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International Tax ADVISORY ■

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Proposed Tax Regulations Address International Aspects of the New Partnership Audit Regime

We are about to witness an almost unprecedented centralized partnership audit regime that takes full effect for taxable years starting on or after January 1, 2018, as adopted in late 2015 by Section 1101 of the Bipartisan Budget Act (BBA), with some minor modifications shortly after enactment. The new regime represents a break with the principle, long thought to be axiomatic, that a partnership always passes through income tax liability to the partners and is not itself taxable. In general, the legislation will permit the IRS on audit to assess and collect income taxes at the partnership level. The default rule will be that the partnership itself is required to pay any "imputed underpayment" resulting from an audit adjustment. Moreover, in the process of shifting tax liability from the partners to the partnership in an audit, the BBA has a tendency to increase the aggregate amount that taxpayers owe the government. Coordinating this upheaval in partnership tax procedure with existing partnership tax principles is at best challenging for both taxpayers and the government.

On November 29, 2017, the IRS revealed, in the form of proposed regulations (REG-119337-17), the fruits of its efforts thus far to meet that challenge in the international tax context. The new proposals supplement an earlier package of proposed guidance, which had for the most part reserved the international issues. The earlier package was first released in January 2017, withdrawn in response to a White House freeze on regulations, and then re-released in almost identical form in June (REG-136118-15).

The new proposals devote much of their attention to the interaction between the new centralized audit rules and the preexisting requirements for withholding on amounts paid or allocated to foreign partners. Proposed guidance on creditable foreign tax expenditures (CFTEs) is also offered. In addition, the preamble to the new proposals presents a few comments on treaty issues and on implications for foreign corporations.

Withholding Taxes

Chapters 3 and 4 of Subtitle A of the Code impose tax withholding requirements under various circumstances, including on certain distributions or allocations to foreign partners. Chapter 3 may require withholding on U.S.-source fixed or determinable annual or periodic (FDAP) income, income from dispositions of U.S. real property interests, and income of foreign partners that is considered effectively connected with a U.S. trade or business. Chapter 4 withholding enforces reporting on certain foreign accounts under the Foreign Account Tax Compliance Act (FATCA).

Chapters 3 and 4 are not intended to impose additional taxes. Their objective is to collect tax otherwise owed by the partners or to ensure compliance with information reporting requirements. In almost all instances, the underlying tax liabilities targeted by Chapters 3 and 4 are in essence the same as those that an audit of the partnership under the BBA would be attempting to uncover: the income tax liabilities of the beneficial owners. Yet a partnership's compliance with Chapters 3 and 4 is not subject to the BBA's audit procedures; the IRS's examination of a partnership's compliance under Chapters 3 and 4 is a separate proceeding. The result is two separate mechanisms for determining the amount of, and collecting, what is fundamentally the same tax. Without effective coordination of the two mechanisms, tax on the same item might be collected twice.

Under the new proposals, the collection mechanism that the IRS happens to conclude first generally takes precedence. If an audit under the BBA adjusts an amount that is subject to Chapter 3 or 4 withholding, the partnership's payment of the imputed underpayment under the BBA is treated as satisfying the withholding obligation. Conversely, if the IRS in an examination of Chapter 3 or 4 compliance collects tax attributable to an adjustment, that adjustment will be "disregarded" (the adjustment will not add to the imputed underpayment amount) in a subsequent BBA audit.

The coordination plays out differently, however, when the partnership takes advantage of the BBA's election to "push out" audit adjustments. If the partnership makes the election, each partner pays its allocable share of the imputed underpayment as determined in the BBA audit. The new proposals, however, do not allow the partnership to push out what otherwise would be its withholding obligations. Suppose a BBA adjustment reflects an amount allocable to a partner, which had not been properly accounted for. In that case, the partnership generally must withhold to the same extent it would have had to if the amount had been properly accounted for in the first place.

However, the withholding may turn out to be higher as a result of the BBA push-out election than it would have been in the normal course of events. To sidestep what the preamble calls "administrability issues," the new proposals do not allow the electing partnership to take into account partner-level deductions and losses that might have reduced the amount of withholding had the amounts originally been reported correctly. On the other hand, it may be possible for those partner-level items to be factored in under the general process for modifying the imputed underpayment that the BBA authorizes.

Foreign Tax Credits

Taxpayers are generally allowed a credit (or, alternatively, a deduction) against U.S. taxes for certain foreign taxes (primarily income taxes) paid or accrued. In addition, corporations in some instances are deemed to have paid—and therefore may receive a credit for—a share of the taxes of foreign subsidiaries from which the parent corporations receive a dividend.

A partnership cannot claim a foreign tax credit (or deduction). Rather, each partner takes into account its share of foreign taxes paid by a partnership (CFTEs) as a separately stated item. Adjustments, such as the foreign tax credit limitation, are generally computed at the partner level. But of course under the BBA, tax liability is determined at the partnership level; partner-level information may not even be available.

Under the new proposals, a decrease in a partnership's CFTEs increases the imputed underpayment, but no downward adjustment to the imputed underpayment results from an increase in the CFTEs. The preamble attempts to justify this "heads I win, tails you lose" proposition by pointing out that partner-level limitations, which the partnership returns and records often will not reveal, might nullify the benefit of increased CFTEs for certain partners. The preamble also alludes to the partnership's opportunity, under the general process for modifying an underpayment amount, to present to the IRS favorable facts and circumstances affecting particular partners.

The new proposals also provide for special grouping and subgrouping of CFTEs that are subject to audit adjustments under the new regime. The rules are generally designed to prevent netting of CFTEs between partners, or between separate categories for the same partner, in order to preserve the category-by-category limitations required under existing foreign tax credit rules.

Tax Treaties

The preamble discusses possible modifications to the underpayment amount that might be appropriate if a partnership or partner is entitled to benefits under an international tax treaty. However, the discussion is preliminary and inconclusive, and the IRS repeats its previous request for comments from the public on the topic.

Similarly, the preamble reiterates a prior request for comments on coordinating the BBA rules with the mutual agreement procedures (MAPs) that may be available by treaty. The IRS intends to allow access to MAPs "when and where appropriate," but so far the IRS does not appear willing to venture beyond this vague statement of intent.

Foreign Corporations

The IRS previously announced its intention to issue regulations addressing the push out of an audit adjustment to a controlled foreign corporation (CFC), or other entity that is not liable for U.S. tax, when the owner of the entity is or at least may be liable for tax from the adjustment. For example, an audit adjustment that the partnership pushes out to a CFC may have no impact on the CFC's own U.S. tax liability, while nevertheless affecting the liability of the CFC's U.S. owner. The IRS does not yet appear to have made a great deal of progress on this topic, but the IRS evidently continues to study it and is still soliciting public comments.

Prognosis

Indications are that the BBA will go live, as scheduled, for taxable years starting after this month, despite many pleas to scrap, overhaul, or at least delay what promises to be a disastrous new statutory scheme. Few partnerships if any have taken up—or are likely to take up—the statute's offer to elect into the BBA system any earlier than the scheduled 2018 effective date. In fact, many partnerships should be eligible to elect out of the system after it goes into effect, and current conventional wisdom holds that if a partnership is able get out from under the BBA, it is likely to jump at the chance. Many other partnerships, however, will have no choice but to subject themselves to this unpopular new regime. For those partnerships, many questions remain. The new proposals represent incremental progress toward coping with the BBA, but cannot be called a major breakthrough. Another unknown at this moment is whether Congress will enact some version of the pending Tax Cuts and Jobs Act, and what effect, if any, the enactment of this massive piece of legislation would have on the issues surrounding the BBA.

For more information, please contact Andy Immerman at 404.881.7532 or Danny Reach at 704.444.1272.

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If you have any questions or would like additional information, please contact your Alston & Bird attorney or any of the following:

Sam K. Kaywood, Jr.
Co-Chair
404.881.7481
sam.kaywood@alston.com

Edward Tanenbaum
Co-Chair
212.210.9425
edward.tanenbaum@alston.com

George B. Abney
404.881.7980
george.abney@alston.com

John F. Baron
704.444.1434
john.baron@alston.com

Henry J. Birnkrant
202.239.3319
henry.birnkrant@alston.com

James E. Croker, Jr.
202.239.3309
jim.croker@alston.com

Jasper L. Cummings, Jr.
919.862.2302
jack.cummings@alston.com

Scott Harty
404.881.7867
scott.harty@alston.com

Brian D. Harvel
404.881.4491
brian.harvel@alston.com

L. Andrew Immerman
404.881.7532
andy.immerman@alston.com

Stefanie Kavanagh
202.239.3914
stefanie.kavanagh@alston.com

Brian E. Lebowitz
202.239.3394
brian.lebowitz@alston.com

Clay A. Littlefield
704.444.1440
clay.littlefield@alston.com

Ashley B. Menser
919.862.2209
ashley.menser@alston.com

Daniel M. Reach
704.444.1272
danny.reach@alston.com

Heather Ripley
212.210.9549
heather.ripley@alston.com

Michael Senger
404.881.4988
michael.senger@alston.com

ALSTON & BIRD

WWW.ALSTON.COM

ATLANTA: One Atlantic Center ▪ 1201 West Peachtree Street ▪ Atlanta, Georgia, USA, 30309-3424 ▪ 404.881.7000 ▪ Fax: 404.881.7777
BEIJING: Hanwei Plaza West Wing ▪ Suite 21B2 ▪ No. 7 Guanghua Road ▪ Chaoyang District ▪ Beijing, 100004 CN ▪ +86 10 8592 7500
BRUSSELS: Level 20 Bastion Tower ▪ Place du Champ de Mars ▪ B-1050 Brussels, BE ▪ +32 2 550 3700 ▪ Fax: +32 2 550 3719
CHARLOTTE: Bank of America Plaza ▪ 101 South Tryon Street ▪ Suite 4000 ▪ Charlotte, North Carolina, USA, 28280-4000 ▪ 704.444.1000 ▪ Fax: 704.444.1111
DALLAS: 2828 North Harwood Street ▪ 18th Floor ▪ Dallas, Texas, USA, 75201 ▪ 214.922.3400 ▪ Fax: 214.922.3899
LOS ANGELES: 333 South Hope Street ▪ 16th Floor ▪ Los Angeles, California, USA, 90071-3004 ▪ 213.576.1000 ▪ Fax: 213.576.1100
NEW YORK: 90 Park Avenue ▪ 15th Floor ▪ New York, New York, USA, 10016-1387 ▪ 212.210.9400 ▪ Fax: 212.210.9444
RESEARCH TRIANGLE: 4721 Emperor Blvd. ▪ Suite 400 ▪ Durham, North Carolina, USA, 27703-85802 ▪ 919.862.2200 ▪ Fax: 919.862.2260
SAN FRANCISCO: 560 Mission Street ▪ Suite 2100 ▪ San Francisco, California, USA, 94105-0912 ▪ 415.243.1000 ▪ Fax: 415.243.1001
SILICON VALLEY: 1950 University Avenue ▪ 5th Floor ▪ East Palo Alto, California, USA, 94303-2282 ▪ 650-838-2000 ▪ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ▪ 950 F Street, NW ▪ Washington, DC, USA, 20004-1404 ▪ 202.239.3300 ▪ Fax: 202.239.3333