the IRS for that year for the appropriate line of business.

- The preamble notes that the Treasury and IRS anticipate providing in future guidance that estimated salvage recoverable is to be discounted using the published discount factors applicable to unpaid losses. This would eliminate the need to publish separate discount factors for estimated salvage and subrogation. The Treasury and IRS also request comments regarding whether net payment data and net losses incurred data should be used to compute loss discount factors.

- The proposed regulations were not subject to review by the Office of Management and Budget (pursuant to Executive Order 12866). However, the notice of proposed rulemaking is being submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

**Additional observation**

A public hearing for the proposed regulations has been scheduled for December 20, 2018. The regulations would not be finalized until after that date, and the IRS is unlikely to issue 2018 discount factors until final regulations are issued. As such, it is expected that 2018 discount factors will not be published until 2019. As a result, companies need to consider how to approach their year-end processes absent specific guidance.

The preamble's extended discussion on the appropriate discount rate and the requests for comments on alternative discount rates and the application of section 846 to reinsurance and international lines of business appear to support the view that Treasury and the IRS are open to alternative approaches and mechanisms to address the new law changes to section 846.

## Future regulations, information reporting on reportable policy sales of life insurance contracts (new section 6050Y): Notice 2018-41

On April 26, 2018, the IRS issued **Notice 2018-41** [PDF 63 KB] describing the new information reporting requirements under new section 6050Y and setting forth details of future regulations that will be issued to assist taxpayers in complying with these

information reporting requirements for reportable policy sales of life insurance contracts. The IRS also released a press release—**IR-2018-104**—concerning Notice 2018-41.

In addition to indicating that the IRS and Treasury intend to issue proposed regulations regarding the new information reporting obligations for certain life insurance contract transactions under section 6050Y, the notice:

- States that the future proposed regulations will provide guidance on a modification to the transfer for valuable consideration rules for life insurance contracts, added to section 101(a) by the new law
- Provides transitional guidance delaying any reporting under section 6050Y until final regulations are issued
- Provides taxpayers additional time to satisfy any reporting obligations arising prior to publication of final regulations

**Overview**

Under Notice 2018-41, information returns need to be filed:

- By anyone who acquires a life insurance contract, or any interest in a life insurance contract, in a "reportable policy sale"
- By an issuer of a life insurance contract upon notice of a transaction required to be reported above or upon any notice of a transfer of a life insurance contract, or any interest in a life insurance contract, to a foreign person
- By any payor of "reportable death benefits"

A "reportable policy sale" is generally the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship to the insured.

A "reportable death benefit" is an amount paid at the death of the insured under a life insurance contract that was transferred in a reportable policy sale.
Intended proposed guidance

**Information reporting for certain life insurance contract transactions.** Section 6050Y provides that each of the returns required by section 6050Y must be made "at such time and in such manner as the Secretary shall prescribe." Notice 2018-41 indicates that Treasury and the IRS intend to propose regulations under section 6050Y describing the manner by which and time at which the reporting requirements of section 6050Y must be satisfied. The proposed regulations would also clarify which parties are subject to the reporting requirements and other definitional issues.

For example, according to the notice, Treasury and the IRS intend to define the term "reportable policy sale" in the proposed regulations to include a viatical settlement. A viatical settlement (a subset of life settlement transactions) may involve the sale of a life insurance contract, but may not be taxed as a sale. Under a viatical settlement, a policyholder may sell or assign a life insurance contract after the insured has become terminally ill or chronically ill.

In addition, the notice indicates that Treasury and the IRS intend to clarify the extent to which section 6050Y applies to sales or acquisitions effected by transferors and transferees outside the United States and to sellers and issuers that are foreign persons for purposes of reporting under section 6050Y(b) or (c).

**Section 6050Y(a) reporting of payments by acquirer in a reportable policy sale.** According to the notice, Treasury and the IRS intend to propose regulations that will:

- Require every person who acquires a life insurance contract or any interest in a life insurance contract in a reportable policy sale to file an information return, to be made according to forms and instructions to be published by the IRS.

- Require every person that is required to file a return under section 6050Y(a)(1) to furnish written statements to each payment recipient and issuer whose name is required to be set forth in such return.

- Provide a definition of "acquirer" for purposes of section 6050Y, defined as any person who acquires a life insurance contract, or an interest in a life insurance contract, directly or indirectly, and who has no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in such life insurance contract. The future proposed regulations may further refine the definition of an "acquirer" for purposes of section 6050Y. For example, the proposed regulations may define "acquirer" in a reportable policy sale to include any person, including the life settlement or viatical settlement provider or financing entity that takes title or possession for state law purposes or acquires a beneficial interest in the life insurance contract at any time. The statute defines "indirectly" for purposes of a reportable policy sale as the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract. The proposed regulations may further refine the definition of "indirectly" for purposes of section 6050Y reporting.

- Clarify the definition of a "reportable payment" for purposes of section 6050Y. Under section 6050Y(d)(1), "payment" is defined with respect to any reportable policy sale, as "the amount of cash and the fair market value of any consideration transferred in the sale." Treasury and the IRS intend to clarify that a reportable payment may include payments to persons other than the seller—such as brokers and, potentially, life settlement providers acting as intermediaries.

- Clarify that the "payment" to the seller reported under section 6050Y(a) is the seller's net proceeds. The net proceeds equal the gross proceeds minus any selling expenses (e.g., broker's fees and commissions).

Section 6050Y(b) reporting of transferor's investment in the contract by issuer (reportable policy sale or transfer to a foreign person). The notice indicates that Treasury and the IRS intend to propose regulations to accomplish the following:

- Implement reporting obligations under section 6050Y(b) on any issuer of a life insurance contract who has either: (1) received the statement required by section 6050Y(a)(2) to be furnished by the acquirer in a reportable policy sale; or (2) received notice of a transfer of a life insurance contract to a foreign person.

- Limit the information reporting obligations imposed under section 6050Y(b) to the life insurance company that is responsible for administering the contract, including paying death benefits under the life insurance contract. Under the future proposed regulations, the reporting obligations would not apply, for instance, to a reinsurer in an indemnity contract covering all or a portion of the risks that the original issuer (and continuing contract administrator) might otherwise have incurred with respect to a life insurance contract. This proposed definition of "issuer" will reduce the burden on reporting life insurance companies and prevent duplicative reporting.

- Require under section 6050Y(b)(1) issuers who have received a statement under section 6050Y(a)(2) to report a reportable policy sale or notice of a transfer of a life insurance contract to a foreign person to file an information return, to be made according to forms and instructions to be published by the IRS.

- Require every issuer to make a return under section 6050Y(b)(1) to furnish written statements to each seller whose name is required to be set forth in a return.

- Define "seller" for purposes of section 6050Y(b) to include any person who transfers an interest in a life insurance contract to an acquirer in a reportable policy sale or to a foreign person.

- Define the term "investment in the contract" that is required to be reported by the issuer with respect to a seller. Section 6050Y(b) requires an issuer to report the "investment in the contract (as defined in section 72(e)(6)) with respect to such seller."

- Define notice of a transfer of a life insurance contract to a foreign person for purposes of section 6050Y(b) as any notice, including information provided for non-tax purposes such as change of address notices for purposes of sending statements or for other purposes, or information relating to loans, premiums, or death benefits with respect to the contract.

- Provide that issuers who have not received a written statement from an acquirer under section 6050Y(a)(2), but who have received notice of a transfer of a life insurance

contract to a domestic person, may optionally file a return with the IRS under section 6050Y(b)(1) and furnish written statements to sellers under section 6050Y(b)(2), unless the issuer knows the transfer is not a reportable policy sale.

**Section 6050Y(c) reporting of reportable death benefits by payor.** According to the notice, Treasury and the IRS intend to do the following:

- Propose regulations related to the reporting obligations under section 6050Y(c) on persons making payments of reportable death benefits during any tax year.

- Propose regulations under section 6050Y(c)(1) requiring a payor of reportable death benefits to file an information return, to be made according to forms and instructions to be published by the IRS, reporting the following information to the IRS.

- Propose regulations under section 6050Y(c)(2) requiring every person required to file a return under section 6050Y(c)(1) to furnish written statements to each recipient of reportable death benefits whose name is required to be set forth in a return made under section 6050Y(c)(1).

- Define the term “estimate of the investment in the contract” that is required to be reported by the payor with respect to a buyer to include only the amount of premiums paid by the buyer under the contract, less the aggregate amount received by the buyer under the contract.

- Define “buyer” in the proposed regulations. For example, the proposed regulations may define “buyer” to include any person either holding a beneficial interest in the life insurance contract or taking title or possession for state law purposes.

The definition of “reportable policy sale” applies only to transfers made after December 31, 2017. Section 6050Y(d)(4) defines “reportable death benefits” as “amounts paid by reason of the death of the insured under a life insurance contract that has been transferred in a reportable policy sale.” Accordingly, death benefits are “reportable death benefits” under section 6050Y(d)(4), and are subject to the reporting requirements of section 6050Y(c), only if the death benefits are paid by reason of the death of the insured under a life insurance contract transferred after December 31, 2017, in a reportable policy sale.

**Timing of section 6050Y reporting.** The notice also indicates the following:

- The recipients of the written statements required to be furnished under section 6050Y may use the information therein to determine their taxable income. To facilitate recipients’ proper tax reporting, Treasury and the IRS intend to require that an acquirer furnish the written statements required under section 6050Y(a)(2) to an issuer by the later of: (1) 20 days after the reportable policy sale; or (2) five (5) days after the end of the applicable state law rescission period, if any, but in no event later than January 15 of the year following the calendar year in which the reportable policy sale occurs. The

notice indicates that Treasury and the IRS intend to require that all other written statements required under sections 6050Y(a)(2), (b)(2), and (c)(2) be furnished to the recipients identified in the statute and regulations no later than January 31 of the year following the calendar year in which the reportable policy sale or reportable death benefit payment occurs.

- Treasury and the IRS intend to propose regulations requiring the returns required by sections 6050Y(a)(1), (b)(1), and (c)(1) to be filed with the IRS no later than February 28 of the year following the calendar year in which the reportable policy sale or reportable death benefit payment occurs, for paper returns; and no later than March 31 of the year following the calendar year in which the reportable policy sale or reportable death benefit payment occurs, for electronically filed returns.

- Treasury and the IRS intend to propose regulations regarding reporting obligations upon the rescission of a reportable policy sale or transfer to a foreign person. Upon receiving notice of the rescission, any person who has filed a return required by section 6050Y with respect to the reportable policy sale or transfer would have 15 days to file a corrected return.

- The reporting requirements of section 6050Y apply to reportable policy sales that occur after December 31, 2017, and reportable death benefits paid after December 31, 2017. For reportable policy sales and payments of reportable death benefits occurring after December 31, 2017, and before the date final regulations under section 6050Y are published in the Federal Register, Treasury and the IRS intend to allow additional time after the date final regulations are published to file the returns and furnish the written statements required by section 6050Y.

**Modification to the transfer for value consideration rules**

According to the notice, Treasury and the IRS intend to propose amendments to Treas. Reg. section 1.101-1 to reflect the addition of section 101(a)(3).

**Request for comments**

Treasury and the IRS requested comments on the proposed rules described in the notice and on any additional issues that should be addressed by the regulations.

**KPMG observation:** Some tax professionals have observed that it is helpful that the notice describes new tax reform information reporting requirements for certain life insurance contract transactions and provides transitional guidance delaying reporting until final regulations are issued.

It further has been observed that Notice 2018-41 also may be beneficial because there has been ambiguity regarding what is defined as a reportable policy sale. The expected section 101 regulations would help identify what qualifies as a substantial interest. In addition, some have viewed as beneficial the fact that there is an opportunity for a

comment period. There may be some questions as to why viatical settlements (which are covered by section 101(g)) are included given that these are not life settlement-type transactions.

## Computing insurance company reserves: Rev. Proc. 2019-19

On December 13, 2014, the IRS released Rev. Proc. 2019-10. Insurance companies may follow this revenue procedure to obtain automatic consent to account for changes in computing their reserves as required by section 807(f), as amended by the new law.

Read **Rev. Proc. 2019-10** [PDF 47KB]

**Background**

Section 807(f), as amended by the new law, requires an insurance company to treat any changes as a result of computing its reserves on a different basis in the current year compared to the previous year under the section 481 change in method of accounting rules. This new requirement is effective for tax years beginning after December 31, 2017. Previously, an insurance company was required to account for any changes in the basis for computing its reserves by ratably including the change in income over 10 years (the 10-year spread).

**Rev. Proc. 2019-10**

Rev. Proc. 2019-10 modifies Rev. Proc. 2018-31 to address the amendment to section 807(f) and adds section 26.04 to the List of Automatic Changes.

- When a taxpayer's reserves are increased in the tax year (the year of change) as a result in a change of basis for determining the reserves, any adjustment under section 481 because of the change in method of accounting under section 807(f) will be accounted for in the year of change. For example, a taxpayer whose reserves would have been $105 under an old basis but are now $109 under a new basis will account for the $4 increase to the reserves as a $4 deduction in the year of change.

- When a taxpayer's reserves are decreased in the year of change as a result in a change of basis for determining the reserves, any adjustment under section 481 will be accounted for over four years, beginning with the year of change. For example, a taxpayer whose reserves would have been $105 under an old basis but are now $101 under a new basis will account for the $4 decrease to the reserves as a $1 increase to income in the year of change and in each of the next three years.

A taxpayer that changes its basis for calculating its reserves and that must make a change in its method of accounting must file Form 3115, *Application for Change in Accounting Method*. Rev. Proc. 2019-10 details specific information that must be included on Form 3115 as a result of a method change under section 807(f).

A single Form 3115 is required for all basis changes made in a tax year. However, all basis changes made in a tax year are considered separate changes. The changes in basis of computing the reserve for each type of contract (life insurance, annuity, etc.) must be aggregated into a single section 481(a) adjustment. All basis adjustments must be separately identified on Form 3115. A single Form 3115 is to be filed for all changes in basis for all members of a consolidated group.

In order to make sure there are no duplications or omissions of the changes in reserves as a result of the new law, the following rules apply:

- Any changes to reserves under prior law section 807(f) in tax years beginning before January 1, 2018, must be continue to use a 10-year spread.

- Any changes to reserves due to the transitional rule for section 807(d) must continue to be accounted for over eight years (i.e., the pre-new-law closing balance compared to the post-new-law closing balance). To the extent any changes in basis are required under prior law section 807(f), such changes are to be included in the pre-new law closing balance.

- Any changes to reserves in subsequent years must be taken into account as change in method of accounting.

The eligibility requirements prohibiting a method change for the same item within five tax years do not apply to changes under section 26.04.

An automatic change under section 26.04 does not qualify for audit protection in the year of change or in any subsequent year. In other words, the IRS may require a taxpayer to change the basis for computing reserves if such basis does not constitute a permissible method of accounting, even if an automatic change was granted for the year of change. Rev. Rul. 94-74 and Rev. Rul. 2002-6, which previously described situations when adjustments may be made to reserves without treating such adjustments as method changes (e.g., filing an amended return), are modified to the extent they were inconsistent with the required procedures to change a method of accounting of section 446.

**KPMG observation:** The release of Rev. Proc. 2019-10 was much anticipated and is mainly in line with industry expectations. It provides a methodology for applying the updated section 807(f) provisions.

The revenue procedure does not discuss what qualifies as a change in basis for computing reserves. Since the post-new-law federally prescribed reserve computation is based on statutory reserves, it is not clear whether a change in basis for computing statutory reserves would be subject to the new section 807(f) rules.

While it can be helpful that all basis changes for a single year are aggregated by product line, it may open questions as to what constitutes any particular product line. Presumably, variable annuities would be separate from fixed annuities.

It is important to note the section 481(a) adjustment is included in the year of change, and is not deferred to the year subsequent to the year of change (as in the former section 807(f) rules).

Finally, because the revenue procedure is effective for only tax years beginning after December 31, 2017, taxpayers should be entitled to utilize previous procedures to make changes in pre-new-law tax years (e.g., under Rev. Rul. 94-74 and Rev. Rul. 2002-6). Taxpayers need to be careful, however, to determine that such changes do not duplicate or omit changes in reserves. For example, a taxpayer may be required to amend its return to recalculate the transition amount under the new law.

## State-assumed interest rates, insurance company post-2016 reserves: Rev. Rul. 2018-13

On April 26, 2018, the IRS issued **Rev. Rul. 2018-13** [PDF 25 KB], which provides the schedules of prevailing state-assumed interest rates for use by insurance companies to compute their reserves for tax years beginning after December 31, 2016, and on or before December 31, 2017.

The guidance provided by the revenue ruling is to be used by insurance companies in computing their reserves for contracts concerning:

- Life insurance and supplementary total and permanent disability benefits
- Individual annuities and pure endowments
- Group annuities and pure endowments

**Changes to section 807(d) under the new law**

The revenue ruling is the last in a series of supplements to the interest rate schedules (originally set forth in Rev. Rul. 92-19) because the new law amended section 807(d) for tax years beginning after December 31, 2017.

Under the new law, life insurance reserves are no longer required to be computed using the greater of the applicable federal interest rate or the prevailing state assumed interest rate. Accordingly, Rev. Rul. 2018-13 only provides the prevailing assumed interest rate for certain insurance products issued in 2017 for use by insurance companies in computing their reserves for tax years beginning after December 31, 2016, and on or before December 31, 2017.

## Effects of new law on captive insurance companies: KPMG report

Read a 2018 article by Thomas Cyr, Sheryl Flum, and William Olver of KPMG on ***Insurance Perspectives: Effects of the Tax Cuts and Jobs Act of 2017 on Captive***

***Insurance Companies*** [PDF 156 KB], that ran in Vol. 15, Issue 3 of the Journal of Taxation of Financial Products. The article highlights some of the relevant domestic and multinational provisions of the new law and applies them to several common property and casualty captive scenarios.

The article explains that, although the new law did not include any sections specific to captive insurance companies, the changes to the Code may have an important impact on captives, depending on the particular relationship between the insured and the captive. Entities using foreign captives in particular must be mindful of potential mandatory repatriation implications for tax years ended December 31, 2017, or fiscal years ending in 2018, as well as BEAT implications going forward. These considerations, as well as FET and state premium and self-procurement taxes, are important to account for when analyzing the tax implications of a captive.

### Mandatory repatriation considerations for insurance companies: KPMG report

On December 29, 2017, immediately after the IRS issued **Notice 2018-07** [PDF 151 KB] (described in the **International section** of this supplement), KPMG issued a *TaxNewsFlash* report, ***Insurance: Mandatory repatriation considerations under new tax law***, with analysis and observations regarding how the new law's mandatory repatriation measures might affect insurance companies.

## Exempt organizations

### Parking expenses: Notice 2018-99 and Notice 2018-100

On December 10, 2018, the IRS released **Notice 2018-99** [PDF 171 KB] as interim guidance to use in determining the amount of parking expenses for qualified transportation fringe (QTF) benefits that is nondeductible under section 274(a)(4) and for tax-exempt organizations to determine the corresponding increase in the amount of unrelated business taxable income (UBTI) under section 512(a)(7) attributable to the nondeductible parking expenses. See discussion of Notice 2018-99 in the **Compensation section** of this supplement.

A separate IRS notice—**Notice 2018-100** [PDF 82 KB]—provides for certain exempt organizations relief from the estimated tax penalty in 2018 for parking QTF benefits for those entities that were not previously required to file a Form 990-T or that will not exceed the $1,000 threshold below which an organization is not required to file a Form 990-T or pay the unrelated business income tax.

**Background**

Section 512(a)(7), added to the Code by the new law, increases unrelated business taxable income (UBTI) by amounts paid or incurred to provide certain transportation fringe benefits to employees of tax-exempt organizations.

In general, taxpayers must pay estimated income tax on a quarterly basis (to the extent that the taxes are not withheld), and section 6655(a) imposes an addition to tax for failure to make a sufficient and timely payment of estimated income tax.

**Notice 2018-100**

Recognizing that enactment of section 512(a)(7) may result in tax-exempt organizations owing unrelated business income tax and having to pay estimated income tax for the first time, Notice 2018-100 waives the addition to tax under section 6655 for a failure to make estimated income tax payments. The waiver applies if the exempt organization meets the following conditions:

- It was not required to file Form 990-T for the tax year preceding its first tax year ending after December 31, 2017 (e.g., 2016 Form 990-T for fiscal year filers and 2017 Form 990-T for calendar year filers);
- The estimated tax was required to be paid on or before December 17, 2018; and
- The underpayment is attributable to section 512(a)(7).

To claim the waiver, the tax-exempt organization must timely file its Form 990-T, timely pay the amount reported for the tax year for which relief is granted, and write "Notice 2018-100" on the top of its Form 990-T.

**KPMG observation:** The lack of guidance about the tax law changes enacted with respect to the fringe benefit UBTI left tax-exempt organizations with questions about the extent of their UBTI liability under section 512(a)(7) and, as acknowledged in the notice, with a need for "additional time to develop the knowledge and processes to comply with estimated income tax payment requirements."

However, the relief provided by Notice 2018-100 generally is available only for those tax-exempt organizations that did not have a 2016 Form 990-T (fiscal year filers) or 2017 Form 990-T (calendar year filers) filing requirement (i.e., for the tax year preceding the organization's first tax year ending after December 31, 2017). The IRS has not indicated whether it will grant additional relief or waivers to other exempt organizations. Exempt organizations that do not qualify for relief under the notice may, however, avoid the addition to tax under section 6655(a) if their previous tax year was 12 months in length and they made timely installment payments equal to at least 100% of the tax shown on the prior year's return.

## Section 163(j) business interest limitation: Proposed regulations

For a brief discussion of the references to tax-exempt organizations in the proposed regulations relating to the business interest limitation provisions of section 163(j), see the **discussion of the 163(j) proposed regulations** earlier in this book.

## Guidance for new UBTI rules under section 512(a)(6): Notice 2018-67

On September 4, 2018, **Notice 2018-67** [PDF 113 KB] was published concerning new section 512(a)(6), which requires an organization subject to the unrelated business income tax under section 511 with more than one unrelated trade or business to calculate unrelated business taxable income (UBTI) separately with respect to each trade or business. Notice 2018-67 describes issues arising under new section 512(a)(6) and provides transition rules and interim guidance under section 512(a)(6) on which organizations may rely pending publication of proposed regulations. More specifically:

- For exempt organizations investing in partnerships, Notice 2018-67 provides the following interim and transition rules:
  - An exempt organization may aggregate its UBTI from its interest in a single partnership with multiple trades or businesses (including trades or businesses conducted by lower-tier partnerships) if one of two tests is met:
    - A ***de minimis* test**, which the exempt organization satisfies if it holds directly no more than 2% of the profits interest and no more than 2% of the capital interest of the partnership; or
    - A **control test**, which the exempt organization satisfies if it directly holds no more than 20% of the capital interest and does not have control or influence over the partnership.
  - An exempt organization may aggregate all partnership interests meeting the *de minimis* or control test and treat the aggregate group of qualifying partnership interests as comprising a single trade or business for purposes of section 512(a)(6).
  - As an alternative to the interim rule described immediately above, the Notice provides a transition rule for a partnership interest acquired prior to August 21, 2018, under which an exempt organization may treat each such partnership interest as comprising a single trade or business for purposes of section 512(a)(6)—regardless of whether it meets the *de minimis* or control test and regardless of whether or not there is more than one trade or business directly or indirectly conducted by the partnership or lower-tier partnerships.
- For trades or businesses that an exempt organization engages in other than through a partnership, Notice 2018-67 states that the use of North American Industry Classification System (NAICS) 6-digit codes to determine whether an exempt organization has more than one unrelated trade or business will be considered a reasonable, good-faith interpretation of section 512(a)(6) on which taxpayers may rely.
- In addition, Notice 2018-67:

- Announces that Treasury and the IRS have determined that an inclusion of GILTI under section 951A(a) is to be treated as a dividend, which is generally excluded from UBTI under section 512(b)(1). This is the manner in which an inclusion of subpart F income under section 951(a)(1)(A) is generally treated for UBTI purposes.

- States that any amount included in UBTI under new section 512(a)(7) (relating to certain qualified transportation fringes) is not subject to section 512(a)(6).

- Contains preliminary observations regarding amounts included in UBTI under section 512(b)(4) (relating to unrelated debt-financed income), section 512(b)(13) (relating to certain income from controlled entities), and section 512(b)(17) (relating to certain insurance income). The notice states that Treasury and the IRS do not currently see a distinction between these categories of UBTI and income derived from an unrelated trade or business for purposes of section 512(a)(6) but recognize that aggregating income included in UBTI under section 512(b)(4), (13), or (17) "may be appropriate in certain circumstances."

The notice requests comments on these and other issues and generally provides that exempt organizations may rely on a reasonable, good-faith interpretation of sections 511 through 514, considering all the facts and circumstances, when determining whether an exempt organization has more than one unrelated trade or business for purposes of section 512(a)(6).

## Excise tax based on investment income of private colleges and universities

### Tuition-paying requirement: Legislative change

The Bipartisan Budget Act of 2018 (Pub. L. No. 115-123)[8] amended section 4968 to provide that, in determining whether a college or university has at least 500 students of which more than 50% are located in the United States, only "tuition-paying" students are counted. Prior to the amendment, the 1.4% excise tax imposed on the net investment income of private colleges and universities applied to schools with at least 500 students (more than 50% of which are located in the United States) and non-exempt use assets with a value at the close of the preceding tax year of at least $500,000 per full-time student. There was no requirement that the students be "tuition-paying."

This change is effective for tax years beginning after December 31, 2017.

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8 In addition to the "tuition-paying" amendment to section 4968, the Bipartisan Budget Act of 2018 also added a new exception to the private foundation excess business holding tax for independently operated philanthropic business holdings. *See* section 4943(g). Although considered during the 2017 legislative process, this provision was not included in the final version of the new law.

Note that the tuition-paying requirement had been included in an earlier version of a conference agreement for the new law as H.R. 1 moved through the legislative process. However, on December 19, 2017, the Senate parliamentarian determined that the tuition-paying requirement (along with two other provisions) violated the budget reconciliation rules that were being used to move H.R. 1 through the Senate with fewer than 60 votes. As a result, the provision was stricken from the conference agreement early in the morning of December 20, 2017. The enactment of the Bipartisan Budget Act of 2018 added back the provision.

### Form 4720 filing requirement: Proposed regulations and draft form

On November 5, 2018, Treasury and the IRS released for publication in the Federal Register proposed regulations (REG-107163-18) specifying which return to use to pay certain excise taxes imposed by sections 4960 and 4968 (Form 4720) and the time for filing the return (the 15th day of the fifth month after the end of the tax year during which the excise tax liability was incurred). (See the **Compensation section** of this supplement for discussion of the section 4960 excise tax and more information regarding the Form 4720 filing requirements.) The **proposed regulations** [PDF 92 KB] were published in the Federal Register on November 7, 2018. Comments are due by December 7, 2018.

### Future regulations for determining net investment income: Notice 2018-55

On June 25, 2018, **Notice 2018-55** [PDF 82 KB] was published, indicating that Treasury and the IRS intend to issue regulations clarifying the calculation of net investment income for purposes of section 4968(c).

The notice explains that proposed regulations will provide a special basis step-up rule that, for purposes of determining gain on the disposition of property held on December 31, 2017 and continuously thereafter until disposition, deems the basis of such property to be not less than its fair market value on December 31, 2017 (plus or minus certain adjustments consistent with the regulations under section 4940(c)). The notice indicates that colleges and universities subject to section 4968 may rely on this provision in the notice until further guidance is issued.

In addition, the notice addresses the rules for netting capital gains and losses and states that—similar to the rules found in section 4940(c)(4)(C)—future regulations will provide that losses from sales or other dispositions of property generally will be allowed only to the extent of gains from such sales or other dispositions, and that there will be no capital loss carryovers or carrybacks. The notice indicates that Treasury and the IRS expect that, with respect to related organizations described in section 4968(d)(2), overall net losses from sales or other dispositions of property in one related organization (or from the applicable educational institution) will be allowed to offset overall net gains from sales or other dispositions of other related organizations (or from the applicable educational institution).

## Excise tax on excess tax-exempt organization executive compensation

See the **Compensation section** of this report regarding guidance on this issue.

## Employer credit for paid family and medical leave unavailable to section 501(c)(3) organizations: Notice 2018-71

On September 24, 2018, the IRS issued **Notice 2018-71** [PDF 115 KB], providing guidance—in a "question and answer" ("Q&A") format—about the employer credit for paid family and medical leave under section 45S as added to the Code by the new law.

Notice 2018-71 clarifies—in an example—that the Family and Medical Leave Act (FMLA) credit is unavailable to section 501(c)(3) organizations, but the notice does not address the eligibility of other section 501(c) organizations to claim the credit.

Read general information about Notice 2018-71 in the **Business Credits section** of this supplement.

### Notice 2018-71 and exempt organizations

Although new section 45S allows many employers to claim a credit for a percentage of wages paid to employees if qualifying criteria are met, the manner in which the statute defines certain terms precludes section 501(c)(3) organizations from claiming the credit. Specifically, Notice 2018-71 explains that because "wages" (the amount upon which the credit is based) is defined as "all remuneration for employment" under the FUTA employment tax provisions—and because employment by a section 501(c)(3) organization is not "employment" for such purposes—section 501(c)(3) organizations would not have any wages upon which to claim the credit. Notice 2018-71, Q&A 24, Ex. 2.

**KPMG observation:** In light of the IRS's rationale in concluding that section 501(c)(3) organizations are ineligible to claim the credit, it appears that other entities that enjoy a similar FUTA employment tax exception—such as the federal and state governments, political subdivisions, and instrumentalities—would also be ineligible to claim the credit.

Notice 2018-71 does not address the eligibility of other section 501(c) organizations to claim the credit. Presumably such organizations may claim the credit if amounts they pay to employees constitute wages for FUTA employment tax purposes and all other relevant requirements are met.

The notice also provides that leave paid by a state or local government or required by a state or local law is not taken into account for purposes of determining the credit. Notice 2018-71, Q&As 9, 21 and 26.

### Mandatory repatriation proposed regulations – Implications for exempt organizations

As described in the International section of this supplement, Treasury and the IRS published **proposed regulations** [PDF 453 KB] relating to the transition tax under section 965 on August 9, 2018. For exempt organizations, the guidance in the proposed regulations generally is limited to section 4940 – the excise tax that private foundations pay on their net investment income. The preamble to the proposed regulations indicates that section 965(a) inclusions generally will be included in the calculation of gross investment income of a private foundation for purposes of determining the excise tax imposed under section 4940 and provides that elections may not be made under section 965(h) to pay tax imposed under section 4940 in eight installments. The proposed regulations further provide that a section 965(c) deduction is not treated as an ordinary and necessary expense paid or incurred for the production or collection of gross investment income in computing the excise tax imposed under section 4940. *See* Prop. Reg. section 1.965-3(f)(4).

## Cooperatives

### Application of sections 199 and 199A to cooperatives: Legislation enacted

The Consolidated Appropriations Act, 2018 (Pub. L. No. 115-141) includes law changes regarding the application of the new section 199A deduction to certain cooperatives and grain companies. (See discussion of section 199A in the **Passthroughs section** of this supplement.)

The provision in the Consolidated Appropriations Act attempts to address certain concerns that had been raised within the agricultural industry that, under the new law as initially enacted in December of 2017, farmers selling their farm commodities to cooperatives were tax-advantaged over similarly situated farmers selling to non-cooperatives. Section 199A(a)(2), as initially enacted, had provided for a 20% gross deduction for “qualified cooperative dividends,” and this term was defined as including per-unit retain allocations paid in money (essentially the sales price of the commodities delivered for marketing to a cooperative).

The new provisions are effective retroactively from January 1, 2018. These provisions generally:

- Restore prior-law section 199 treatment for specified agricultural and horticultural cooperatives under new section 199A(g). The Treasury is instructed to base new guidance on regulations under the prior-law version of section 199.

- Allow eligible patrons to claim a deduction passed through from a specified agricultural and horticultural cooperative. Eligible patrons include all non-corporate taxpayers, S corporations, and other specified agricultural and horticultural cooperatives.

- Revise the farmer-level deduction to 20% of taxable income or qualified business income (in line with all other non-corporate taxpayers), with limitations for farmers with high taxable incomes or capital gains.

Under the new law, for farmers who enter into transactions with a cooperative:

- The 20% deduction is reduced by the lesser of: (1) 9% of qualified business income allocable to qualified payments received from cooperatives; or (2) 50% of wages allocable to such qualified payments.

- This reduction applies regardless of the amount of section 199A(g) deduction passed through by the cooperative. This treatment is intended to replicate the deduction the farmer had foregone by dealing with the cooperative under prior-law section 199.

- The cooperative member's total deduction for the year is the passthrough deduction plus the modified 20% deduction.

Taxpayers, including patrons of cooperatives structured as C corporations, are not eligible for the 199A deduction including the passthrough deduction under section 199A(g) from specified agricultural and horticultural cooperatives.

Special rules are provided for cooperatives with oil-related qualified production activities income.

## Revised draft instructions for cooperatives: Form 1120-C for 2017

The IRS has posted a draft version of instructions—with changes that reflect the new law measures—for Form 1120-C, U.S. Income Tax Return for Cooperative Associations, as proposed guidance for filing Form 1120-C for 2017.

The draft instructions for **Form 1120-C** [PDF 567 KB] reflect a date of March 30, 2018, and include cautionary language that the instructions are not to be relied upon for filing purposes and are subject to change and to OMB approval before being officially released. Under the "What's New" section of these draft instructions are descriptions of the following items:

- Tax rates for fiscal year filers

- Increase in penalty for failure to file

- Alternative tax for cooperatives with qualified timber gains

- Deduction for foreign-source portion of dividends received by domestic corporations from specified 10%-owned foreign corporations
- Treatment of deferred foreign income upon transition to participation exemption system of taxation
- Disaster relief
- Film, television, and live theatrical productions
- Entertainment expenses, membership dues, and facilities
- Net operating loss
- Principal business activity codes

## Real estate

### "Qualified real property" expensing and alternative depreciation: Rev. Proc. 2019-08

On December 21, 2018, the IRS released **Rev. Proc. 2019-08** [PDF 70 KB] as guidance concerning expense deductions and depreciation measures related to real property that were enacted by the new law. See discussion in the **Cost Recovery section** of this report.

### REIT qualifying income and GILTI: Rev. Proc. 2018-48

On September 13, 2018, the IRS issued **Rev. Proc. 2018-48** [PDF 24 KB], pursuant to which certain types of income, including so-called "GILTI," are treated as qualifying income for purposes of the 95% "gross income test" applicable to real estate investment trusts (REITs).

Specifically, the revenue procedure addresses the following types of income:

- Amounts required to be included in gross income under sections 951(a)(1) (except by reason of section 965), 951A(a), 1291(a), 1293(a)(1), and 1296(a)
- Amounts required to be taken into account under section 986(c) as foreign currency gain with respect to distributions of previously taxed earnings and profits

The revenue procedure notes that the IRS had previously received requests to exercise the authority under section 856(c)(5)(J) and (n)(3)(C) to treat certain amounts determined under sections 951(a)(1) (Subpart F income and inclusions under section 956), 986(c)

(foreign currency gain that is related to the distribution of certain previously taxed earnings), 1291(a) (excess distributions from, and gain on the sale of stock, of certain passive foreign investment companies), and 1293(a)(1) (inclusions from qualified electing funds) either as not constituting gross income or as qualifying gross income, for purposes of section 856(c)(2). The IRS further noted that, since section 951A was added to the Code by the new law, the IRS has received similar requests to exercise the authority under sections 856(c)(5)(J) and 856(n)(3)(C) regarding REIT income inclusions and foreign currency gain with respect to "global intangible low-taxed income" (GILTI) under section 951A(a).

Accordingly, Rev. Proc. 2018-48 applies to any REIT that is required to include in gross income amounts under sections 951(a)(1) (except by reason of section 965), 951A(a), 986(c), 1291(a), 1293(a)(1), or 1296(a). The revenue procedure is effective for tax years beginning after September 13, 2018, but may be applied for a prior tax year by a REIT.

**Additional observations and information**

For more information, read an October 2018 report [PDF 81 KB] prepared by Stephen Giordano and Louis Cosentino of KPMG, ***Putting at Ease the GILTI Conscience: IRS Treats Cross-Border Income Inclusions as Qualifying Income*** [PDF 81 KB]. The article describes how Rev. Proc. 2018-48 allows certain cross-border income—including the new GILTI —to be treated as qualifying income for purposes of a REIT qualifying gross income test.

Note also that Rev. Proc. 2018-48 is the first time the IRS used REIT-related discretionary authority to issue general guidance instead of private rulings.

## Tax reform and investment in U.S. real estate: Article

James Sowell and Jon Finkelstein of KPMG authored an article on ***Tax Reform and Investment in U.S. Real Estate*** [PDF 1 MB] that was published in Tax Notes on April 16, 2018.

The article walks through a host of changes made by the new law that could affect the real estate industry, including individual and corporate rate changes, the new deduction for qualified business income, new rules for applicable partnership interests (carried interest), net operating loss provisions, limits on business interest deductibility, cost recovery provisions, treatment of small businesses, deduction of investment management fees, excess business loss limitation, financial accounting timing rule, like-kind exchanges, non-shareholder contributions to capital, tax-exempt entities, FIRPTA, anti-base-erosion rules, tax credits, technical changes to partnership rules, and qualified opportunity zones.

Among other things, the authors note that the new law contains provisions that force reconsideration of historical decision-making processes and structuring assumptions. That reconsideration will be needed in some situations to obtain new benefits; in others

to preserve prior treatment; and in still others to mitigate, to the extent possible, detriments that flow from the new law.

# Natural resources

## New law changes affecting natural resources publicly traded partnerships: KPMG report

Read a June 2018 report prepared by KPMG: ***Tax Reform and Publicly Traded Partnerships*** [PDF 167 KB]. Based on developments at the time of its issuance, the report considered certain changes that affect natural resources publicly traded partnerships, discussed issues surrounding implementation of the new rules for these partnerships, and identified issues for which further guidance may be necessary.

# Individuals

The new law made numerous changes to individual taxation, most of which are scheduled to expire after 2025. For example, the new law temporarily revised the income tax rates and brackets for individual taxpayers, increased the standard deduction and child tax credit amounts, suspended the personal exemptions, and suspended or limited certain deductions for individual taxpayers. It also temporarily increased the estate, gift, and generation-skipping transfer tax exclusion to $11.18 million (for 2018, indexed for inflation) per individual.

The new law introduces a new method for indexing the tax rate thresholds, standard deduction amounts, and other amounts for inflation. Read related **Guidance on various inflation adjustments** and **Revised inflation adjustments for 2018: Rev. Proc. 2018-18 and IRS release**, later in this supplement.

## In general

### Draft Form 1040 for 2018

In July of 2018, the IRS released a **draft of Form 1040** [PDF 123 KB] "U.S. Individual Income Tax Return" to be filed by individual taxpayers for tax year 2018. In September, the IRS released a **draft version of the Form 1040 instructions** [PDF 3 MB]. These drafts include cautionary language that they are not to be used for filing purposes and are subject to change and to OMB approval before being officially released.

In brief, the drafts indicate that Form 1040 has been redesigned for 2018 and reflects changes under the new U.S. tax law, such as:

- Changes in tax rates (most have been reduced)
- Increased standard deduction

- Increased child tax credit
- New credit for other dependents
- Changes to itemized deductions (including measures limiting the deduction for state and local taxes and eliminating both the deduction for miscellaneous expenses and the overall limit on itemized deductions)

## Income tax rates

### Withholding, wages and retirement & annuity distributions: Notice 2018-92

On November 26, 2018, the IRS released an advance version of **Notice 2018-92** [PDF 60 KB] as interim guidance for the 2019 calendar year on income tax withholding from wages and from retirement and annuity distributions.

The notice was issued because certain withholding rules in Notice 2018-14—that applied for 2018—remain in effect for the 2019 calendar year or, in certain instances, until April 30, 2019. See **discussion of Notice 2018-14** below.

The notice also explains that the IRS is providing interim guidance because it plans to develop regulations under sections 3401 and 3402 as amended by the new law. According to an **IRS transmittal message**, these withholding regulations will reflect changes made by the new law, other changes in the Code since the regulations were last amended, and certain miscellaneous changes consistent with current procedures.

Comments were requested both on the interim guidance provided by Notice 2018-92 and on guidance that ought to be provided in regulations. Comments are due by January 25, 2019.

### Withholding forms and calculator: Updated Form W-4 and calculator

On February 28, 2018, the IRS announced the release of a new version of Form W-4, *Employee's Withholding Allowance Certificate* and an updated "withholding calculator" to help individual taxpayers verify their 2018 tax withholding following enactment of the new law. The IRS release—**IR-2018-36**—highlights some of the changes made to individual income taxation in the new law.

As a general matter, many employees may need to re-do their Forms W-4 to take into account the new calculations. The IRS "**withholding calculator**" is intended to help individual taxpayers determine if they need to make changes to their withholding and to determine if they need to submit a new Form W-4 to their employer.

The IRS withholding calculator asks taxpayers to estimate their 2018 income and other items that affect their taxes, including the number of children claimed for the child tax credit, the earned income tax credit, and other items.

### Withholding forms and calculator: Notice 2018-14

On January 29, 2018, the IRS issued **Notice 2018-14** [PDF 52 KB regarding tax law changes affecting withholding. The notice announced that the IRS was in the process of revising Form W-4, *Employee's Withholding Allowance Certificate*, to reflect the legislative changes made by the new law, and indicated that the withholding calculator would be updated. (See discussion above regarding subsequent release of the revised Form W-4 and updated withholding calculator.)

The IRS notice stated that the 2018 Form W-4 might not be released until after February 15, 2018. It indicated that, until a new Form W-4 was issued, employees and employers should use the 2017 Form W-4.

Very generally, Notice 2018-14:

- Extends the effective period of Forms W-4 furnished to claim exemption from income tax withholding under section 3402(n) for 2017 until February 28, 2018
- Permits employees to claim an exemption from withholding for 2018 by temporarily using the 2017 Form W-4
- Temporarily suspends the requirement under section 3402(f)(2)(B)1 that employees must furnish their employers with new Forms W-4 within 10 days of changes in status that reduce the withholding allowances the employees are entitled to claim
- Confirms that the optional withholding rate on supplemental wage payments is 22% for 2018 through 2025
- Provides that, for 2018, withholding under section 3405(a)(4) on periodic payments when no withholding certificate is in effect, will be based on treating the payee as a married individual claiming three withholding allowances

### Withholding tables: Notice 1036

On January 11, 2018, the IRS released **Notice 1036** [PDF 161 KB], announcing that the 2018 withholding tax tables had been revised and updated to reflect enactment of the new law. Employers were directed to begin using the 2018 withholding tables as soon as possible, although no later than February 15, 2018, and to continue to use the 2017 withholding tables until implementing the 2018 withholding tables.

## Filing status, personal exemptions, and credits

### Definition of "qualifying relative": Notice 2018-70

On August 28, 2018, the IRS released **Notice 2018-70** [PDF 42 KB], indicating that the IRS and Treasury intend to issue proposed regulations regarding the definition of "qualifying relative" in Code section 152(d) for purposes of various Code provisions (including the new $500 credit for "other" dependents and head of household filing status) for tax years in which the exemption amount is zero.

Very generally, the notice explains that proposed regulations would clarify that the reduction of the personal exemption amount to zero for tax years 2018-2025 would not be taken into account in determining whether a person is a qualifying relative. Thus, in defining a qualifying relative for various Code provisions that refer to the definition of "dependent" in Code section 152 (including the new $500 credit and head of household filing status), the Code section 151(d) exemption amount would be treated as $4,150 (adjusted for inflation) for years in which the exemption amount is zero.

The notice further indicates that taxpayers may rely on the rules in the notice prior to the issuance of proposed regulations.

### Health plan implications of reduction of personal exemption: Notice 2018-84

See the **Healthcare part of this supplement** for a discussion of **Notice 2018-84** [PDF 36 KB]. The notice addresses how the reduction of the personal exemption deduction to zero for a 10-year period affects the premium tax credit and the individual shared responsibility payment.

## Deduction for qualified business income (new section 199A)

New section 199A provides a deduction for qualifying income of certain noncorporate owners of some passthrough entities and sole proprietorships. The provision is complex and contains a number of important limitations and special rules. The deduction only applies to tax years beginning after December 31, 2017 and before December 31, 2025.

See **Passthroughs section** of this supplement for material on this topic.

## Suspension of certain deductions

### Future regulations to clarify effect of suspension of itemized deductions for estates and trusts: Notice 2018-61

On July 13, 2018, the IRS released **Notice 2018-61** [PDF 30 KB], which clarifies the effect of new section 67(g) (which suspends miscellaneous itemized deductions for years 2018-2025) on the ability of estates and non-grantor trusts to deduct certain expenses.

The notice states that the Treasury and IRS intend to issue regulations to clarify that estates and non-grantor trusts may continue to deduct expenses described in section 67(e)(1) and amounts allowable as deductions under section 642(b), 651, or 661—including the appropriate portion of a bundled fee—for purposes of determining the estate or non-grantor trust's adjusted gross income during certain tax years (i.e., the years during which application of section 67(a) is suspended because of section 67(g)).

Expenses under section 67(e)(1) are costs that are paid or incurred in the administration of an estate or trust and that would not have been incurred if the property were not held in such estate or trust (unlike the costs that commonly or customarily would be incurred by a hypothetical individual holding the same property).

According to the IRS notice, the future regulations will clarify:

> *…deductions enumerated in section 67(b) and (e) continue to remain outside the definition of 'miscellaneous itemized deductions' and thus are unaffected by section 67(g).*

Notice 2018-61 further states that the IRS and Treasury are aware of concerns that the enactment of section 67(g) will affect a beneficiary's ability to deduct section 67(e) expenses upon the termination of the trust or estate as provided in section 642(h). The IRS notice states that the IRS and Treasury:

> *…are studying whether section 67(e) deductions, as well as other deductions that would not be subject to the limitations imposed by sections 67(a) and (g) in the hands of the trust or estate, should continue to be treated as miscellaneous itemized deductions when they are included as a section 642(h)(2) excess deduction.*

## Deductibility of payments for certain state and local tax credits: Proposed regulations, Notice 2018-54, and Notice 2019-12

On August 27, 2018, **proposed regulations** [PDF 261 KB] on the availability of charitable contribution deductions when a taxpayer receives or expects to receive a state or local tax credit in return for a contribution were published in the Federal Register. Comments on the proposed regulations were due October 11, 2018. Several months later, the IRS released Rev. Proc. 2019-12.

### Background

Prior to these proposed regulations, Treasury and the IRS had not addressed whether a taxpayer's expectation or receipt of a state or local tax credit might reduce the taxpayer's charitable contribution deduction in published guidance. However, in a 2010 Chief Counsel Advice memorandum (CCA), the IRS Office of Chief Counsel advised that taxpayers may take a deduction under section 170 for the full amount of a contribution made in return for a state tax credit without subtracting the value of the credit received. *See* CCA 201105010 (Oct. 27, 2010). The CCA also noted that certain circumstances

might yield a different result if a charitable contribution, in form, was a satisfaction of a tax liability, in substance.

The new law added section 164(b)(6), which imposes a $10,000 limit on the deductibility of state and local taxes ($5,000 in the case of a married individual filing a separate return). The new limitation applies to tax years beginning after December 31, 2017, and before January 1, 2026. In response and relying, in part, on the rationale of the CCA, certain states created tax credit programs to provide taxpayers with federal charitable contribution deductions while simultaneously providing a tax credit against state income taxes.

On May 23, 2018, the IRS issued **Notice 2018-54** [PDF 29 KB], stating that Treasury and the IRS intended to propose regulations to address the federal income tax treatment of certain payments made by taxpayers for which taxpayers receive a credit against their state and local taxes. According to the notice, "[d]espite these state efforts to circumvent the new statutory limitation on state and local tax deductions, taxpayers should be mindful that federal law controls the proper characterization of payments for federal income tax purposes."

The proposed regulations, if finalized, generally would render the tax credit "workarounds" described above ineffective. They also would affect existing credit programs (i.e., credit programs for education and other purposes).

On December 28, 2018, the IRS released **Rev. Proc. 2019-12** [PDF 173 KB], which provides safe harbors under section 162 for certain payments made by C corporations or passthrough entities to (or for the use of) a charitable organization (that is, one described by section 170(c)) if the C corporations or passthrough entities receive or expect to receive a state or local tax credit in return for these payments made to the charitable organization.

**Proposed regulations**

The proposed regulations, which would apply to charitable contributions made after August 27, 2018, generally require a taxpayer to reduce its charitable contribution deduction by the amount of a state or local tax credit received or expected to be received as a result of the contribution. This rule would apply to individual and corporate taxpayers under section 170 and to trusts and estates under section 642(c).

However, the proposed regulations contain two exceptions to this general rule:

- **De minimis**: If the state tax credit received or expected to be received by the taxpayer does not exceed 15% of the payment or of the fair market value of the property contributed, the taxpayer does not reduce the value of its deduction.

- **Deductions**: If the taxpayer receives or expects to receive a state or local tax deduction in exchange for the contribution, the taxpayer reduces the value of the

federal income tax deduction only if the state or local tax deduction exceeds the payment or the fair market value of the property contributed. Treasury and the IRS requested comments on how to determine the amount of the reduction in such cases.

**FAQ**

Following the release of the proposed regulations, the IRS and Treasury received questions from taxpayers and others regarding application of the proposed regulations to business entities that make payments to charitable organizations pursuant to state and local tax credit programs. These questions related to the application of section 162 to these payments—that is, whether a business entity may deduct these payments under section 162 as ordinary and necessary business expenses incurred in carrying on a trade or business.

To answer these questions, the IRS in September 2018 released a "frequently asked question" (FAQ) document stating that the proposed regulations do not affect the availability of an ordinary and necessary business expense deduction under section 162. Thus, a business taxpayer making a payment to a charitable or government entity generally would be permitted to deduct the payment as an ordinary and necessary business expense under section 162 if the payment was made with a business purpose.

The FAQ also notes that the rules permitting an ordinary and necessary business expense deduction under section 162 apply to a taxpayer engaged in carrying on a trade or business regardless of the form of the business. Read ***TaxNewsFlash***

**Rev. Proc. 2019-12**

On December 28, 2018, the IRS released **Rev. Proc. 2019-12** [PDF 173 KB], which provides safe harbors under section 162 for certain payments made by C corporations or passthrough entities to (or for the use of) a charitable organization (that is, one described by section 170(c)) if the C corporations or passthrough entities receive or expect to receive a state or local tax credit in return for these payments made to the charitable organization.

The IRS explained that, since the release of the FAQ, the IRS and Treasury continued to receive questions regarding the application of the proposed regulations and sections 162 and 164 to taxpayers engaged in trades or businesses.

In providing safe harbors, Rev. Proc. 2019-12 states that, to the extent a C corporation receives or expects to receive a state or local tax credit in return for a payment to a section 170(c) organization:

> *…it is reasonable to conclude that there is a direct benefit to the C corporation's business in the form of a reduction in the state or local taxes the C corporation would otherwise have to pay and, therefore, to the extent of the amount of the credit received*

> *or expected to be received, there is a reasonable expectation of financial return to the C corporation commensurate with the amount of the transfer.*

The safe harbor for C corporations provides that, if a C corporation makes a payment to or for the use of a section 170(c) organization and receives or expects to receive a tax credit that reduces a state or local tax imposed on the C corporation in return for such payment, the C corporation may treat such payment as meeting the requirements of an ordinary and necessary business expense for purposes of section 162(a) to the extent of the credit received or expected to be received. Examples illustrating the safe harbor are provided.

Rev. Proc. 2019-12 further provides that for a business entity other than a C corporation that is regarded as separate from its owner for all federal tax purposes—i.e., a passthrough entity—to the extent the credit received in return for a payment can reduce the passthrough entity's tax liability:

> *…it is reasonable to conclude that there is a direct benefit to the pass-through entity in the form of a reduction in the state or local taxes the entity would otherwise have to pay. However…the deductibility of the payment must be determined at the level of the individual owners of the entity if the credit received or expected to be received will reduce a state or local income tax subject to the limitations in section 164(b)(6).*

The safe harbor for certain passthrough entities provides that, if a passthrough entity (as defined by the revenue procedure) makes a payment to or for the use of a section 170(c) organization and receives or expects to receive a tax credit that the entity applies or expects to apply to offset a state or local tax other than a state or local income tax, the passthrough entity may treat such payment as meeting the requirements of an ordinary and necessary business expense for purposes of section 162(a) to the extent of the credit received or expected to be received. Examples illustrating this safe harbor are provided.

### Suspension of deduction for qualified moving expense reimbursements: Notice 2018-75

On September 21, 2018, the IRS released **Notice 2018-75** [PDF 47 KB], concerning the tax treatment of employer reimbursements of "qualified moving expenses."

Before the new law, reimbursements made by employers for qualified moving expenses of their employees generally were excludable from an employee's gross income and from wages for employment tax purposes. The new law suspended the exclusion from gross income and from wages for employment tax purposes for qualified moving expense reimbursements for years 2018-2025. (The exclusion, however, was preserved for members of the U.S. Armed Forces and their family members.) The suspension of the income and wage exclusion is effective for tax years beginning after December 31, 2017.

Notice 2018-75 specifically addresses employer reimbursements made in tax years beginning after December 31, 2017, for qualified moving expenses incurred in connection

with a move that occurred before 2018. The notice states that reimbursements received after 2017 for a move made before 2018 will not be subject to the suspension of the income exclusion.

To qualify, the reimbursements or payments must be for work-related moving expenses that would have been deductible by the employee if the employee had directly paid them prior to January 1, 2018. Also, the employee must not have deducted the expenses in 2017.

As an example, the notice explains that, if an individual moved in 2017 and the expenses for the move would have been deductible by the individual under section 217 as in effect before the new law if the expenses had been paid directly by the individual in 2017, and if the individual did not deduct the moving expenses, then the amount received (directly or indirectly) in 2018 by the individual from an employer as payment for or reimbursement of the expenses will be a qualified moving reimbursement. As such, the payment or reimbursement of the expenses is excludable from income as a qualified moving expense reimbursement and the amount is both excludable from wages and excludable from compensation for employment tax purposes.

The notice addresses how employers that have included these amounts in their employees' wages or compensation and have withheld and paid federal employment taxes on these amounts can seek an adjustment or a refund for the overpayment.

A related IRS release—**IR-2018-190**—explains it this way: Employer reimbursements made in 2018 for moves by employees in 2017 are "generally tax-free."

### Home equity interest: KPMG article

Read an article by Liz L'Hommedieu and Chris Stroeer of KPMG, published in Bloomberg BNA's Daily Tax Report, on June 28, 2018, ***Home Equity Interest May Still Be Deductible*** [PDF 192 KB]. The article explains that, for tax years beginning after December 31, 2017, and before January 1, 2026, an individual's deduction for qualified residence interest expense has been amended to disallow a deduction for interest on ''home equity indebtedness.'' However, the article further explains that "home equity indebtedness'' is a specifically defined term. As a result, to the extent certain criteria are met, a taxpayer may still be able to deduct some interest paid on a home equity loan, home equity line of credit, second mortgage, or similar product.

## Estate, gift, and generation-skipping transfer tax

### Basic exclusion amount, estate and gift taxes: Proposed regulations

On November 23, 2018, **proposed regulations** [PDF 240 KB] addressing the effect of changes made by the new law to the basic exclusion amount used in computing federal estate and gift taxes were published in the Federal Register (FR 2018-25538). The proposed regulations could affect the estates of decedents dying after 2017 and donors

of gifts made after 2017. See also a related IRS release: **IR-2018-229** (*Treasury, IRS: Making large gifts now won't harm estates after 2025*).

It was indicated that comments on the proposed regulations are due by February 21, 2019. This is also the "due date" for any outlines of topics to be discussed at a public hearing currently scheduled for March 13, 2019.

**Background**

The new law temporarily increased the basic exclusion amount (BEA) (also known as the lifetime exemption) used in computing federal estate and gift taxes from $5 million to $10 million per person (adjusted for inflation to $11.18 million for 2018 and $11.4 million for 2019). However, the new law makes this enhanced BEA available only for tax years 2018 through 2025. In 2026, the BEA is scheduled to revert to $5 million (as adjusted for inflation) – absent enactment of future legislative changes changing this result.

In general, gift and estate taxes are calculated, using a unified rate schedule, on cumulative taxable transfers of property during life and at death. Any tax due is determined after applying a credit – formerly known as the unified credit – generally calculated by applying the rate schedule to the BEA. The credit is first used during life to offset gift tax and any remaining credit is available to reduce or eliminate estate tax.

To address concerns that an estate tax could apply to gifts that were exempt from gift tax after the temporary increase in the BEA expires, the proposed regulations provide a special rule that allows the estate to compute its estate tax credit using the higher of the BEA applicable to gifts made during life or the BEA applicable on the date of death.

To illustrate the "clawback" concern and the remedy in the proposed regulations, consider the following example. Assume an unmarried individual makes a $10 million gift in 2018 when the BEA is $10 million (therefore paying no gift tax in 2018). Assume the individual dies in 2026 and that the BEA has reverted to $5 million at that time. The individual's remaining estate is $10 million. To keep the math simple, the illustrative computations below ignore inflation adjustments to the BEA and apply a flat estate tax rate of 40%:

*Estate tax calculation with "clawback"*

| | |
|---|---|
| Tentative tax on $20 million (cumulative gifts plus estate) | $8m |
| Gift tax payable on prior gifts (with $10 million BEA) | ($0m) |
| Net tentative estate tax | $8m |
| Lifetime credit (using $5 million as BEA at death) | ($2m) |
| Estate tax due | $6m |

*Estate tax calculation under proposed regs (no clawback)*

| | |
|---|---|
| Tentative tax on $20 million (cumulative gifts plus estate) | $8m |
| Gift tax payable on prior gifts (using $10 million BEA) | ($0m) |

| | |
|---|---|
| Net tentative estate tax | $8m |
| Lifetime credit (using $10 million as BEA at death) | ($4m) |
| Estate tax due | $4m |

## Other

### ABLE accounts

On August 3, 2018, the IRS released **Notice 2018-62** [PDF 66 KB], indicating that the Treasury and IRS intend to issue proposed regulations to clarify the contribution limits provided in section 529A(b)(2) with respect to "achieving a better life experience" (ABLE) accounts. (ABLE accounts are designed to allow disabled individuals and their families to save and pay for disability-related expenses.) The contribution limits for ABLE accounts and other provisions of section 529A were modified by the new law.

A related **IRS transmittal message** explains that Notice 2018-62:

- Provides that, in addition to the annual gift tax exclusion, a designated beneficiary who works may also contribute up to the lesser of: (1) the designated beneficiary's compensation for the tax year, or (2) the poverty line for a one-person household in the state in which the designated beneficiary lives

- States that an employed designated beneficiary is not eligible for the increased contribution limit for the tax year if any contribution is made on behalf of the employee to a 401(a) defined contribution plan or 403(a) annuity contract, a 403(b) annuity contract, or a 457(b) eligible deferred compensation plan

Before the proposed regulations are issued, Notice 2018-62 states that taxpayers, beneficiaries, and administrators of ABLE programs may rely on the notice.

### Combat zone tax benefits

*IRS release*

On April 13, 2018, the IRS issued a release as a reminder to U.S. Armed Forces members who served in the Sinai Peninsula of Egypt of their eligibility for combat zone tax benefits retroactive to June 2015.

The IRS release—**IR-2018-95**—notes that under the new law, members of the U.S. Army, U.S. Navy, U.S. Marines, U.S. Air Force, and U.S. Coast Guard who performed services in the Sinai Peninsula of Egypt can claim combat zone tax benefits -- and may be able to exclude part or all of their combat pay from their income for federal income tax purposes.

### Changes to treatment of alimony

### *Future regulations regarding alimony payments: Notice 2018-37*

On April 13, 2018, the IRS issued **Notice 2018-37** [PDF 17 KB], stating that the Treasury and the IRS intend to issue regulations to clarify the application of the effective date provisions of the new law provisions concerning the repeal of section 682—the Code section that provided rules for trust income payable to a former spouse.

**Background**

Prior to the new law, alimony and separate maintenance payments were deductible by the payor spouse and includible in income by the payee spouse.

The new law prospectively repealed these measures. Under the new law, alimony and separate maintenance payments are not deductible by the payor spouse and are not includible in the income of the payee spouse for any divorce or separation agreement executed after December 31, 2018, and for any agreement executed before but modified after that date if the modification expressly provides that this new provision applies to that modification.

Section 682—also before being repealed—provided rules regarding the tax treatment of the income of certain trusts payable to a former spouse who was divorced or legally separated

**Notice 2018-37**

Notice 2018-37 includes a request for comments as to whether guidance is needed with respect to application of sections 672(e)(1)(A), 674(d), and 677 to trusts for the benefit of a spouse following a divorce or separation.

The notice states that the future regulations will provide that section 682 (as in effect before December 22, 2017) will continue to apply to trust income payable to a former spouse who was divorced or legally separated under a divorce or separation instrument executed on or before December 31, 2018, unless that instrument is modified after that date and the modification provides that the changes made by the new law apply to the modification.

### Standard mileage rates

On May 25, 2018, the IRS issued **Notice 2018-42**, modifying **Notice 2018-03** to reflect certain changes made by the new law. These notices relate to the optional 2018 standard mileage rates for taxpayers to use in computing the deductible costs of operating an automobile for business, charitable, medical, or moving expense purposes.

# Healthcare

## Health plan implications of reduction of personal exemption: Notice 2018-84

On October 18, 2018, the IRS released **Notice 2018-84** [PDF 36 KB], announcing that the Treasury and IRS intend to amend existing guidance that is based in part on the personal exemption because the new law reduced the personal exemption deduction to zero for a 10-year period (i.e., for tax years beginning after December 31, 2017, and before January 1, 2026).

The notice explains that the rules in the existing regulations for determining the premium tax credit in a qualified health plan (sections 36B and 6011) and the individual shared responsibility provision under a health plan (section 5000A) currently rely on a determination as to whether the taxpayer claimed a personal exemption deduction.

The fact that the new law temporarily reduced the personal exemption amount to zero raises questions concerning what it means to claim a personal exemption deduction for purposes of the premium tax credit and the individual shared responsibility provision.

As interim guidance, the notice explains that:

- A taxpayer is considered to have claimed a personal exemption deduction for himself or herself for a tax year if the taxpayer files an income tax return for the year and does not qualify as a dependent of another taxpayer under section 152 (the Code provision providing the personal exemption deduction) for the year.

- A taxpayer is considered to have claimed a personal exemption deduction for an individual other than the taxpayer if the taxpayer is allowed a personal exemption deduction for the individual (taking into account section 151(d)(5)(B)) and lists the individual's name and TIN on the Form 1040, *U.S. Individual Income Tax Return*, or Form 1040NR, *U.S. Nonresident Alien Income Tax Return*, that the taxpayer files for the year.

The guidance provided in Notice 2018-84 applies to tax years beginning in 2018.

# Procedural issues

## Preparer due diligence: Final regulations

On November 7, 2018, the Treasury and IRS issued **final regulations** [PDF 206 KB] regarding tax return preparer due diligence. Among other things, the regulations expand the new law's application of the due diligence requirement to individual income tax returns claiming head of household filing status. The due diligence requirement has already

applied to the child tax credit, the additional child tax credit, and the American opportunity tax credit.

## Craft beverage modernization

Effective January 1, 2018, the so-called Craft Beverages and Modernization Act ("CBMA") part of the new law amended the Code with respect to the tax treatment of certain alcoholic beverages. The CBMA provisions are effective during calendar years 2018 and 2019.

### Bipartisan Budget Act of 2018—Legislative changes

The Bipartisan Budget Act of 2018 (Pub. L. No. 115-123) included two amendments relating to the CBMA provisions of the new law.

The first amendment adds the following at the end of the CBMA title of the new law, effective as if included in the new law:

> ***SEC. 13809. RULE OF CONSTRUCTION.***
> *Nothing in this subpart, the amendments made by this subpart, or any regulation promulgated under this subpart or the amendments made by this subpart, shall be construed to preempt, supersede, or otherwise limit or restrict any State, local, or tribal law that prohibits or regulates the production or sale of distilled spirits, wine, or malt beverages.*

The second amendment adds a sentence to the end of section 5555 (relating to records, statements, and returns) with respect to the imposition of tax on beer under section 5051, as amended by the new law. The new sentence reads:

> *For calendar quarters beginning after the date of the enactment of this sentence, and before January 1, 2020, the Secretary shall permit a person to employ a unified system for any records, statements, and returns required to be kept, rendered, or made under this section for any beer produced in the brewery for which the tax imposed by section 5051 has been determined, including any beer which has been removed for consumption on the premises of the brewery.*

This amendment applies to calendar quarters beginning after the date of the enactment of the Bipartisan Budget Act (i.e., calendar quarters beginning after February 9, 2018).

### "Single taxpayer" rules for excise tax credits, reduced rates on beer, wine, distilled spirits: Treasury guidance

On September 14, 2018, the Treasury's Alcohol and Tobacco Tax and Trade Bureau (TTB) issued **TTB Industry Circular 2018-5** concerning the "single taxpayer" rules for

excise tax credits and reduced rates on beer, wine, and distilled spirits produced in the United States.

The TTB guidance addresses certain situations where two or more domestic industry members would be treated as a “single taxpayer” and how this affects their eligibility to claim the credits or reduced rates available under the new law on beer, wine, or distilled spirits they produce and remove subject to tax.

**Background**

The new law amended the rules for excise taxes on beer, wine, and distilled spirits, and included tax credits and reduced excise tax rates on certain limited quantities of products removed from breweries, bonded wine cellars (including bonded wineries), and distilled spirits plants in the United States during calendar years 2018 and 2019.

The new law provides that two or more entities (whether or not under common control) that produce products such as beer or distilled spirits under a similar brand, license, franchise, or other arrangement are to be treated as a single taxpayer for the reduced rates—the “single taxpayer” rules.

The credits and reduced rates generally apply with respect to the first products removed subject to tax from these facilities in the calendar year—subject to certain limitations including the “single taxpayer” rules that apply to domestic producers of beer, wine, and distilled spirits.

**Application of the “single taxpayer” rules**

According to the TTB industry circular, under the “single taxpayer” rules, “two or more entities” are “treated as a single taxpayer” when they “produce [beer, wine, or distilled spirits] marketed under a similar brand, license, franchise, or other arrangement,” even if those entities are not under common control.

Thus, similar to “controlled group” rules—i.e., rules to aggregate the production of commonly controlled entities for the purpose of determining eligibility for credits or reduced rates among the commonly controlled entities—the “single taxpayer” rules aggregate the production of multiple entities under various arrangements for determining eligibility for credits and reduced rates under the new law.

The TTB industry circular notes that under the new law, each producer is eligible for a credit or reduced rate on only a fixed quantity of products, and the “single taxpayer” rules prevent producers from obtaining the credits or reduced rates on products beyond that quantity by contracting out the production of their products to other producers.

Examples are provided to illustrate the basic application of the “single taxpayer” rules.

## Transfers of beer between breweries not of same ownership: Treasury guidance

On July 17, 2018, the TTB issued a "procedure" as guidance with respect to changes to the excise tax rules for transfers of beer between breweries "not of the same ownership." **TTB Procedure No. 2018-1** is intended to implement changes made to Code section 5414 by the new law.

### Background

The new law amended section 5414 to allow more situations when beer may be transferred tax-free under bond. Under the new law, brewers may so transfer beer from one brewer to another when:

- The breweries are owned by the same person (prior law).
- One brewery owns a controlling interest in the other (new).
- The same person(s) have a controlling interest in both breweries (new).
- The proprietors of the transferring and receiving premises are independent of each other, and the transferor has divested itself of all interest in the transferred beer and the transferee has accepted responsibility for the payment of tax (new).

### TTB guidance

TTB Procedure No. 2018-1 provides brewers with guidance regarding the transfer of beer, without payment of tax, from one brewery to another brewery not of the same ownership.

As noted in the guidance, existing TTB regulations address transfers of beer between breweries of the same ownership without payment of tax—but not the new law's rules for transfers of beer between breweries not of the same ownership. The TTB release explains that, because of the length of time required to amend the regulations and the fact that the recent statutory changes are effective for a two-year period, TTB issued this guidance to apply the same requirements currently prescribed by regulation for transfers of beer between breweries of the same ownership to transfers of beer between breweries not of the same ownership.

This TTB guidance also addresses the effect of transfers of beer between breweries not of the same ownership on the applicability of the reduced beer excise tax rates included in the new law.

TTB Procedure No. 2018-1 describes:

- The procedure for transferring beer between breweries including:

  - The record of beer transferred (such as transfer document information, reconsignment of beer, the return of beer, and disposition of the invoice)
  - The rules for preparation of records and reports
  - Bond coverage
  - The kinds or types of containers
  - Rules for determining the quantity transferred
- Application of the reduced rates of tax for beer transferred between brewers not of the same ownership including:
  - When reduced rates apply (transfers of domestically produced beer in bulk or packaged beer)
- Records for substantiating the tax rate and losses in transit
- Storage
- Marks, brands, and labeling requirements

The TTB guidance explains that the new law measures relate to the transfer of beer between breweries not of the same ownership with an effective date through December 31, 2019.

## Calculating effective tax rates for distilled spirits products: Treasury guidance

On June 28, 2018, the TTB issued an "industry circular" concerning how to calculate the effective tax rates for distilled spirits products containing eligible wine and eligible flavors, and how to obtain approval of standard effective tax rates for imported distilled spirits products.

The **TBB industry circular (2018-04)** offers guidance on how to calculate the "effective tax rate" for distilled spirits products containing eligible wine and eligible flavors pursuant to changes made by the new law. The term "effective tax rate" refers to the tax rate applicable to a distilled spirits product after subtracting the credits allowable under section 5010 for the wine content and flavors content of the product. The TTB industry circular provides:

- Guidance for distilled spirits plants (DSPs) and importers on how to calculate effective tax rates for distilled spirits products that are subject to reduced tax rates

- Guidance for importers on how to obtain TTB approval of “standard effective tax rates” (SETRs) for imported products that are eligible for reduced tax rates.

**Background**

Under sections 5001 and 7652, a tax is imposed on all spirits produced in or imported into the United States at $13.50 per proof gallon. Wines containing more than 24% of alcohol by volume are taxed as spirits. A credit against this tax is allowed under section 5010 on each proof gallon of alcohol derived from eligible wine or eligible alcohol-containing flavors that do not exceed 2.5% of the finished product on a proof gallon basis. These credits apply to distilled spirits that are subject to the reduced tax rates of $2.70 and $13.34 per proof gallon for 2018-2019.

**Calculating effective tax rates, distilled spirits products subject to reduced tax rates**

Provisions under the TTB regulations (27 CFR 19.246 and 27.41) prescribe how DSPs and importers, respectively, must compute effective tax rates for distilled spirits products.

The equation outlined in the TTB regulations for calculating effective tax rates applies in instances when the taxes are determined on the product at a rate of $13.50 per proof gallon, but this equation does not apply in situations when the taxes are determined at rates of $2.70 or $13.34 per proof gallon.

The TTB industry circular sets out steps for calculating effective tax rates when reduced rates apply. If the resulting number is greater than or equal to zero, this number represents the actual effective tax rate for the product on a proof gallon basis. Alternatively, if the resulting number is less than zero, then the actual effective tax rate for the product on a proof gallon basis is equal to zero.

The TTB industry circular provides examples illustrating the calculation method.

This industry circular also provides guidance for importers on how to obtain TTB approval of standard effective tax rates under 27 CFR 27.77 for imported products that are eligible for reduced tax rates under the new law.

## Temporary relief for producers claiming the wine production credit under new law: Treasury announcement

On March 5, 2018, the TTB announced that for a limited time, “producing wineries” can determine and pay the federal excise tax, on removal from bond, on such wine of their production that is stored “untaxpaid” at a bonded wine cellar as if the wine had been removed from the producing winery’s bonded premises. On May 30, 2018, a second industry circular was issued expanding and modifying the initial guidance.

The **TTB announcements** describe changes related to the taxation of alcohol made by the new law. The announcements note that the new law did not provide for a transfer of the new tax credits that apply to wine removed in 2018 and 2019. As a result, for calendar years 2018 and 2019, any wine that is removed by a "wine premises" that did not produce the wine is not eligible for the new tax credits.

During calendar years 2018 and 2019, a winery can only apply the new tax credits to wine produced by the winery. During this time, if the wine is being held at premises that did not produce the wine, the "producing wine premises" can bring the wine back to its premises and remove the wine as "taxpaid" from its premises in order to apply the new tax credits to the wine. Otherwise, a bonded wine cellar or other wine premises that removes wine that it did not produce must pay excise tax on the wine at the applicable tax rate—without application of credits that would otherwise be available to the producing wine premises.

The TTB announcements authorize an alternate procedure, applicable for 2018-2019, by which the wine producer may tax-determine and tax-pay the wine without physically returning the wine to its premises.

Under the alternate procedure, wine producers will be allowed to tax-determine and tax-pay wine of their production stored untaxpaid at a bonded wine cellar or bonded winery without the wine producer being required to physically receive its wine back "in bond." The alternate procedure allows such wine producers to "receive" their wine "in bond" solely through documentation and reporting.

**KPMG observation:** After the new law was enacted, there was uncertainty in the industry as to whether the new statutory language changed the rules related to claiming the wine producer credit. The TTB announcement clearly states that the provisions allowing for the transfer of tax credits have been suspended for 2018 and 2019. Therefore, the credit may only be claimed by the wine producer. Although the alternate procedure announced by TTB provides relief from the strict rules for wine removed under bond from the production facility for 2018-2019, the fact remains that only the wine producer is eligible to claim the credit under the new statute. Producers need to evaluate their current practices involving transfers in bond to a bonded wine cellar, bonded winery, or other wine premises to determine that they are following appropriate procedures to claim the credit in 2018 and 2019.

## Refunds of excise tax on imported beer, wine, distilled spirits

As discussed below, U.S. Customs and Border Protection ("CBP") has issued several pieces of guidance on the implementation of the CBMA. The Treasury and CBP also have jointly issued an interim rule.

Very generally, under the CBMA, reduced tax rates and/or tax credits are applicable to imports of certain limited quantities of distilled spirits, beer, or wine imported from each foreign producer or "assigning entity." The allocations of the tax credits or reduced tax rates by the foreign producer or assigning entity to all importers may not exceed certain

quantities. Thus, for an importer to be eligible to receive a reduced tax rate or a tax credit, importers must substantiate that the foreign producer or assigning entity has assigned an allotment of its reduced tax rate or tax credits to the distilled spirits, beer, or wine imported by that importer.

### Customs release 18-000609

On October 16, 2018, U.S. Customs and Border Protection released **CSMS #18-00609,** addressing the foreign assignment aspect of the CBMA provisions for 2018 entries. The release states that CBP will issue, at a later date, information about 2019 entries as well as separate procedures and requirements addressing the CBMA's temporary changes to the tax classification of certain wines—including wines containing more than 14% but not more than 16% alcohol by volume.

The CBP release sets forth instructions and procedures including the following:

- Importers are not to use the CBMA flag to identify entry lines to which such tax classification changes apply.

- Instead, the CBMA flag is to be used to identify entry lines for which the importer has received a CBMA assignment from a foreign producer or assigning entity and for which the CBMA rate is claimed.

- Importers claiming a reduced tax rate or tax rate incorporating applicable tax credits (under the CBMA) are to do so at the time of entry summary.

- Importers are to use the CBMA flag to identify entry lines for which the CBMA rate is claimed and declare the lower tax rate (as opposed to the excise tax rate required prior to the enactment of the CBMA).

- Importers are only to use the CBMA flag when claiming the CBMA rate, whether at the time of entry summary filing or the filing of a post summary correction (PSC).

- For entries filed since January 1, 2018, and that have not liquidated and for which the importer wants to make a CBMA claim, effective immediately: (1) if not flagged, importers need to file a PSC with the CBMA flag and the CBMA rate; but (2) if flagged but the CBMA rate has not been claimed, importers need to file another PSC with the CBMA rate and the CBMA flag.

- For those importers that have liquidated entries for which they would like to claim the CBMA rate, the importer may file a protest. Importers filing protests claiming the CBMA rate need to identify "CBMA" in the protest issue dropdown.

- For any entries filed since January 1, 2018, for which the low excise tax rate was claimed, importers must complete the CBMA claim by flagging the entry immediately via PSC, and submitting the substantiating documents prior to CBP review and

liquidation. PSC is the mechanism for submitting CBMA claims in this situation if within the PSC timeframe.

- Importers are required to file documentation to complete their CBMA claim, and the documentation must be filed at the time of entry summary, PSC filing or protest filing.

- Specifics concerning items to be included to complete a CBMA claim are provided.

The release states that CBP will process and liquidate claims for entries made in calendar year 2018, beginning January 31, 2019. CBP will begin its review with the oldest entry on file with a CBMA claim and work forward chronologically. CBP cautions that any 2018 CBMA claims that are not substantiated with the required documentation by January 31, 2019, are at risk of being liquidated without the benefit of the CBMA rate. If the importer has a complete and valid claim and the assignment limit has not been reached at the time of CBP review, CBP will liquidate the entry and apply the CBMA rate.

### Customs release 18-000587

On October 3, 2018, CBP released **CSMS #18-000587**, setting forth procedures and requirements for implementing the CBMA.

As background, under the interim final rule concerning refunds of alcohol excise tax discussed below, CBP and the Treasury authorized CBP to issue refunds with respect to entries when the importer received a foreign producer allocation or assignment pursuant to the CBMA when appropriate.

CBP in September 2018 deployed in the Automated Commercial Environment (ACE) an "entry summary line level flag" to identify imported alcohol for which the importer has received a CBMA allocation from the foreign producer or assigning entity. CBP encouraged importers to use the CBMA flag to identify imported alcohol for which the importer had received a CBMA allocation from a foreign producer or assigning entity. CBP advised the trade that the CBMA flag could be transmitted at time of entry summary filing, or subsequently as a post-summary correction (PSC) for unliquidated entry summaries.

CMS #18-000587 provides information about future changes, revises previous CBP guidance, and addresses the foreign allocation aspect of CBMA for 2018 entries.

Among the measures in the CBP guidance are the following:

- CBP stated that it will issue further communication for 2019 entries at a later date.

- CBP also stated that it will issue separate procedures and requirements addressing the CBMA's temporary changes to the tax classification of certain wines, including wines containing more than 14% but not more than 16% alcohol by volume.

- In mid-October 2018, CBP will advise importers to claim, at the time of entry summary, the reduced tax rate or tax rate incorporating applicable tax credits as permitted by the CBMA for which the importer has received a CBMA allocation from a foreign producer or assigning entity.

- Going forward from mid-October 2018, importers will use the CBMA flag to identify entry lines for which the CBMA rate will be claimed and declare the lower tax rate (as opposed to the excise tax rate required prior to the enactment of the CBMA). At that time, importers are instructed only to use the CBMA flag when claiming the CBMA rate, whether at the time of entry summary filing or the filing of a PSC.

- For entries filed since January 2018 with CBMA claims that have not liquidated as of mid-October: (1) if not flagged, importers are to file a PSC with the CBMA flag and the CBMA rate; and (2) if flagged but the CBMA rate has not been claimed, importers are to file a PSC with the CBMA rate and the CBMA flag is to continue to be part of the entry record.

- For those importers that have liquidated entries for which they would like to claim the CBMA rate, the importer may file a protest. Importers filing protests claiming the CBMA rate need to identify "CBMA" in the protest issue dropdown.

- For any entries filed since January 1, 2018, for which the low excise tax rate was claimed, importers must complete the CBMA claim by flagging the entry immediately via PSC, and submitting the substantiating documents prior to CBP review and liquidation. PSC is the mechanism for submitting CBMA claims in this situation if within the PSC timeframe.

- Importers will be required to file documentation to complete their CBMA claim, and the documentation must be filed at the time of entry summary, PSC filing or protest filing.

### Treasury and Customs interim final rule

On August 15, 2018, Treasury and CBP jointly issued an **interim final rule** [PDF 222 KB] for publication in the Federal Register announcing that CBP regulations will be updated to reflect the current organization of the Treasury and CBP for purposes of eliminating a restriction pertaining to CBP's authority to refund excessive duties, taxes, fees, or interest imposed on distilled spirits, wine, and beer.

These changes are intended to facilitate implementation of CBMA provisions of the new law. As discussed above, the new law amended the Code for two calendar years with respect to the tax treatment of alcoholic beverages, including beer, wine, and distilled spirits. For an importer to be eligible to receive a reduced tax rate or a tax credit, the importer must be able to substantiate that the foreign producer has assigned an allotment of its reduced tax rate or tax credits to the beer, wine, or distilled spirits imported by that importer. The new CBP regulations clarify that CBP has authority to refund the difference between the full excise taxes an importer pays at the time of entry summary filing and the

new law's lower effective tax rate. An importer must request and substantiate its entitlement to the reduced tax rate or tax credit appropriately.

The interim final rule is effective on August 16, 2018—the date it was published in the Federal Register.

### Other (earlier) Customs releases

On June 27, 2018, the CBP issued a release on implementing federal excise tax relief for imports of beer, wine, and distilled spirits, and that outlines what refund procedures will apply with respect to such imports. The CBP guidance is Cargo Systems Messaging Service (CSMS) **#18-000403**.

The CBP guidance provides that:

- Importers must continue to pay the full excise tax rate at time of entry summary filing.
- CBP and the Treasury are considering amending current regulations (19 CFR 24.36) to allow CBP to issue refunds owed pursuant to the new law measures for imports of eligible beer, wine, and distilled spirits when appropriate. These amendments would apply to entries that have not been finally liquidated, and would be retroactive.
- In anticipation of the new regulations, CBP suggests that importers file protests on liquidated entries for which a CBMA reduced tax rate or credit may be due. These refund requests will be processed no earlier than January 15, 2019.

CBP also provided information required for an importer to substantiate its eligibility to receive the reduced tax rates or the tax credits from the foreign producer. Importers that are assigned reduced tax rates or tax credits from multiple foreign producers are directed to maintain this information for each foreign producer.

### Frequently asked questions: TTB website

For additional guidance on the alcohol tax reforms for beer, wine, and distilled spirits, see the TTB frequently-asked questions available on the **TTB website**.

## Guidance on various inflation adjustments

### Inflation adjustment for certain debt instruments: Rev. Rul. 2018-11

Rev. Rul. 2018-11—appearing in the Internal Revenue Bulletin (IRB 2018-18) dated April 30, 2018—provides the dollar amounts, increased by the 2018 inflation adjustments, for purposes of determining whether a debt instrument is a qualified debt instrument or a cash method debt instrument under section 1274A. Read text of Rev. Rul. 2018-11 in **IRB 2018-18** [PDF 3.2 MB]

Section 1274A concerns certain debt instruments given in consideration of nonpublicly traded property when the stated principal amount does not exceed $2.8 million (as adjusted for inflation). The new law revised the rules for determining the inflation adjustment for the dollar amounts stated in section 1274A.

Rev. Rul. 2018-11 sets out, in table format, the inflation adjusted amounts under section 1274A for debt instruments arising out of sales or exchanges.

## HSA contribution limit for 2018

On April 26, 2018, the IRS issued **Rev. Proc. 2018-27** [PDF 18 KB], which modifies the annual limitation on deductions for contributions to Health Savings Accounts (HSAs) for calendar year 2018 that was announced in Rev. Proc. 2018-18 (described below).

Under Rev. Proc. 2018-17, for 2018, a taxpayer may treat the annual limitation on the deduction for an individual with family coverage under a high deductible health plan under section 223(b)(2)(B) as $6,900.

## Corrected AMT phase-out threshold for estates and trusts: Rev. Proc. 2018-22

On April 13, 2018, the IRS issued **Rev. Proc. 2018-22** [PDF 14 KB]. The revenue procedure modifies and supersedes provisions of Rev. Proc. 2018-18 (that addresses the inflation adjustments for 2018, following enactment of the new law) to reflect:

- An increase in the state housing credit ceiling
- A corrected alternative minimum tax (AMT) phase-out threshold amount for estates and trusts of $81,900 (not $500,000 as stated in a prior IRS release)

Read a related IRS release: **IR-2018-94**

## Revised inflation adjustments for 2018: Rev. Proc. 2018-18 and IRS release

**Rev. Proc. 2018-18**—which appears in Internal Revenue Bulletin 2018-10 (March 5, 2018)—reflects amendments made by the new law with respect to the annual inflation adjustments for certain tax provisions.

The changes made by Rev. Proc. 2018-18 reflect the amendments made to the tax rate schedules and to other amounts that taxpayers will use in filing their 2018 income tax returns (to be filed in 2019).

As background, the IRS in October 2017 released **Rev. Proc. 2017-58** [PDF 95 KB] to provide the annual inflation adjustments for more than 50 tax provisions, including the tax rate schedules and other tax amounts for 2018, as adjusted for inflation for 2018.

A few months later, Congress passed the new law. The new law not only amends the income tax rates for individual taxpayers, but it also includes many other changes that affect individual taxpayers and business taxpayers.

Because Rev. Proc. 2018-18 amends certain measures under Rev. Proc. 2017-58, these two revenue procedures must be read together.

**IRS update**

The IRS subsequently noted in **IR-2018-94** (April 13, 2018) that for 2018:

- The foreign earned income exclusion will be $103,900.
- The maximum earned income credit amount will be $6,431 for taxpayers with three or more qualifying children, for 2018. (Other earned income credit amounts are detailed in Rev. Proc. 2018-18.)
- Participants who have self-only coverage in a Medical Savings Account, the plan must have an annual deductible that is not less than $2,300, but not more than $3,450. For self-only coverage, the maximum out-of-pocket expense amount is $4,550. For tax year 2018, participants with family coverage, the floor for the annual deductible is $4,550; however, the deductible cannot be more than $6,850. For family coverage, the out-of-pocket expense limit is $8,400 for tax year 2018. (Only the "$4,550" amount differs from what was previously listed in IR-2017-178.)

## No changes to pension plan cost-of-living adjustments for 2018: IRS release

On February 6, 2018, the IRS announced that the new law does not affect the tax year 2018 dollar limitations for retirement plans, as previously announced in October 2017.

**Notice 2017-64** [PDF 30 KB] provided the dollar limitations for qualified retirement plans for tax year 2018.

The IRS release—**IR-2018-19**—notes that, because the new law made no changes to the section of the tax law limiting benefits and contributions for retirement plans, the qualified retirement plan limitations for tax year 2018 as previously announced in October 2017 remain unchanged.

The IRS release further notes that, while the new law included changes concerning how cost-of-living adjustments are made with respect to contribution limits for IRAs, as well as the income thresholds related to IRAs and the saver's credit, the amounts for 2018 also remain unchanged.

# Accounting for income taxes

## KPMG reports

This report does not cover accounting for income taxes developments. For information on this topic, read a report on tax reform prepared by KPMG: ***Supplement to KPMG's Handbook, Accounting for Income Taxes*** [PDF 1.3 MB]. This question and answer (Q&A) report supplements KPMG's Handbook, ***Accounting for Income Taxes*** [PDF 12 MB], and considers financial reporting implications under US GAAP of the new law.

Also read a report in Q&A format that addresses certain frequently asked questions about the IFRS financial reporting implications of U.S. tax reform, and includes a comparison to U.S. GAAP: **IFRS Q&As** [PDF 415 KB]

These reports were issued as preliminary guidance and are updated as developments warrant.

## KPMG contacts

For more information on any of the provisions discussed in this supplement, please contact a professional in KPMG's Washington National Tax office.

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