KPMG

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Notice 2019-46: Relief for domestic partnerships or S corporations, determining GILTI amounts (initial impressions and observations)

The IRS today released an advance version of Notice 2019-46 announcing that the Treasury Department and IRS intend to issue regulations that will permit a domestic partnership or S corporation that is a U.S. shareholder of a controlled foreign corporation (CFC) to apply Prop. Reg. section 1.951A-5—related to the treatment of domestic partnerships and S corporations for determining the amount of the global intangible low-taxed income inclusion (GILTI)—for tax years ending before June 22, 2019.

Notice 2019-46 [PDF 53 KB] also addresses the applicability of certain penalties for a domestic partnership or S corporation that acted consistently with Prop. Reg. section 1.951A-5 on or before June 21, 2019, but files a tax return consistent with the final regulations under Reg. section 1.951A-1(e).

Today's notice provides that to apply the rules in Prop. Reg. section 1.951A-5 or for penalties not to apply under the notice, a domestic partnership or S corporation must satisfy certain notification and reporting requirements. Notice 2019-46 states that the to-be-issued regulations will be effective for tax years ending before June 22, 2019, and that domestic partnerships and S corporations may rely on the guidance provided in today's notice in advance of those future regulations, provided the partnerships and S corporations satisfy the requirements under the notice.

This report provides initial impressions and observations about Notice 2019-46.

Background

Proposed regulations under section 951A were released in October 2018. Those proposed regulations provided a hybrid approach to the treatment of a domestic partnership that is a U.S. shareholder (a U.S. shareholder partnership) of a CFC (a partnership CFC). For GILTI purposes, the rules applicable to partnerships also apply to S corporations, which are treated as partnerships for purposes of the subpart F provisions.

Under the hybrid approach, a U.S. shareholder partnership would determine its GILTI inclusion amount, and the partners of the partnership that were not also U.S. shareholders of the partnership CFC would take into account their distributive share of the partnership's GILTI inclusion amount. Partners that were themselves U.S. shareholders of a partnership CFC would not take into account their distributive share of the partnership's GILTI inclusion amount, but instead would be treated as proportionately owning the stock of the partnership CFC within the meaning of section 958(a) as if the domestic partnership were a foreign partnership.

Final regulations under section 951A were issued in June 2019. The final regulations did not adopt, from the proposed regulations, the hybrid approach with respect to domestic partnerships. Under the final regulations, a domestic partnership (including a U.S. shareholder partnership) does not have a GILTI inclusion amount, and therefore no partner of the partnership has a distributive share of a GILTI inclusion amount.

Under the final regulations, for purposes of determining the GILTI inclusion amount of any partner of a domestic partnership, each partner is treated as proportionately owning the stock of a CFC owned by the partnership within the meaning of section 958(a) in the same manner as if the domestic partnership were a foreign partnership. Because only a U.S. person that is a U.S. shareholder can have a GILTI inclusion amount, a partner that is not a U.S. shareholder of a partnership CFC does not have a GILTI inclusion amount determined by reference to such partnership CFC.

In other words, under the final regulations, a partner that is not a U.S. shareholder with respect to a partnership CFC has neither a distributive share of a GILTI inclusion amount nor a GILTI inclusion amount that is determined by reference to such partnership CFC.

The final regulations apply to tax years of foreign corporations beginning after December 31, 2017, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end. Therefore, domestic partnerships and S corporations that file their income tax returns for the 2018 tax year after June 21, 2019, must—absent the relief provided in Notice 2019-46—file income tax returns consistent with the final regulations and furnish Schedules K-1 to their partners and shareholders that are consistent with these income tax returns.

Relief provided by Notice 2019-46

According to the notice, the Treasury Department and IRS were aware that many domestic partnerships and S corporations furnished Schedules K-1s to their partners and shareholders on or before the date of publication of the final regulations in June 2019. These Schedules K-1—that were consistent with the proposed regulations—may have reported a distributive share of the domestic partnership's GILTI inclusion amount or a pro rata share of the S corporation's GILTI inclusion amount.

Without the penalty relief provided by Notice 2019-46, these domestic partnerships and S corporations could be required to file returns for the 2018 tax year consistent with the final regulations, and furnish Schedules K-1 consistent with their Form 1065 (Schedule K) or Form 1120S (Schedule K). Treasury and the IRS further noted that issuing corrected Schedules K-1 consistent with the final regulations could "result in significant additional costs" for these domestic partnerships and S corporations, and could impose a "significant burden" on the IRS related to processing amended returns based on corrected Schedules K-1.

Therefore, Treasury and the IRS decided to provide relief by issuing Notice 2019-46 for certain domestic partnerships and S corporations so that they may apply Prop. Reg. section 1.951A-5 for tax years ending before June 22, 2019. Also, the notice provides that certain penalties that might otherwise apply to domestic partnerships or S corporations that acted consistently with the proposed regulations before June 22, 2019, do not apply if the partnership or S corporation satisfies certain conditions.

Future regulations

Notice 2019-46 states that the future regulations will provide that a domestic partnership or S corporation may apply the rules in Prop. Reg. section 1.951A-5, in their entirety, for tax years that ended before June 22, 2019.

Thus, for example, a domestic partnership that applies the proposed regulations for a tax year ending before June 22, 2019, would file a Form 1065, including Form 8992, *U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI),* for the tax year on the basis of Prop. Reg. section 1.951A-5 and furnish to its partners for that tax year Schedules K-1 on the basis of the proposed rule. The IRS notice states that the future regulations are expected to provide that in order to apply the rules in Prop. Reg. section 1.951A-5, a partnership or S corporation would have to satisfy certain notification and reporting requirements listed in Notice 2019-46.

Notice 2019-46 further states that Treasury and the IRS received comments that Prop. Reg. section 1.951A-5 did not provide taxpayers with guidance in a number of areas, and that the adoption of an aggregate approach to domestic partnerships in the final regulations did not resolve all of these open questions. Therefore, it is anticipated that the future regulations will provide---regarding future distributions by a partnership CFC to a partnership or S corporation—that the amount excludible from gross income under section 959 reflects only amounts included in income by a partner or shareholder under Prop. Reg. section 1.951A-5.

If a domestic partnership or S corporation satisfies the requirements of Notice 2019-46, penalties for failures described in sections 6698(a), 6699(a), 6722(a) or any similar provision will not apply to the domestic partnership or S corporation to the extent such failures arise from acting consistently with the proposed regulations before June 22, 2019 (such as, by issuing one or more Schedules K-1 that followed the proposed regulations and not re-issuing Schedules K-1 based on the final regulations) including from filing a Form 1065 or Form 1120S based on the final regulations after June 21, 2019, that incorporates Schedules K-1 consistent with the proposed regulations that were issued before June 22, 2019.

Notice 2019-46 provides several examples illustrating the relief provisions.

Notification to partners or shareholders

Notice 2019-46 includes notification requirements. A domestic partnership or S corporation must provide notification to each partner of the partnership or shareholder of the S corporation:

- That the Schedule K-1 provided to the partner or shareholder is consistent with Prop. Reg. section 1.951A-5

- That the domestic partnership or S corporation filed a Form 1065 or Form 1120S consistent with the proposed regulations or final regulations (noting which set of the rules were applied)

- That the notification is being provided in accordance with Notice 2019-46

This notification must be provided no later than the extended due date of the domestic partnership's or S corporation's tax return—e.g., September 16, 2019, in the case of a calendar-year filer—and may be provided through any reasonable method, including by mail, e-mail, or posting on a website through which the domestic partnership or S corporation would ordinarily disseminate tax information to its partners or shareholders. In the event a domestic partnership or S corporation has filed its tax return and not filed for an extension of time to file its return, the notification must be provided by the date on which the return would have been due had an extension been properly requested.

The domestic partnership or S corporation must also attach the notification (as described above) and Form 8992 reflecting computations under Prop. Reg. section 1.951A-5 to any tax return with respect to which the rules described by Notice 2019-46 are being applied—if the tax return has not been filed as of the date of publication of the notice.

Follow-up Schedule K-1 distribution reporting

If a domestic partnership or S corporation furnished a Schedule K-1 based on the proposed regulations, it must separately state on Schedules K-1 for subsequent tax years the partner's or shareholder's distributive share or pro rata share of a foreign corporation's distributions to the domestic partnership or S corporation of earnings and profits that relate to the GILTI inclusion amount of the partnership or S corporation that was reflected on the first mentioned Schedules K-1. This information must be provided for each tax year of the domestic partnership or S corporation following the tax year to which the first Schedule K-1 relates.

The information could be used by a partner of a domestic partnership or a shareholder of an S corporation that receives a Schedule K-1 separately stating such distributions to calculate its gross income if such partner or shareholder filed inconsistently with the first Schedule K-1 and did not include in gross income its distributive share or pro rata share of the GILTI inclusion amount reported on such Schedule K-1.

KPMG observation

Notice 2019-46 provides that certain domestic partnerships with tax years ending prior to June 22, 2019—the date after the final regulations were published—may elect to apply the rules of Prop. Reg. section 1.951A-5 in computing their taxable income.

Presumably, although not specifically stated in Notice 2019-46, if a domestic partnership meets the requirements stipulated in the notice and elects to apply the partnership rules in the proposed regulations, such an election is binding on both the partnership and its partners for all federal income tax purposes. Accordingly, even U.S. taxpayer partners of the partnership owning less than 10% of an underlying CFC would include their distributive share of GILTI as computed at the partnership level. Similarly, the domestic partnership's basis in the CFC stock it holds would be increased, as would the basis in such partnership of any partner that includes its distributive share of the section 951A inclusion in its taxable income.

In conjunction with permitting an election to follow the proposed regulations, Notice 2019-46 provides penalty relief to partnerships that "acted consistently with the proposed regulations" by for example, issuing Schedules K-1 or filing Form 1065 prior to June 22, 2019, following the proposed regulations. Notice 2019-46 does not indicate what is meant by the term to "act consistently with the proposed regulations." As such, it is unclear whether the notice provides penalty relief for a partnership that may have followed the proposed regulations and computed its taxable income with a GILTI inclusion prior to June 22, 2019, but then actually filed its returns or issued its Schedules K-1 after such date. One would hope that such a partnership can provide the appropriate notifications as required by Notice 2019-46 and not be subject to the various penalties, as the returns that were filed and the Schedules K-1 that were issued are consistent with the election the partnership ultimately made.

Notice 2019-46 does not address, however, the protocols for partners who may not know at the time they file their income tax returns whether the issuing partnership is going to file consistent with the final or proposed regulations. The notice requires notification be made to partners of the election to apply the proposed regulations on or before September 16, 2019 (for calendar year issuing partnerships). This date is one month earlier than the extended return filing deadline for an individual partner or corporate partners that have a calendar tax year, and is coterminous with the extended filing deadline of a partner that is a calendar tax year partnership. As such, the notification to the partner that the issuing partnership is electing to follow the proposed regulations may not be received by such

partner in time to know whether there will (or will not) be section 951A income to include in that partner's own return (e.g., the partner will not know whether the issuing partnership that previously provided a Schedule K-1 with a GILTI inclusion will ultimately file consistently by meeting the Notice 2019-46 requirements or will revise and reissue the Schedules K-1 pursuant to the final regulations).

Another common situation is one when a partner received a Schedule K-1 prior to June 22, 2019, that reflected application of the proposed regulations and such partner filed its return with a notice of inconsistent treatment excluding the section 951A inclusion on the basis that the Schedule K-1 received was incorrect on its face. It is possible that the issuing partnership may subsequently provide notification of its election to follow the proposed regulations, rendering the originally issued Schedule K-1 accurate. Notice 2019-46 does not address whether this partner should amend its return or potentially be subject to an underpayment penalty. The penalty discussion in Notice 2019-46 is limited to partnership-level penalty provisions. Thus, for example, no guidance is provided as to partners that filed their returns consistent with the final regulations, and that later receive notification that their proper distributive shares included a GILTI inclusion pursuant to the provisions of Notice 2019-46.

It is clear that a partner may receive Schedules K-1 with a GILTI inclusion that was valid under the proposed regulations, but that ultimately could be reissued by a partnership that elects to follow the final regulations so as to eliminate such inclusion. In such a situation (assuming, as discussed above, that a partnership election is binding on a partner) the partners will not know with certainty the proper inclusion until potentially after the partners file their own income tax returns. Consequently, partners will need to track the Schedules K-1 received and their treatment of the Schedule K-1 GILTI inclusion, and then compare it to the final information provided by the issuing partnership. When there is a difference, the partners will then need to determine the impact on their 2018 income tax returns that were filed, their adjusted basis in the partnership interest held, and the impact on future receipt of a distribution disclosure.

Today's release indicates the IRS intends to issue regulations that implement the provisions of Notice 2019-46 with effect for tax years ending before June 22, 2019. Hopefully such guidance will address the treatment of partners as noted in the above situations.