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IRS Issues Proposed Regulations Regarding Withholding on Foreign Partner's Sale or Exchange of Partnership Interest

The IRS issued proposed regulations, REG-113604 (https://www.irs.gov/pub/irs-drop/reg-113604-18.pdf), implementing Section 864(c)(8), as added by the 2017 Tax Cuts and Jobs Act (TCJA), which provides that gain or loss of a nonresident alien individual or foreign corporation from the sale, exchange or other disposition of a partnership interest is treated as effectively connected with the conduct of a trade or business within the U.S. to the extent that the transferor would have had effectively connected gain or loss if the partnership had sold all of its assets at fair market value as of the date of the sale or exchange. The proposed regulations set forth detailed rules to determine how gain or loss under Section 864(c)(8) is determined. (Section references are to the Internal Revenue Code of 1986, as amended (the Code).)

Under pre-TCJA law, the IRS, in Revenue Ruling 91-32, ruled that gain or loss of a foreign partner from a disposition of an interest in a partnership that conducts a trade or business through a fixed place of business or has a permanent establishment in the U.S. is treated as gain or loss effectively connected with the U.S. trade or business or is gain or loss attributable to the permanent establishment. However, the Tax Court, in *Grecian Magnesite Mining, Industrial & Shipping Co.*, 149 TC 63 (2017), rejected the IRS's position and held that a foreign corporation's gain on the sale of an interest in a partnership that engaged in a U.S. trade or business was not U.S.-source income and was not effectively connected with a U.S. trade or business. Section 864(c)(8), added by the TCJA and effective for sales, exchanges and dispositions on or after Nov. 17, 2017, generally overturns the result of *Grecian Magnesite Mining*.

IRS Issues Notice on Special Enforcement Matters Under Centralized Partnership Audit Regime

The IRS issued Notice 2019-6, 2019-3 IRB (https://www.irs.gov/pub/irs-drop/n-19-06.pdf), informing taxpayers that it intends to issue proposed regulations addressing certain special enforcement matters under Section 6241(11) with regard to the centralized partnership audit regime. The IRS has also requested comments on other special enforcement matters that could be the subject of future proposed regulations.

The first matter concerns certain situations in which an adjustment during an examination of a person other than the partnership requires a change to a partnership-related item. Specifically, the regulations will allow the IRS to effectively and efficiently focus on a single partner or a small group of partners with respect to a limited set of partnership-related items without unduly burdening the partnership, thus avoiding procedural concerns about the appropriate level at which such items must be examined.

Consequently, the regulations will provide that the IRS may determine that the centralized partnership audit regime does not apply to adjustments to partnership-related items when the following conditions are met:

1. The examination being conducted is of a person other than the partnership;

2. A partnership-related item must be adjusted, or a determination regarding a partnership-

related item must be made, as part of an adjustment to a non-partnership-related item of the person whose return is being examined; and

3. The treatment of the partnership-related item on the return of the partnership under Section 6031(b) or in the partnership's books and records was based in whole or in part on information provided by or under the control of the person whose return is being examined.

The second matter concerns situations where a qualified subchapter S subsidiary (QSub) is a partner in a partnership. The regulations will provide that this situation presents special enforcement considerations because partnership structures with QSubs as partners could have far more than 100 ultimate partners, including many thousands, and still potentially elect out of the centralized partnership audit regime. Allowing such a large partnership to elect out of the centralized partnership audit regime would give rise to significant enforcement concerns for the IRS and frustrate the efficiencies introduced by the centralized partnership regime. As a result, the regulations will provide that Section 6221(b), which allows certain partnerships to elect out of the centralized partnership audit regime, generally does not apply to a partnership with a QSub as a partner. However, the regulations also will provide that if a partnership meets certain requirements as set out in the regulations, the partnership may make an election under Section 6221(b).

IRS Issues Proposed Regulations Regarding Hybrid Arrangements

The IRS has issued proposed regulations, REG-104352-18 (https://www.stradley.com/-/media/files/publications/2018/12/reg10435218.pdf?la=en&hash=3F20384D3BF90D6E21C13E568080335D), that would implement Sections 245A(e) and 267A, which were added to the Code by the TCJA, regarding hybrid dividends and certain amounts paid or accrued in hybrid transactions or with hybrid entities. A hybrid entity is an entity that is fiscally transparent for U.S. tax purposes but not fiscally transparent for foreign tax purposes. The IRS has also issued proposed regulations (1) under Sections 1503(d) and 7701 to prevent the same deduction from being claimed under the tax laws of both the U.S. and a foreign country, and (2) under Sections 6038, 6038A and 6038C to facilitate administration of certain rules in the proposed regulations.

IRS Provides Guidance on Content of Disclosure to Reduce or Avoid Penalties

The IRS issued Revenue Procedure 2019-9, 2019-2 IRB (https://www.irs.gov/pub/irs-drop/rp-19-9.pdf), in which it identifies the circumstances under which the disclosure on a taxpayer's income tax return with respect to an item or position is adequate for the purpose of reducing the understatement of income tax under the substantial understatement accuracy-related penalty and the tax return preparer penalty due to unreasonable positions with respect to income tax returns. The Revenue Procedure applies to any income tax return filed on 2018 tax forms for a tax year beginning in 2018, and to any income tax return filed in 2019 on 2018 tax forms for short tax years beginning in 2019.

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IRS Releases Guidance on Treatment of Previously Taxed E&P Accounts Under TCJA

The IRS released Notice 2019-1, 2019-3 IRB (https://www.irs.gov/pub/irs-drop/n-19-01.pdf), announcing its intent to issue regulations addressing certain issues arising under the TCJA with respect to foreign corporations with previously taxed earnings and profits (PTEP). The regulations will include rules relating to (1) the maintenance of PTEP in annual accounts and within certain groups of PTEP, (2) the ordering of PTEP upon distribution and reclassification, and (3) the adjustment required when an income inclusion exceeds the earnings and profits (E&P) of a foreign corporation. It is anticipated that these regulations will apply to tax years of U.S. shareholders ending after the date of release of the Notice and to tax years of foreign corporations ending with or within such tax years. Taxpayers can rely on the Notice until the regulations are issued.

IRS Issues Guidance on Changes to Excess Business and NOLs

The IRS issued IR-2018-254 (https://www.irs.gov/newsroom/irs-issues-guidance-on-changes-to-excess-business-and-net-operating-losses) on excess business loss limitations and net operating losses (NOL) following law changes made by the TCJA. The TCJA modified existing tax law on excess business losses by limiting losses from all types of business for noncorporate taxpayers. An excess business loss is the amount by which the total deductions from all trades or businesses exceed a taxpayer's total gross income and gains from those trades or businesses plus $250,000, or $500,000 for a joint return. Excess business losses that are disallowed are treated as a NOL carryover to the following taxable year. The TCJA also modified NOL rules. Most taxpayers no longer have the option to carry back a NOL. For most taxpayers, NOLs arising in tax years ending after 2017 can only be carried forward. Exceptions apply to certain farming losses and NOLs of insurance companies other than life insurance companies. For losses arising in taxable years beginning after Dec. 31, 2017, the TCJA limits the NOL deduction to 80 percent of taxable income.

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