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U.S. Tax Laws: A Review of 2019 and a Look Ahead to 2020

Authors: Peter Glicklich, Gregg M. Benson and Heath Martin

Review of U.S. Tax Developments in 2019

In 2019, the U.S. tax world continued to be primarily concerned with developing guidance under the monumental *Tax Cuts and Jobs Act* (TCJA), which was enacted at the end of 2017. Major regulatory projects were proposed beginning in 2018, including extensive rules on the global intangible low-taxed income (GILTI) regime, the revised anti-earnings stripping rules of section 163(j),[1] the base erosion anti-abuse tax (BEAT) and the anti-hybrid rules. This work continued throughout 2019, with the Internal Revenue Service (IRS) finalizing many of the regulations that were proposed in 2019 and proposing several additional regulatory projects.

Even after two years of frenzied activity, the IRS has yet to issue several major sets of regulations under the TCJA. The IRS has stated that one of its main goals for 2020 is to finish developing guidance under the TCJA. Accordingly, U.S. tax practitioners expect to see significant progress in this area throughout 2020.

In the international context, 2019 was a year in which some countries, frustrated by the glacial pace of the efforts of the Organisation for Economic Co-operation and Development (OECD) to combat international tax avoidance, took unilateral measures to combat base erosion by large companies such as Google and Amazon. France, in particular, attracted attention for instituting a "digital services tax," which is a tax on revenues generated by a company from French consumers with respect to the provision of certain digital services.[2] The United States views these new taxes as targeted at U.S. companies and has proposed retaliating against France by adding tariffs on French goods.

A brief review of tax developments in 2019 precedes our outlook for 2020.

Federal Tax Legislation

No significant federal tax legislation was enacted in 2019, even though tax practitioners widely recognize the need for a technical corrections bill to address certain drafting problems with the TCJA.

Federal Administrative Developments

The IRS and the Treasury Department continued throughout 2019 to work on guidance under many aspects of the TCJA.

1. Finalized Regulations Under the TCJA

The IRS was successful at finalizing several important regulatory projects. Most of these regulations were finalized with only minor changes to the proposed versions. Finalized regulations issued in 2019 under the TCJA included regulations on GILTI, section 199A, and the BEAT.

2. Additional Proposed Regulations Under the TCJA

In addition, the IRS proposed several new sets of regulations, some of which would be taxpayer-favourable, including the following:

Withholding on Transfer of an Interest in an ECI-Generating Partnership. Before the TCJA, it was unclear under U.S. federal tax law whether substantive tax applied to a foreign person's transfer of an interest in a partnership (or other entity classified as a partnership for

U.S. federal tax purposes) that generated income that was (in whole or in part) effectively connected with a U.S. trade or business (ECI). The TCJA resolved the issue, and now gain on such a transfer is treated as ECI and the transferee of an interest in an ECI-generating partnership is required to withhold 10% of the purchase price for the interest. This rule is known as "1446(f) withholding."

In 2018, the IRS provided temporary guidance on the new withholding tax in the form of two notices. In 2019, the IRS issued proposed regulations based partly on those notices, but with some significant differences. For example, under the notices, certain exceptions from 1446(f) withholding would have been available if the amount of ECI from a hypothetical sale of the partnership's assets was less than 25% of the total gain or if less than 25% of the transferor partner's share of the underlying partnership's income was ECI. The proposed regulations reduced the threshold for these exceptions from 25% to 10%.

Other provisions under these proposed regulations relate to an exception from 1446(f) withholding for taxpayers entitled to tax treaty benefits and procedures to be used for taxpayers to qualify for the exceptions from 1446(f) withholding.

GILTI. The TCJA created a new tax regime for GILTI, which requires a taxpayer to recognize certain income of a CFC in excess of a specified rate of return on the CFC's foreign assets, even if such income is not distributed to the taxpayer. In addition to finalizing regulations on GILTI that were proposed in 2018, the IRS proposed new regulations relating to GILTI. The proposed regulations provide a high-tax exception for income that would otherwise be considered GILTI. Under the new high-tax exception, a controlling domestic shareholder of a controlled foreign corporation (CFC) may elect to exclude GILTI from gross income, provided that the GILTI is subject to foreign income tax at a rate in excess of 90% of the U.S. corporate income tax rate. In addition, proposed regulations issued in 2019 clarify that the deduction for GILTI is available for an individual who makes an election to be taxed as a corporation for the purposes of the CFC rules and apply the aggregate approach to determine whether a partner of a domestic partnership is a "United States shareholder" for the purposes of the subpart F income rules in general (i.e., generally, under this approach, only a U.S. partner that has an indirect interest in a CFC of at least 10% will be subject to current inclusion of the CFC's subpart F income).

FDII. Under the TCJA, a U.S. corporation is entitled to deduct a portion of its income from the sale of goods or services to a foreign buyer for use outside of the United States. Such income is known as foreign-derived intangible income (FDII). The IRS released proposed regulations relating to the deduction under section 250 for FDII, most of which provide detail about the calculation of the FDII deduction. The FDII rules effectively provide U.S. corporate taxpayers with a lower tax rate for sales of products and services to foreign purchasers.

Section 199A. The TCJA included a new deduction under Section 199A for certain qualified business income realized through a pass-through entity or by a sole proprietor. In addition to finalizing previously proposed regulations under Section 199A, the IRS issued new proposed regulations and published a notice under section 199A that offers favourable treatment of certain real estate operating businesses. The proposed regulations include provisions on the treatment of suspended losses, certain dividends from a regulated investment company and amounts received from split-interest trusts and charitable remainder trusts. The IRS reserved and asked for comments on the treatment of publicly traded partnerships under section 199A.

Qualified Opportunity Zones. The IRS released proposed regulations on the qualified opportunity zone regime. The proposed regulations provide that a qualified opportunity fund (QOF) can realize tax benefits on an asset-by-asset basis; provide that a QOF can hold cash as working capital without affecting the QOF's compliance with the applicable asset test; and provide several safe harbors intended to prevent ordinary business operations from violating the rules for qualified opportunity zones.

The BEAT. The BEAT is essentially a new minimum tax imposed on large corporate taxpayers that use deductible, depreciable or amortizable payments to foreign affiliates to reduce income taxable in the United States. In addition to finalizing previously proposed regulations, the IRS issued new proposed regulations on the BEAT. These new rules include an election for a taxpayer to waive tax deductions in order to reduce its base erosion payments, which may enable a taxpayer to avoid triggering the BEAT in a particular year. The election must be made annually. Since the base erosion percentage is determined on an aggregate group basis, it may be necessary for a taxpayer's affiliates to waive deductions if the taxpayer intends to reduce its base erosion percentage under this rule.

Foreign-Source Dividend Deduction. The IRS issued temporary regulations on the calculation of the deduction for the foreign-source portion of dividends from 10%-owned foreign corporations. These regulations provide limitations on the availability of the deduction with respect to certain "extraordinary transactions."

Offshore Sales of Inventory Produced in the United States. The IRS issued proposed regulations on rules under Section 863, as revised by the TCJA, that determine the source of income from sales of inventory and certain other personal property. Under these rules, income from the sale of property produced entirely in the United States but sold outside the United States is entirely sourced to the United States. If the seller of such property is a U.S. person there will be no credit for foreign taxes because, under the Code, a foreign tax credit is only available for foreign source income. A tax treaty may override this rule and provide a seller with a foreign tax credit. On the other hand, if a foreign person produces goods abroad and sells them in the United States, the proposed regulations confirm that a portion of the resulting profit would be sourced in the United States under Section 865.

CFC Status. The TCJA eliminated a provision that "turned off" downward attribution of share ownership to U.S. persons for the purposes of determining a corporation's status as a CFC. The elimination of this provision has been widely criticized by tax practitioners as having consequences that were not intended by Congress, on the basis of the legislative history of the provisions governing attribution of share ownership with respect to CFCs. The IRS released proposed regulations and a proposed revenue procedure that scale back some effects of downward attribution. It should also be noted that a technical correction was proposed that would reinstate the provision that turned off downward attribution except where a person would directly or indirectly own more than 50% of the stock of a foreign corporation if downward attribution were applied; however, this correction has not yet been enacted.

FTCs. The IRS issued final and proposed regulations regarding foreign tax credits (FTCs), addressing a laundry list of FTC issues. These regulations provide guidance on coordination with provisions introduced by or enacted under the TCJA, such as GILTI, FDII, the anti-hybrid rules and allocation rules for research and development expenses, interest on loans to controlled entities and certain other expenses. In addition, these regulations provide detailed guidance on determining foreign branch category income.

3. Other New Regulations

In addition to regulations under the TCJA, the IRS issued regulations interpreting some other provisions of the Code:

Partnership Audit Rules. The IRS finalized regulations under the new partnership audit rules, which allow the IRS to assess taxes, interest and penalties against a partnership instead of requiring the IRS to make an assessment against the partnership's partners. Under these regulations, a U.S. person must be designated as a representative of a partnership to act in connection with such audits, and such U.S. person will have broad powers to resolve tax issues that may arise during audits. The finalized regulations include only minor changes to the regulations that were proposed in August 2018.

QFPFs. The IRS issued long-awaited proposed regulations on the exemption from the *Foreign Investment in Real Property Tax Act* (FIRPTA) for qualified foreign pension funds (QFPFs). This exemption was enacted as part of the *Protecting Americans from Tax Hikes Act of 2015*. The proposed regulations on QFPFs are generally taxpayer-favourable and include provisions that (i) expand the definition of "controlled entities," which are eligible for the QFPF exemption in addition to the QFPF itself; (ii) allow a QFPF to provide "ancillary" benefits in addition to retirement benefits, as long as the value of the ancillary benefits is less than 15% of the value of all provided benefits; and (iii) loosen the requirement that a QFPF be entitled to tax benefits in its home country. The preamble to the proposed regulations notifies taxpayers that the IRS will revise Form W-8EXP to be used by QFPFs, but in the meantime a taxpayer can certify that it is a QFPF by providing a certification of non-foreign status under FIRPTA.

Partnership Liabilities. The IRS released two sets of final regulations governing the allocation of partnership liabilities with respect to disguised sales and other transactions. The regulations address the situations when certain obligations to restore a deficit balance in a partner's capital account are disregarded under section 704; when partnership liabilities are treated as recourse liabilities under section 752; and how bottom-dollar payment obligations are treated under section 752. These final regulations provide guidance necessary for a partnership to allocate its liabilities among its partners. Among the changes to the previously proposed regulations was a change that adds capital contributions and partnership deficit restoration obligations to the types of payment obligations that can constitute a bottom-dollar guarantee for purposes of the Code.

Section 382. The IRS proposed new regulations under section 382, which, among other things, limit a corporation's ability to use net operating losses after the corporation undergoes an "ownership change," as defined for the purposes of section 382. Under these rules, unrealized gains and losses existing at the time of the ownership change and recognized after the ownership change are treated as if they were recognized before the ownership change. Under prior law, the amount of gain or loss recognized after the ownership change could be based on a hypothetical sale of the corporation's assets or based on actual dispositions of the corporation's assets. The new proposed regulations require taxpayers to base the recognized gain or loss on actual dispositions. This new rule is expected to be detrimental to taxpayers.

REIT Conversions. In partial response to an executive order by President Trump to review prior regulations, the IRS issued new proposed regulations to limit the amount of gain required to be recognized upon a conversion of a C corporation to a real estate investment trust (REIT) within 10 years of a spinoff of or by the C corporation.

S Corporations. Regulations were proposed to clarify that income of an S corporation is subject to tax with respect to shares held by a non-resident alien indirectly through an electing small business trust.

Tax Case

Altera. In 2018, the IRS enjoyed a victory in *Altera v Commissioner*, a transfer-pricing case about the allocation of the cost of stock-based compensation under cost-sharing agreements with foreign subsidiaries; however, the Ninth Circuit withdrew the decision a month later because of the death of one of the judges. In 2019, the Ninth Circuit reissued its opinion that the regulation in question should be upheld under the traditional *Chevron* test for regulatory actions. The taxpayer in *Altera* has until early 2020 to appeal the case to the U.S. Supreme Court.

Updates on Tax Treaties

After years of being blockaded by Senator Rand Paul, several protocols to existing tax treaties were ratified by the Senate. The ratified protocols include protocols to the treaties with Japan, Luxembourg, Spain and Switzerland. Senator Paul continued to resist the protocols on the ground that they do not include enough protection for the privacy of U.S. taxpayers living abroad. Updated treaties with Chile, Hungary and Poland are still waiting to be ratified.

State-Level Developments

Last year, we reported that *South Dakota v Wayfair Inc.* was the most significant state tax case decided by the U.S. Supreme Court in decades. In *Wayfair*, the Supreme Court adopted a new "substantial virtual connection" standard that finds nexus for sales and use taxes when a retailer without a physical presence in a state accesses the state's residents only online, as long as the retailer meets thresholds regarding the minimum number of customers and minimum sales revenues during the relevant taxable period.

In the year since *Wayfair* was decided, almost all the states that impose a sales or use tax have adopted new nexus standards similar to (and in some cases, more aggressive than) South Dakota's. Nevertheless, different states' standards vary in terms of the actual thresholds used, the method of measuring whether a taxpayer has met the threshold and how the standard applies to "marketplace facilitators" such as Amazon or eBay. One state, New Hampshire, has even enacted an "anti-*Wayfair*" statute intended to prevent other states from taxing New Hampshire's residents under a *Wayfair*-style nexus statute.

State income tax nexus is regulated by federal statute and not case law, so *Wayfair* does not directly authorize states to impose income tax on out-of-state sellers. Some states, however, are already beefing up their income tax nexus rules in the expectation that, if challenged, the Supreme Court will permit a substantial virtual connection standard for income tax as well as for sales and use tax.

International Developments Affecting the United States

The OECD has been developing its base erosion and profit shifting (BEPS) project since 2012. Even though many of the BEPS actions are designed to reduce the kinds of tax avoidance that have been made possible by the digital economy, the United States has generally stood on the sidelines of the BEPS debate and has declined to sign on to BEPS-inspired measures such as the common reporting standard, or the MLI (defined below).

In 2019, some countries became tired of waiting for the OECD's efforts to bear fruit and instead took unilateral action to collect tax from big Internet companies such as Amazon, Google and Uber. These unilateral measures generally took the form of "digital services taxes," which are taxes imposed on revenues derived from the jurisdiction into which the company provides certain digital services. France attracted the most attention for its digital services tax, although similar measures were proposed by several countries, including Hungary, Spain, Poland, India and Turkey. For a discussion of the prospects of such a tax in Canada, see the Canadian portion[2] of this memorandum.

These measures were widely seen as an attack on the United States, or at least some of the largest and most powerful U.S. companies. Ultimately, President Trump's administration retaliated against France by proposing tariffs on a wide variety of French imports into the United States, such as wine.

The OECD has continued to develop its BEPS project throughout 2019. Many of the cross-border tax reforms proposed by BEPS have been incorporated into a multilateral tax treaty known as the Multilateral Instrument (MLI). As of this writing, 93 countries, including Canada, have signed on to the MLI. The United States, however, has been reluctant to sign on, even though some recent changes to U.S. tax law and policy are similar to provisions of the MLI, and the United States would benefit from more widespread adoption of the MLI's arbitration provisions.

U.S. Tax Development Outlook for 2020

Even though the IRS spent much of the last two years developing regulatory guidance under the TCJA, major regulatory projects under the TCJA are still pending. As of the time of this writing, the IRS and the Treasury Department are targeting the end of 2020 to finish issuing all interpretive guidance under the TCJA. This will entail issuing nearly 100 items of guidance, including final regulations on the limitation on the deductibility of interest under section 163(j), the availability of capital gains treatment for carried interest and many other provisions.

The most controversial tax news in 2020 is likely to relate to the tax policies of each of the presidential candidates. Many of the Democratic hopefuls are proposing massive expansions of expensive social programs like Medicare, which will require new sources of funding. Wealth taxes proposed by Bernie Sanders and Elizabeth Warren for this purpose are already making headlines. Other tax-related measures that could be revenue raisers include the following:

- Increasing the tax rate on carried interest
- Adopting a value-added tax or wealth tax
- Increasing the corporate tax rate
- Reducing deductions for GILTI
- Lowering the exemption for gift and estate taxes

Other potential measures that would not be revenue raisers but would be politically motivated might include eliminating the unpopular cap on the deduction for state and local taxes, increasing the participation by the United States in OECD measures such as BEPS or the MLI, or declining to enact technical corrections for the TCJA.

[1] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (Code) or the Treasury Regulations promulgated thereunder.

[2] See the Canadian portion of this memorandum for the prospects of such a tax in Canada.

Key Contact: Peter Glicklich