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Tax Insights

A Publication of the Stradley Ronon
Tax Practice Group

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MARCH 20, 2019

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IRS Releases Final Regulations on RIC Commodity Subsidiary and PFIC Distributions and Limitations on the Definition of a Security for RIC Qualification Purposes

Treasury and the IRS have issued final regulated investment company (RIC) regulations (T.D. 9851 https://www.federalregister.gov/documents/2019/03/19/2019-05130/guidance-under-section-851-relating-to-investments-in-stock-and-securities) regarding the treatment of subpart F and passive foreign investment company (PFIC) income inclusions. The final regulations reverse, in part, Treasury's and the IRS's 2016 proposed regulations. (See our prior coverage here https://www.stradley.com/insights/publications/2016/tax-insights-2016/tax-insights-september-28-2016.) The regulations, which were issued on March 18, adopt commentators' recommendations to treat subpart F income from controlled foreign corporations (CFCs) and qualified electing fund (QEF) income from passive foreign investment companies (PFICs) as qualifying income to a RIC, even when the foreign corporation does not make a distribution. Also, the final regulations retain the rule in the proposed regulations that income inclusions under Section 951 (CFC) and Section 1293 (PFICs) will be treated as dividends for purposes of Section 851(b)(2), if actual distributions attributable to those inclusions are made. (Section references are to the Internal Revenue Code of 1986, as amended (the Code).

The final regulations are consistent with the proposed regulations, which stated that for purposes of the RIC qualifying income and the asset diversification requirements, an asset is a security if it is a security under the Investment Company Act of 1940 (the 1940 Act). The preamble to the proposed regulations stated that "any future guidance regarding whether particular financial instruments, including investments that provide RICs with commodity exposure, are securities for purposes of the 1940 Act is…within the jurisdiction of the SEC."

The proposed regulations also called for comments on whether previous guidance regarding determinations of whether a financial instrument or position held by a RIC is a security under the 1940 Act should be withdrawn when the regulations are finalized. A 2016 Revenue Procedure (Rev. Proc. 2016-50 https://www.irs.gov/pub/irs-drop/rp-16-50.pdf) stated that the IRS ordinarily will not issue rulings or determinations on that issue. The final regulations do not withdraw revenue rulings determining whether an instrument or position held by a RIC is a security. Treasury and the IRS cite commentators who said that "RICs rely on those rulings to invest with confidence in certain derivatives on stocks and securities." Therefore, removing them would create confusion and uncertainty for a RICs' investments.

Section 851(b) provides that a RIC must meet certain election, gross income and diversification requirements. Section 851(b)(2) requires that a RIC derive at least 90 percent of its gross income from qualifying sources, such as dividends, interest and gains from the sale or other disposition of stock or securities and "other income…derived with respect to its business of investing in such stock, securities or currencies."

The proposed regulations also stated income inclusions under Sections 951(a)(1) or 1293(a) (relating to QEFs) did not qualify as other income derived from a RIC's business of investing in stock, securities or currencies. Based on comments received on the proposed regulations, Treasury and the IRS excluded that rule from the final regulations because it would have

created “an unintended effect on the RIC income test of [S]ection 851(b)(2).” The final regulations added a provision to “treat inclusions under [S]ections 951(a)(1)(A) and 1293(a) derived with respect to a RIC’s business of investing in stock, securities, or currencies as other qualifying income for purposes of the RIC income test.” The final regulations provide that taxpayers may rely on this rule for tax years beginning after Sept. 28, 2016, even though the final regulations generally are effective on the date the regulations are published in the Federal Register. The New York State Bar Association recommended the rule change in a November 2016 comment letter. (See our prior coverage here https://www.stradley.com/insights/publications/2016/tax-insights-2016/tax-insights-december-7-2016.)

LB&I Releases Procedures for Delinquent Foreign Payment Withholding Returns

The IRS’s Large Business and International (LB&I) Division has released procedures (https://www.irs.gov/pub/foia/ig/spder/lbi-04-0219-002.pdf) for entities that identify shortfalls in their systems resulting in delinquent foreign payment withholding tax returns. The IRS notes that it has frequently been contacted by withholding agents that have identified shortfalls in their systems and are seeking to comply with their obligations for filing Form 1042 (Annual Withholding Tax Return for U.S. Source Income of Foreign Persons), Form 8804 (Annual Return for Partnership Withholding Tax (Section 1446)) and/or Form 8288 (U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests) and related information returns.

LB&I’s Foreign Payments Practice (FPP) has created a central point of contact where withholding agents can submit delinquent withholding tax returns of the types listed above and pay their withholding obligations. When returns are received under these procedures, FPP revenue agents will review the information submitted and consider a request for penalty relief if one is included. Each submission may be subject to an audit referral, with approval by the FPP territory manager. The procedures do not provide a determination by the IRS about whether a payment (such as the amount, timing, character or source of such payment) was subject to withholding.

Overview of procedures:

- A withholding agent may file delinquent returns using the procedures if it is a withholding agent that is not a qualified intermediary, a withholding foreign partnership or a withholding foreign trust, as these entities are subject to other agreements.

- A withholding agent is not eligible to use the procedures if the withholding agent is under examination with respect to any liabilities related to withholding tax filings on the date of the delinquent return(s) submission. For this purpose, an examination is treated as commencing on the date the withholding agent receives notification from the IRS of an impending examination or of an impending referral for examination.

- In addition, filing under the procedures is not available to any withholding agent that has the same issue pending in the IRS office of appeals or is in litigation on issues involving Chapter 3 (Withholding of Tax on Nonresident Aliens and Foreign Corporations) or Chapter 4 (Foreign Account Tax Compliance Act (FATCA)) tax, withholding or reporting obligations. Additionally, the agent cannot have filed delinquent returns using these procedures in prior years.

IRS Eliminates TIN Reporting Requirement for Partnership Audit Regime Reps

The IRS announced (https://www.irs.gov/pub/irs-pdf/i1065.pdf)that an individual serving as the partnership representative (PR) or designated individual (DI) under the partnership audit regime does not need to list their taxpayer identification number (TIN) on the return. The announcement states that language in the 2018 Form 1065 (U.S. Return of Partnership Income) requiring the TINs is no longer valid. The original instruction stated: “The full TINs of the partnership representative and designated individual must be shown on the Form 1065 filed with the IRS. However, these TINs may be truncated on the copies of Form 1065 which the partnership furnishes to others, such as its partners.” Under the guidance, on Forms 1065 and 1066 (U.S. Real Estate Mortgage Investment Conduit (REMIC) Income Tax Return), taxpayers may enter all zeros for the TIN of the PR or DI.

IRS Revises Penalty Relief for Reporting Negative Capital Account Information

The IRS has reissued Notice 2019-20, 2019-13 IRB (https://www.irs.gov/pub/irs-drop/n-19-20.pdf) providing penalty relief under Sections 6722 (failure to furnish correct payee statements), 6698 (failure to file partnership return), and 6038(b) and 6038(c) (failure to furnish information with respect to certain partnerships), and any other Code section for filing or furnishing Schedules K-1 (Form 1065) or other forms or statements, where a penalty is imposed solely as a result of failing to include information about partners’ negative tax basis capital accounts for tax years that began after Dec. 31, 2017, but before Jan. 1, 2019.

Item L of Schedule K-1 to Form 1065 (Partner’s Share of Income, Deductions, Credits, etc.) and Item F of Schedule K-1 to Form 8865 (Return of U.S. Persons With Respect to Certain Foreign Partnerships) require reporting of a partner’s capital account. Generally, a partnership may report partner capital to a partner using tax basis, Generally Accepted Accounting Principles, Section 704(b) book or some other

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method. Pursuant to updates, the 2018 Instructions for Form 1065 and Partner's Instructions for Schedule K-1 (Form 1065), for Item L, now require a partnership that does not report tax basis capital accounts to its partners to report, on line 20 of Schedule K-1 using code AH, the amount of such partner's tax basis capital account both at the beginning of the year and at the end of the year if either amount is negative (negative tax basis capital account information). The Instructions for Form 8865, Schedule K-1, incorporate this requirement by reference to the Instructions for Form 1065.

The IRS has become aware that certain persons and partnerships may be unable to comply timely with this new requirement, and it will waive penalties under Sections 6722 for failure to furnish a partner a Schedule K-1 (Form 1065), 6698 for filing a Schedule K-1 (Form 8865), and under any other Code section for failure to file or furnish a Schedule K-1 or any other form or statement, for any penalty that arises solely as a result of failing to include negative tax basis capital account information, if both the following conditions are met:

- The partner Schedules K-1 are timely filed, including extensions, with the IRS and furnished to the partners and contain all other required information.
- The person or partnership required to file the Schedule K-1 or other applicable form or statement files with the IRS, no later than one year after the original, unextended due date of the form to which the Schedule K-1 or other applicable form or statement must be attached, a schedule setting out for each partner for which negative tax basis capital account information is required:

  a) the partnership's name and employee identification number, if any, and Reference ID Number, if any;

  b) the partner's name, address and taxpayer identification number; and

  c) the amount of the partner's tax basis capital account at the beginning and end of the tax year at issue.

The schedule should be captioned "Filed Under Notice 2019-20" and in accordance with instructions and additional guidance posted by IRS on IRS.gov.

IRS Releases Fact Sheet Outlining TCJA Changes for Businesses

The IRS has released a fact sheet (FS-2019-3 https://www.irs.gov/newsroom/irs-highlights-tax-reform-changes-that-affect-businesses) that summarizes tax law changes under the 2017 Tax Cuts and Jobs Act (TCJA) that affect businesses and provides resources to help business owners track down details specific to their concerns, noting that most of the changes took effect in 2018 and will affect returns filed in 2019.

IRS Issues FATCA FAQs Regarding Penalty Relief for Dividend Equivalents and Withholding/Reporting

The IRS has updated its Foreign Account Tax Compliance Act (FATCA) frequently asked questions (FAQs) website (https://www.irs.gov/businesses/corporations/frequently-asked-questions-faqs-fatca-compliance-legal), extending penalty relief for the 2018 calendar year in situations where a withholding agent withholds and reports by Sept. 17, 2019, regarding dividend equivalent payments made with respect to a derivative referencing a partnership (see "General Compliance," Q23). In addition, the IRS has clarified compliance requirements related to the withholding and reporting with respect to a foreign partner's or trust beneficiary's share of undistributed 2018 income for the 2019 year.

IRS Releases International Practice Unit on Competent Authority Process Under MAP Article

The IRS released an international practice unit https://www.irs.gov/pub/default_path_no_value/tre_c_016_12_10.pdf that provides a general explanation of the process for competent authority requests made to the U.S. competent authority under a mutual agreement procedure article representative of most U.S. income tax treaties.

JCT Publishes Overview of Section 199A Passthrough Deduction

The Joint Committee on Taxation (JCT) provided an overview of the Section 199A passthrough income deduction (https://www.jct.gov/publications.html?func=startdown&id=5171), including information on qualified business income, a qualified trade or business, a specified service trade or business, deduction limitations, agricultural or horticultural cooperatives, and taxpayer eligibility.

JCT Issues Report Reviewing Recently Expired and Expiring Federal Tax Provisions

The JCT, in a report (JCX-8-19 https://www.jct.gov/publications.html?func=startdown&id=5169) prepared for a March 12 House Ways and Means Select Revenue Measures Subcommittee hearing, listed federal tax provisions that expired in 2017 and 2018 and those that are scheduled to expire in 2019.

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