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In This Issue:

You Can't Always Get What You Want, Especially with the BEAT

Things Are Looking Up for Downward Attribution: Targeted Relief Provided by Final and Proposed Regulations

Final Regulations Issued on New TCJA Rules for S Corps Converting to C Corps

President of Mexico Submits a Draft Bill to Ban Subcontracting

The Trend Continues; Washington State Legislators May Propose Digital Advertising Tax

You Can't Always Get What You Want, Especially with the BEAT

Congress added the base erosion and anti-abuse tax ("BEAT") of Code Section 59A to the Code as part of the Tax Cuts and Jobs Act ("TCJA"). Section 59A requires "applicable taxpayers" to pay a minimum tax associated with deductible and certain other payments to foreign related parties. An applicable taxpayer is a corporate taxpayer which is a member of an "aggregate group" that (i) has $500 million or more of average annual gross receipts during the three prior taxable years; and (ii) has a "base erosion percentage" of three percent or more (two percent for banks). Section 59A(e)(6). A taxpayer's "base erosion percentage" is the ratio between the taxpayer's "base erosion tax benefits" and the taxpayer's total deductions. This 10 percent tax on payments, such as interest and royalties thought to erode the US tax base, increases to 12.5 percent after 2025.

In December 2019, Treasury and IRS published final and proposed regulations implementing the BEAT (2019 Final Regulations and 2019 Proposed Regulations, respectively). For a thorough discussion of the these regulations, please refer to the following article, *The Final and Proposed BEAT Regulations, A Favorable Turn*, published by TAXES, Vol. 98, No. 3 (available at www.bakermckenzie.com). On October 8, 2020, Treasury and the IRS published final regulations (the "2020 Final Regulations"), which address the following aspects of the BEAT: determining the taxpayer's aggregate group, electing to waive deductions for BEAT purposes; applying the BEAT to partnerships; and applying the anti-abuse rule to basis step-up transactions. The 2020 Final Regulations retain the approach of the 2019 Proposed Regulations with a few key changes and modify certain portions of the 2019 Final Regulations. We discuss those changes below.

BEAT Waiver Election

Some companies initially reacted to the BEAT by avoiding deductions in the 2018 tax year. For example, companies chose to forgo bonus depreciation under section 168(k) or to elect under section 59A(e)(4) to capitalize and amortize research and experimentation expenses over 10 years rather than deduct them in the current year. They feared the "cliff effect" of section 59A, in which a negligible amount of deductions could push a company past the three percent threshold into classification as an "applicable taxpayer" with enormous BEAT liability.

The 2019 Proposed Regulations added a new rule, however, that if a taxpayer elected to forego a deduction and followed specified procedures (the ''BEAT waiver election''), the waived deduction would not be treated as a base erosion tax benefit. In exchange, any deduction waived pursuant to the BEAT waiver

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VAT Around the World
Part II
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14th Annual Transfer Pricing Seminar

The Digitalization of the Economy and its Impact on Transfer Pricing
►December 2, 2020

Present and Future of Transfer Pricing After the Impact of COVID-19
►December 9, 2020

Inspection and Penalization of Intercompany Operations: The New Global Reality
►December 16, 2020

London Annual Tax Conference
►December 8-10, 2020

Clean Energy Revolution and Environmental Justice Webinar

What Will the Future of Energy Look Like in the US
►December 9, 2020

International Tax Planning: Administrations Change, But Tax Planning Remains

International Corporate Tax Planning
►December 10, 2020

International Private Client Planning
►December 15, 2020

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election must be waived for all US federal income tax purposes. A taxpayer may elect to waive a deduction on its original US federal income tax return or on an amended return. A taxpayer may also elect to waive a deduction during an audit of the taxpayer's income tax return for the tax year at issue. These rules are quite generous as they also allow a taxpayer to waive additional deductions on the amended return or during an audit if a taxpayer under-calculated the amount of deductions it needed to waive to avoid the cliff effect.

Requests to Reverse 2018 Filing Positions. Several commenters to the 2019 Proposed Regulations asked that companies be allowed to file amended returns to reverse their decisions to forego bonus depreciation or to capitalize and amortize research and experimentation expenses for the 2018 tax year and to instead apply the BEAT waiver election retroactively. Treasury and the IRS declined to provide this relief in the 2020 Final Regulations because it would "expressly permit taxpayers to use hindsight to change their elections to reduce or eliminate BEAT liability or regular income tax."

Requests to Decrease Waiver Amounts. Similarly, commenters asked for additional flexibility in situations where taxpayers over-calculate the amount of deductions they need to waive to avoid the cliff effect. They requested the ability to decrease waived deductions on an amended return or during an examination where they give up too many valuable deductions in attempt to avoid BEAT liability. Treasury and the IRS also refused this request, arguing it would increase uncertainty about taxpayers' return positions and negatively affect the agency's ability to efficiently conduct and close examinations.

Making the Election. The 2020 Final Regulations clarify the mechanisms and procedures for making and reporting the BEAT waiver election. First, the 2020 Final Regulations clarify that a taxpayer may make or increase a BEAT waiver election only when it has determined that it could be an applicable taxpayer but for the election. This primacy rule prevents manipulation of any existing law addressing ''waiver'' outside of the specific situation covered by the BEAT waiver (i.e., electing not to claim a deduction in order to avoid applicable taxpayer status). In addition, the 2020 Final Regulations clarify that:

- a waived deduction is not included in the denominator of the base erosion percentage, which includes only items allowed in determining taxable income for the taxable year;
- a deduction may be waived in part; and
- a waived deduction attributable to a consolidated group member is treated as a noncapital, nondeductible expense that decreases the tax basis in the member's stock under Treas. Reg. § 1.1502-32 to prevent a shareholder benefit from a waived deduction upon disposition of the member's stock.

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A taxpayer makes the BEAT waiver election on an annual basis and consent is not required if the taxpayer chooses to forgo the election in a subsequent year. To make the BEAT waiver election, a taxpayer completes Form 8991, Tax on Base Erosion Payments of Taxpayers with Substantial Gross Receipts. The information required to make the election to waive allowed deductions is listed in Treas. Reg. § 1.59A-3(c)(6)(ii)(B). Notably in the 2020 Final Regulations, Treasury and the IRS made these requirements less burdensome by removing a requirement for a detailed description of the item or property to which the deduction relates.

In addition to avoiding BEAT liability, taxpayers may find additional planning benefits in the ability to waive expenses for all purposes of the Code. Taxpayers with expiring NOLs could waive expenses in a given year in order to increase income to offset those NOLs. Further, taxpayers could waive expenses to increase income eligible for the foreign-derived intangible income ("FDII") deduction under section 250.

Determining the Taxpayer's Aggregate Group

To determine whether the taxpayer is an applicable taxpayer, a taxpayer and certain affiliated corporations are treated as one person for purposes of applying the gross receipts and base erosion tests. Under the 2019 Final Regulations, a taxpayer makes these determinations on the basis of the taxpayer's gross receipts, base erosion tax benefits, and deductions for the taxable year, as well as the gross receipts, base erosion tax benefits and deductions of each member of the aggregate group for the taxable year of each member that ends "with or within" the taxpayer's taxable year.

Joining or Leaving an Aggregate Group. The 2020 Final Regulations modify the 2019 Proposed Regulations regarding how the gross receipts and the base erosion percentage of an aggregate group are determined when members join or leave a taxpayer's aggregate group. In determining the gross receipts and the base erosion percentage of the aggregate group of a taxpayer, the taxpayer takes into account only the portion of another corporation's taxable year during which the corporation is a member of the aggregate group of the taxpayer. Treas. Reg. § 1.59A-2(c)(4)(i). Items of a member outside this window are disregarded (cut-off rule). The 2019 Proposed Rules treated a corporation that joins or leaves an aggregate group (in a transaction that does not otherwise result in a taxable year-end) as having a deemed taxable year-end occurring immediately before the corporation joins or leaves the aggregate group (''time-of-transaction rule''). In order to conform the BEAT waiver election rules to the consolidated return rules, the 2020 Final Regulations replace this time-of-transaction rule with the end-of-day rule.

Specifically, when a corporation joins or leaves an aggregate group and triggers a deemed taxable year-end, that deemed taxable year-end is treated as

occurring at the end of the day of the transaction. Treas. Reg. § 1.59A-2(c)(4)(ii). A new taxable year is deemed to begin at the beginning of the day. A taxpayer determines items attributable to the deemed short taxable years ending upon and beginning the day after the deemed taxable year-end by either deeming a close of the corporation's books or, in the case of items other than extraordinary items, making a pro-rata allocation without a closing of the books. Treas. Reg. § 1.59A-2(c)(4)(iii). Extraordinary items that occur after the transaction that causes the corporation to join or leave the aggregate group but on the same day are treated as occurring in the deemed taxable year beginning the next day. For BEAT purposes, the term ''extraordinary items" is expanded beyond its meaning in Treas. Reg. § 1.1502-76(b)(2)(ii)(C), to include other payments that are not made in the ordinary course of business and that would be treated as base erosion payments.

Short Taxable Years. The 2019 Proposed Regulations included special rules describing how these aggregation rules operate during short taxable years and when an entity enters or exits the group mid-year. Taxpayers may use a reasonable approach to determine whether a taxpayer's aggregate group meets the gross receipts test and base erosion percentage test with respect to a short taxable year of the taxpayer. Treasury and the IRS provided examples of reasonable approaches in the 2020 Final Regulations and clarified that a reasonable approach does not include an approach that does not take into account the gross receipts, base erosion tax benefits, or deductions of a member whose tax year does not fall "with or within" the taxable year. Treas. Reg. § 1.59A-2(c)(5)(i)(B).

Annualization Rule. If a member of a taxpayer's aggregate group has more than one taxable year that ends with or within the taxpayer's taxable year and together those taxable years are comprised of more than 12 months, the 2020 Final Regulations annualize the member's gross receipts, base erosion tax benefits and deductions for purposes of determining the gross receipts and base erosion percentage of the taxpayer's aggregate group. Treas. Reg. § 1.59A-2(c)(5)(ii)(A). A similar annualization rule applies when a member of the taxpayer's aggregate group changes its taxable year-end, and as a result the member's taxable year (or years) ending with or within the taxpayer's taxable year is comprised of fewer than 12 months. *See* Treas. Reg. § 1.59A-2(c)(5)(ii)(B). These rules also include an anti-abuse provision to prevent other transactions that might also exclude gross receipts or base erosion percentage items of a taxpayer or member of the taxpayer's aggregate group that are undertaken with a principal purpose of avoiding applicable taxpayer status. *See* Treas. Reg. § 1.59A-2(c)(5)(iii).

Assuming a requisite principal purpose, the anti-abuse rule might apply where:

- a taxpayer transfers a portion of its revenue generating assets to a newly formed domestic corporation that is a member of the taxpayer's

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aggregate group (but not a member of the taxpayer's consolidated group) and that has a different taxable year that does not end with or within the taxpayer's current taxable year; or

- stock of a member of the taxpayer's aggregate group is transferred to a consolidated group that is also a member of the taxpayer's aggregate group and that has a different taxable year that does not end with or within the taxpayer's current taxable year.

Applying the Final Regulations to Partnerships

The 2019 Proposed Regulations included operating rules applying the BEAT regulations to partnerships. The rules treat partnerships as an aggregate of their partners and deem certain partnership-level transactions as taking place at the partner level for BEAT purposes. We discuss three areas where Treasury and the IRS clarified these rules in the 2020 Final Regulations.

The BEAT Waiver Election. The 2020 Final Regulations expressly state that a corporate partner, not a partnership, makes a BEAT waiver election. The 2020 Final Regulations also provide that a partner's waived deductions are treated as nondeductible expenditures under section 705(a)(2)(B). *See* Treas. Reg. § 1.59A-3(c)(6)(iv)(B). Further, the Final Rules provide a coordination rule regarding the BEAT waiver election and the rules under section 163(j), whereas the increase in a partner's income from the waiver is treated as a partner basis item (as defined in Treas. Reg. § 1.163(j)-6(b)(2)) and added to the partner's section 163(j) limitation computation. The partner's BEAT waiver election does not affect the partnership's section 163(j) computations, however.

Treasury and the IRS also explicitly permit a corporate partner in a partnership to make a BEAT waiver election with respect to a "partnership item" as set out in the partnership audit procedures of the Bipartisan Budget Act of 2015 (BBA). Treas. Reg. § 1.59A-3(c)(6)(iv)(A). In the preamble to the 2020 Final Regulations, they further clarified that a partner reporting a waiver of a partnership item for BEAT purposes reports the item consistently for purposes of section 6222, which requires consistent reporting between partners and partnerships. The 2020 Final Regulations do not provide additional detail on the interaction of the BEAT with the BBA audit procedures, but further guidance may be forthcoming.

Effectively connected income (ECI) exception. Under the 2019 Final Regulations, amounts subject to tax as effectively connected income ("ECI") generally are not base erosion payments even when paid or accrued to a foreign related party (the ''ECI exception''). *See* Treas. Reg. § 1.59A-3(b)(3)(iii). To qualify for the ECI exception, a taxpayer must receive a withholding certificate on which the foreign related party claims an exemption from withholding under section 1441 or 1442. The 2019 Final Regulations failed to address how the ECI exception applies to partnership transactions.

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Treasury and the IRS correct this omission in the 2020 Final Regulations and expand the ECI exception to certain partnership transactions. The ECI exception applies to a partnership transaction where the taxpayer is treated as making a base erosion payment as a result of a deemed transaction with a foreign related party, which is subject to US federal income tax on allocations of income from the partnership.

The preamble to the 2020 Final Regulations provides an example involving a US taxpayer purchasing a partnership interest from a foreign related party. Under the general BEAT partnership rules for transfers of a partnership interest, this transaction is treated as a transfer by the foreign related party of a portion of the partnership assets to the US taxpayer. To the extent that the partnership assets are used or held for use in connection with the conduct of a trade or business within the United States, this situation is similar to a situation where the foreign related party directly holds the assets, and the ECI exception applies.

The ECI exception may apply to other transactions with a partnership, including if:

- a US taxpayer contributes cash and its foreign-related party contributes depreciable property to the partnership (see Treas. Reg. § 1.59A-7(c)(3)(iii));
- a partnership with a foreign-related partner engages in a transaction with the taxpayer; or
- a partnership engages in a transaction with a foreign related party of a partner in the partnership.

To qualify for the partnership ECI exception, the 2020 Final Regulations require a taxpayer to obtain a written statement from a foreign related party that is comparable to a withholding certification, but which includes any deemed transactions under Treas. Reg. § 1.59A-7. The taxpayer may rely on the written statement unless it has reason to know or actual knowledge that the statement is incorrect.

Derivatives Involving Partnerships. The 2019 Proposed Regulations included a partnership anti-abuse rule for derivatives. Under this rule if a taxpayer acquires a derivative on a partnership interest or partnership assets with a principal purpose of eliminating or reducing a base erosion payment, then the taxpayer is treated as having a direct interest in the partnership interest or partnership asset (instead of a derivative interest). In the 2020 Final Regulations, Treasury and the IRS clarify how the partnership anti-abuse rule for derivatives interacts with the exception from base erosion payments for a qualified derivative payment ("QDP"). *See* Treas. Reg. § 1.59A-3(b)(3)(ii). For purposes of the QDP exception, a derivative is defined as "a contract whose value is determined by reference to one or more of the following: (1) Any shares of stock in a corporation, (2) any evidence of indebtedness, (3) any actively traded commodity, (4) any currency, or (5) any rate, price, amount, index,

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formula, or algorithm." Treas. Reg. § 1.59A-6(d)(1). Under the 2020 Final Regulations the partnership anti-abuse rule for derivatives does not apply when a payment with respect to a derivative on a partnership asset qualifies for the QDP exception. Treas. Reg. § 1.59A-9(b)(5).

Modifications to the Anti-Abuse Rule for Nonrecognition Transactions

Section 59A(d)(2) generally defines a base erosion payment to include an amount paid or accrued to a foreign related party in connection with the acquisition of depreciable or amortizable property. The 2019 Final Regulations provide an exception, however, for certain amounts transferred to or exchanged with a foreign related party in certain nonrecognition transactions (the ''specified nonrecognition transaction exception"). Treas. Reg. § 1.59A-3(b)(3)(viii). The 2019 Final Regulations also include an anti-abuse rule to prevent taxpayers from intentionally entering into a basis step-up transaction immediately before a nonrecognition transaction and manipulating this exception to increase depreciation deductions outside the reach of the BEAT. This rule provides that if a transaction, plan, or arrangement has a principal purpose of increasing the adjusted basis of property that a taxpayer acquires in a specified nonrecognition transaction, the nonrecognition exception will not apply.

The 2019 Final Regulations include an irrebuttable presumption that the principal purpose of a transaction, plan, or arrangement is increasing the adjusted basis of property that a taxpayer acquires in a nonrecognition transaction if it occurs in the six-month period before the specified nonrecognition transaction. In response to a comment, Treasury and the IRS made two taxpayer-friendly changes to the language of the anti-abuse rule in the 2020 Final Regulations. First, to address the concerns regarding a cliff effect whereby a minimal amount of pre-transaction basis step-up could disqualify an entire transaction, the anti-abuse rule turns off the application of the specified nonrecognition transaction exception only to the extent of the basis step-up amount, rather than the entire basis amount. Treas. Reg. § 1.59A-9(b)(4). Second, Treasury and the IRS clarified that the transaction, plan, or arrangement with a principal purpose of increasing the adjusted basis of property must also have a connection to the acquisition of the property by the taxpayer in a specified nonrecognition transaction. These changes are reflected in Treas. Reg. § 1.59A-9(c)(11), Ex. 10 and § 1.59A-9(c)(12), Ex. 11.

Other Issues Addressed in the Final Regulations

We mention only briefly two additional issues addressed in the 2020 Final Regulations. Under the 2019 Proposed Regulations, the BEAT wavier election only applied to deductions and did not include the language related to "reductions in gross income" that was otherwise included in the definition of base erosion

Baker McKenzie.

payments. The 2020 Final Regulations clarify that taxpayers may elect to waive life and non-life reinsurance premiums as the economic function of the premiums matches that of a deduction.

Further, the preamble to the 2020 Final Regulations suggests that the Treasury and IRS will continue studying a late comment on the interaction of the QDP exception, the BEAT netting rule with respect to positions for which a taxpayer applies a mark-to-market method of accounting, and the QDP reporting requirements addressed in the 2019 Final Regulations. They will determine if additional guidance is necessary.

Applicability

The 2020 Final Regulations are effective December 8, 2020, however, taxpayers may apply specific sections of the 2020 Final Regulations to earlier years. The regulations are a major rule subject to the Congressional Review Act, which delays their effective date until 60 days after publication.

Conclusion

Taxpayers did not get everything they wanted out of the 2020 Final Regulations. The rules do not grant taxpayers the added flexibility to go back and change the way they treated expenses in a prior year or to lower the amount of waived deductions if they overestimate what it would take to fall below the three percent threshold. Otherwise, the changes to the 2020 Final Regulations appear to be fairly taxpayer friendly. Treasury and the IRS attempted to provide additional clarity regarding the operation of election and identification of applicable taxpayers, expanded the ECI exception to certain partnership transactions, and narrowed the anti-abuse rule for nonrecognition transactions.

By: Elizabeth Boone, Dallas

Things Are Looking Up for Downward Attribution: Targeted Relief Provided by Finalized and Proposed Regulations

On September 22, 2020, Treasury issued final regulations ("2020 Final Regulations") and proposed regulations ("2020 Proposed Regulations") that addressed the ownership attribution rules under Code Section 958. The 2020 Final Regulations largely address the application of the direct, indirect, and constructive ownership rules of section 958 to Code sections outside of subpart F. The 2020 Proposed Regulations modify certain ownership attribution rules under section 367(a) that refer to section 958(b)(4) and generally limit the application of the look-through rule in section 954(c)(6).

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Background

Section 958 provides rules for determining direct, indirect, and constructive ownership for purposes of subpart F of subchapter N of chapter 1 of the Code. The Tax Cuts and Jobs Act of 2017 ("TCJA") changed the constructive attribution rules under section 958(b) by repealing section 958(b)(4) to allow "downward" attribution of stock ownership under section 318(a)(3) from a foreign person to a US person. Prior to the repeal of section 958(b)(4), if, for example, a foreign parent company owned a foreign subsidiary and a US subsidiary as brother-sister entities, the foreign parent's interest in the foreign subsidiary would not be attributed to the US subsidiary. Post-TCJA, the foreign parent's interest in the foreign subsidiary is attributed "downward" to the US subsidiary, such that the US subsidiary is considered to constructively own the foreign subsidiary. The restoration of "downward" attribution caused a number of foreign entities that were not considered controlled foreign corporations ("CFCs") to become CFCs overnight. The repeal of section 958(b)(4) has a number of other ancillary consequences for the many Code sections outside of subpart F that incorporate the rules in section 958 by reference.

Final Regulations

The 2020 Final Regulations generally adopt the proposed regulations issued on October 2, 2019 ("2019 Proposed Regulations"). For more in depth discussion of the 2019 Proposed Regulations, see Tax News and Developments, "*Downward Attribution Guidance: A Patchwork of Changes But No Comprehensive Solution*." As Treasury noted in the preamble to the 2020 Final Regulations, the rules contained therein are intended to ensure that the operation of certain rules outside of subpart F which rely on the rules of section 958 are consistent with their application prior to the TCJA's repeal of section 958(b). To that end, the 2020 Final Regulations address how the statutory repeal of section 958(b)(4) will interact with the following Code sections:

- Section 267 (deductions for certain payments to foreign related persons): The 2020 Final Regulations expand on the rule in the proposed regulations by providing that the "matching rule" in section 267(a)(3)(B)(i) does not apply if a foreign corporation does not have a section 958(a) US shareholder (i.e., a 10 percent direct or indirect US shareholder). Treas. Reg. § 1.267(a)-3(c)(4). The 2019 Proposed Regulations limited the rule to amounts that were exempt from tax under a treaty and owed to a CFC. Notably, Treasury rejected a comment suggesting a broader exception whereby the matching rule would apply as though section 958(b)(4) had never been repealed.
- Section 332 (gain recognition on certain corporate liquidations): Consistent with the 2019 Proposed Regulations, the constructive ownership rules of section 318(a)(3) are not applied so as to consider a US person as owning stock which is owned by a person who is not a US

Baker McKenzie.

person when determining if a corporation is a CFC for purposes of section 332(d)(3) (effectively ignoring the repeal of section 958(b)(4)). Treas. Reg. § 1.332-8(a).

- Section 367 (gain recognition agreements): Consistent with the 2019 Proposed Regulations, the rules regarding triggering events for purposes of gain recognition agreements do not take into account the repeal of section 958(b)(4). Treas. Reg. § 1.367(a)-8(k)(14)(ii).
- Section 672 (grantor trust rules): Consistent with the 2019 Proposed Regulations, a CFC is generally treated as a domestic corporation for purposes of the grantor trust rules; however, the 2020 Final Regulations limit this treatment to entities that are CFCs without regard to downward attribution from foreign persons. Treas. Reg. § 1.672(f)-2(a).
- Section 706 (taxable years of a partner and partnership): Consistent with the 2019 Proposed Regulations, for purposes of determining the tax year of a partnership the definition of CFC is applied that is consistent with the definition prior to the repeal of section 958(b)(4). Treas. Reg. § 1.706-1(b)(6)(ii).
- Section 863 (special source rules): Consistent with the 2019 Proposed Regulations, a corporation's status as a CFC for purposes of certain sourcing rules for space and ocean income and international communications income is determined without regard to downward attribution from a foreign person. Treas. Reg. §§ 1.863-8(b)(2)(ii), 1.863-9(b)(2)(ii).
- Section 904 (limitations on foreign tax credits): Consistent with the 2019 Proposed Regulations, the CFC look-through rule, the active rents and royalties exception, and the financial services income rule for foreign tax credit purposes are limited to entities that are CFC's without regard to downward attribution from a foreign person. Treas. Reg. § 1.904-5(a)(4)(i). Additionally, the CFC look-through rule applies only to persons that are US shareholders without regard to downward attribution from foreign persons. Treas. Reg. § 1.904-5(a)(4)(vi).
- Section 6049 (chapter 61 reporting provisions): Consistent with the 2019 Proposed Regulations, the 2020 Final Regulations adopt a rule which provides relief from certain Form 1099 reporting requirements for entities that are CFCs only because of downward attribution from a foreign person. Treas. Reg. § 1.6049-5(c)(5)(i)(C). Treasury declined to adopt a comment suggesting that the exception to Form 1099 reporting apply to all CFCs, believing that such a request was outside the scope of the regulations (which were intended to address the repeal of section 958(b)(4)).

The 2019 Proposed Regulations also included relief under section 1297(e). Treasury and the IRS have decided to finalize these provisions as part of package of regulations addressing PFIC rules.

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Applicable Dates and Comments

In general, the 2020 Final Regulations apply to tax years of a foreign corporation ending on or after October 1, 2019, or to relevant transfers or payments made or accrued on or after October 1, 2019. However, taxpayers may, on a rule-by-rule basis, choose to apply the rules contained in the 2020 Final Regulations to the last taxable year of a foreign corporation beginning before January 1, 2018, and to each subsequent taxable year of the foreign corporation, provided that the taxpayer (and related US persons) must consistently apply the chosen rule with respect to all foreign corporations.

During the comment period for the regulations, Treasury received a comment related to section 1248 (gain from certain sales or exchanges of stock in certain foreign corporations). Treasury declined to adopt the comment's suggestion to issue a rule that section 958(b) should be applied without regard to the repeal of section 958(b)(4) for purposes of section 1248, noting that Treasury determined that consistent treatment between subpart F and section 1248 with respect to the repeal of section 958(b)(4) is appropriate.

Treasury also noted comments received related to the portfolio interest exemption under section 881 and withholding requirements under section 1442. A comment requested that the general approach of the regulations (excluding, as appropriate, CFCs that are CFCs only because of the repeal of section 958(b)(4)) be extended to cover the portfolio interest exception in section 881. Treasury declined to adopt such comment, noting its belief that there was no statutory or regulatory authority to make such a rule. Treasury also declined to issue guidelines for withholding agents, noting that the current standards in regulations under section 1441 (which apply to withholding pursuant to section 1442) are appropriate and that it would be outside the scope of rulemaking under section 958 to provide such rules. For an article discussing the repeal of section 958(b)(4) and potential impact on portfolio interest exemption structures, see Tax News and Developments, *"Repeal of Section 958(b)(4) and Potential Impact on Portfolio Interest Exemption Structures."*

Proposed Regulations

Continuing with the trend of providing narrowly-targeted changes to issues around downward attribution, the IRS also issued the 2020 Proposed Regulations focusing on specific situations arising under sections 367(a) and 954(c)(6).

Section 367(a)

Section 367(a)(1) generally provides that if a US person transfers property to a foreign corporation in connection with certain exchanges described in sections 332, 351, 354, 356, or 361, the foreign corporation will not be treated as a corporation for purposes of determining the extent to which gain is recognized on

Baker McKenzie.

the transfer. The US person can obtain non-recognition treatment on an outbound transfer of stock or securities of a domestic corporation ("the US target") under section 367(a) if the US target meets the following four requirements under Treas. Reg. § 1.367(a)–3(c)(1):

i. Fifty percent or less of both the total voting power and the total value of the stock of the transferee foreign corporation is received in the transaction, in the aggregate, by US transferors;

ii. Fifty percent or less of each of the total voting power and the total value of the stock of the transferee foreign corporation is owned, in the aggregate, immediately after the transfer by US persons that are either officers or directors of the US target company or that are 5 percent target shareholders;

iii. Either the US person is not a 5 percent transferee shareholder (as defined in Treas. Reg. §§ 1.367(a)–3(c)(5)(ii)), or the US person enters into a gain recognition agreement; and

iv. The active trade or business test is satisfied.

For purposes of these requirements, the stock attribution rules of section 318, as modified by section 958(b), apply in determining the ownership or receipt of stock, securities, or other property. Therefore, the repeal of section 958(b)(4) causes certain transfers that previously would have satisfied the above requirements to no longer qualify for non-recognition treatment because more shareholders are now considered to be 5 percent target shareholders as a result of downward attribution.

The 2020 Proposed Regulations give some measured relief by providing that when applying the provisions of the first, second, and fourth requirements, a US person's constructive ownership interest should not include an interest that is treated as owned as result of downward attribution from a foreign person. Importantly, the third requirement looking at whether the US person is a 5 percent transferee would continue to take into account downward attribution ownership rules under the 2020 Proposed Regulations.

Section 954(c)(6)

Section 954(c)(6) generally provides that dividends, interest, rents, and royalties received or accrued by a CFC from a CFC that is a related person are not treated as foreign personal holding company income to the extent attributable or properly allocable to income of the related person that is neither subpart F income nor effectively connected income. The repeal of section 958(b)(4) created certain unintended extensions of this exception, such as when a member of a group with a foreign parent receives a payment covered by section 954(c)(6) from a subsidiary of the parent that is treated as a CFC solely by reason of downward attribution. In this instance, the payment received by the first CFC may be eligible for the look-through exception under section 954(c)(6), even though the earnings of the second CFC are not taxable in the United States as the second CFC has no direct or indirect US shareholders.

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To address this situation, the 2020 Proposed Regulations provide that, for purposes of section 954(c)(6), the term CFC has the meaning given by section 957, determined without applying section 318(a)(3)(A), (B), and (C). This change generally makes payments ineligible for look-through treatment under section 954(c)(6) if paid by a CFC that is only a CFC as a result of the repeal of section 958(b)(4).

Applicable Dates and Comments

The 2020 Proposed Regulations under section 367(a) apply to transfers occurring on or after September 21, 2020. The 2020 Proposed Regulations under section 954(c)(6) apply to payments or accruals of dividends, interest, rents, and royalties made by a foreign corporation during tax years of foreign corporations ending on or after September 21, 2000. Consistent with the 2020 Final Regulations, both sets of proposed regulations may also be applied to certain earlier tax years (i.e., the last tax year of the relevant foreign corporation that begins before January 1, 2018, and each subsequent tax year) as long as the taxpayer and related parties apply the proposed regulations consistently.

Implications

As noted in Tax News and Developments, "*Downward Attribution Guidance: A Patchwork of Changes But No Comprehensive Solution*," while the regulations issued thus far continue to address particular problems resulting from downward attribution, it appears that Treasury believes it may have reached the limits of its authority to issue guidance. Therefore, comprehensive relief should not be expected without further action from Congress.

Notably, a March 2020 version of the Coronavirus Aid, Relief, and Economic Security Act (commonly known as the "CARES Act") would have restored section 958(b)(4) to its pre-TCJA wording while addressing the decontrolling transactions that prompted its initial repeal. Given the amount of taxpayer interest in legislative action on this topic, similar proposals appear likely to arise in future legislation.

By: Richard Fink, Houston and Blake Martin, Dallas

Final Regulations Issued On New TCJA Rules for S Corps Converting to C Corps

As part of the Tax Cuts and Jobs Act ("TCJA"), P.L. 115-97 and with the lowering of the corporate income tax rate to 21% (along with other changes), Congress anticipated that many S corporations would consider converting to C corporations. To make it "easier" on S corporations making such a conversion, Congress provided two major provisions as part of the TCJA that provide relief in this area:

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- Recognizing that many S corporations converting to C corporations may be required to change from the cash method to the accrual method, section 481(d)(1) was enacted to permit an eligible terminated S corporation ("ETSC") to take into account any section 481 adjustments that are attributable to the revocation of an S corporation election over a six-taxable year period beginning with the year of change (that is, the section 481(d) inclusion period); and
- Section 1371(f) provides that for cash distributions *following* the post-termination transition period ("PTTP") of an ETSC, the accumulated adjustment account ("AAA") is allocated to the distribution, and the distribution is chargeable to the accumulated earnings and profits ("E&P") in the same ratio that AAA bears to the accumulated E&P.

Previously, the possibility of tax-free AAA distributions were limited to those that occurred during the PTTP, and section 481 adjustments that decreased taxable income were required to be taken into account in the year of the change, while adjustments that increased taxable income could be taken into account over a four-taxable year period beginning with the year of change. For those not intimately familiar with these rules, a few definitions are useful for context:

- An ETSC is a C corporation meeting the following three requirements: (i) the corporation was an S corporation on December 21, 2017; (ii) the S corporation revoked its S corporation election during the two-year period beginning on December 22, 2017, i.e., before December 23, 2019 (the "revocation requirement"); and (iii) the owners of the stock of the corporation, determined on the date the corporation made a revocation of its S corporation election, are the same owners and own identical proportions of the corporation's stock as on December 22, 2017 (the "shareholder identity requirement"). Note that because these special rules only apply to ETSCs, which must have revoked their S corporation election in the 2 year window between December 22, 2017 and December 23, 2019, and it is generally only possible to make a retroactive revocation on or before the 15th day of the 3rd month of the tax year, it is most likely no longer possible to plan into the application of these rules.
- Absent special circumstances (such as an IRS audit or inadvertent S corporation election termination), the PTTP generally will be 1 year from the termination of the S corporation election, or, if later, the due date for filing the final S corporation return (including extensions). The corporation may continue to utilize some of the benefits of S corporation status during the PTTP, including use of suspended losses to the extent basis can be established, and, as noted above, distributions may be taken tax free to the extent a balance exists in the AAA account.

- The AAA represents the earnings of the corporation that have been previously taxed to shareholders for all S corporation years, less any amounts already distributed, i.e., the AAA generally is the accumulation of previously taxed, but undistributed, earnings of the S corporation. Therefore, to the extent that the corporation has a positive balance in the AAA, tax-free distributions can be made to shareholders (limited to stock basis).

Final Regulations

Final regulations (T.D. 9914) under sections 481(d) and 1371(f) were published in the federal register on October 20, 2020. The final regulations provide guidance on the definition of an ETSC and the rules under section 1371(f) relating to distributions of money by such a corporation after its PTTP, and generally are identical to the proposed regulations with a few important exceptions as noted below.

ETSC Regulations

With respect to the definition of ETSCs, final regulations generally are identical to the proposed regulations with respect to the definition of an ETSC and the 3 requirements discussed above. The Preamble to the final regulations (and an example included in the final regulations) does confirm that a corporation is an ETSC even if it did not have E&P on the effective date of its revocation.

The final regulations also clarify that a corporation may test compliance with the revocation requirement and the shareholder identity requirement on the date the revocation was made, or, for retroactive elections, the date the revocation was retroactively effective. In addition, the Preamble to the final regulations indicates that shareholder changes between the two testing dates should not preclude meeting the shareholder identity requirement provided ownership was identical on the relevant testing dates.

Finally, in regard to the ETSC regulations, the final regulations replicate the approach of the proposed regulations in providing for five categories of stock transfers that do not result in an ownership change for purposes of the shareholder identity requirement:

- Transfers of stock between a shareholder and that shareholder's trust treated as wholly owned by that shareholder for federal tax purposes;
- Transfers of stock between a shareholder and an entity owned by the shareholder that is disregarded as separate from its owner;
- An election by a shareholder trust to be treated as part of a decedent's estate or the termination of that election;
- A change in the status of a shareholder trust from one type of eligible S corporation shareholder trust to another; or

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- A transaction that includes more than one of the four events (listed in the bullets above).

Section 1371(f) AAA Distribution Regulations

As part of the operation of the rules of section 1371(f), it is necessary to calculate a ratio between a corporation's AAA and accumulated earnings and profits ("AE&P") for purposes of determining the tax consequences of distributions after the PTTP. The final regulations, like the proposed regulations, adopt a "snapshot approach" pursuant to which an ETSC generally calculates AAA and AE&P only once at the beginning of the day on which revocation of the corporation's S corporation status is effective. At that time, the ratio of AAA and AE&P is determined and continues to apply to all distributions until the corporation's AAA is exhausted. If an S corporation has no AE&P at the time of revocation of its S corporation status, cash distributions will come from the AAA until all AAA has been distributed. The regulations also provide a "section 1371(f) Priority Rule" that coordinates rules for allocating E&P across distributions made during a year. Under the section 1371(f) Priority Rule, the ETSC ratio applies first to "qualified distributions" during the tax year, and, subsequently, the rules of section 301 and 316 (as incorporated into the section 1371(f) Priority Rule) apply.

Finally, before amendment by these final regulations, the special treatment with respect to distributions of money during a corporation's PTTP was limited solely to those shareholders who were shareholders of the corporation at the time that it terminated or revoked its S corporation election (the "no-newcomer" rule); however, the final regulations amend Treas. Reg. § 1.1377-2(b) to eliminate the no-newcomer rule. As a result, shareholders joining after the day on which a corporation's S corporation election terminates are eligible for the special treatment during a corporation's PTTP (and also for purposes of the ETSC distribution provisions).

By: Michael Melrose, Miami

President of Mexico Submits a Draft Bill to Ban Subcontracting (Outsourcing)

On November 12, 2020, the President of Mexico, Andrés Manuel Lopez Obrador, submitted a draft bill to Congress that would prohibit the subcontracting of personnel and regulate the performance of specialized services and works. The draft bill, if passed, would reform the Federal Labor Law ("FLL"), the Social Security Law, the Law of the Institute of the National Workers' Housing Fund ("INFONAVIT"), the Federal Fiscal Code, the Income Tax Law and the Value Added Tax Law.

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Key Takeaways

- The provision of specialized services and execution of works would be limited and the activities of placement agencies would also be regulated.
- The ability to provide specialized services would require an authorization from the Ministry of Labor and Social Welfare ("STPS") and will be subject to additional requirements.
- Compliance with obligations regarding subcontracting and the provision of specialized services and works would be required to be verified by the STPS and the Mexican Social Security Institute ("IMSS"), which could impose higher penalties and also report to the tax authorities when companies fail to comply.
- The deduction of taxes for Income Tax ("ISR") purposes and to credit the Value Added Tax ("VAT") would not be allowed when personnel are subcontracted.
- The beneficiary of the specialized services and works would be jointly and severally liable for labor, social security and tax obligations.
- If contributions are omitted, tax penalties would increase.
- Subcontracting of personnel and simulated specialized services and works would be considered a tax felony.

In Depth

If the draft bill passes, the provision of personnel services--defined as that by which an individual or legal entity provides workers or makes them available for the benefit of another party--would be prohibited.

Specialized services and the execution of works would only be allowed when they do not form part of the corporate purpose or economic activity of the beneficiary, and when they are authorized by the STPS. The parties would be required to formalize their relationship by entering into a written contract detailing the number of workers participating in the specialized services or execution of works.

The activity of the placement agencies would be regulated, permitting intervention during the hiring process, including during recruitment, selection, training and education, among others. These placement agencies would be considered intermediaries and the beneficiary would be considered the employer.

The labor authority would be able to impose penalties from USD 8,476 to USD 212,000 in subcontracting of personnel situations to whoever: (a) provides and/or

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benefits from personnel subcontracting services; and (b) provides or benefits from specialized services and works when they are not authorized by the STPS and do not comply with the corresponding requirements.

The beneficiary of the specialized services or works would be jointly and severally liable to the subcontracted employees for labor, social security and tax obligations.

In addition, the service providers and contractors of specialized works would be required to submit reports to the IMSS and INFONAVIT information regarding contracts, clients, the workers providing the services or executing the works every three months and four months, respectively, as well as compliance with social security obligations. Failure to timely submit the reports to the IMSS would be subject to penalties from USD 2,120 to USD 8,476.

The transfer of assets from the substituted employer to the substitute employer is incorporated in the FLL as a requirement to transfer employees through an employer substitution. This criteria was taken from prior court precedents.

Companies providing personnel services that have been operating with different employer registration numbers for each class of professional risk insurance would have to terminate those registrations and, when possible secure a new registration in 120 days of the effective date of the reform.

In case of subcontracting personnel and if employees were originally employed by the contracting party or if employees provide services that cover the contracting party's predominant activities, the deduction for income tax purposes and to credit the VAT would not be permitted, and instead would be an aggravating factor considered in the determination of penalties for the omission of tax contributions.

Subcontracting of personnel services resulting in tax fraud would be a felony, that could be prosecutable as organized crime and preventive detention would proceed in accordance with the criminal-tax reforms that came into effect on January 1, 2020.

For specialized services and execution of works, there would be an obligation for companies to provide (1) proof of authorization from the STPS to provide such services, as well as (2) evidence of compliance with tax obligations for those in charge of the employees providing the specialized services or executing the works to be able to deduct the service fee and to credit the corresponding VAT.

The draft bill would be in effect the day after its publication in the Daily Official Gazette, with the exception of the new tax provisions, which would come into effect on January 1, 2021.

Actions to Take

Companies that subcontract personnel services, as well as those that provide and benefit from specialized services and works, should closely follow any developments, and should review their structures and operations in Mexico in light of the draft bill.

By: Rosario Lombera, Liliana Hernandez-Salgado, and Roxana Gomez-Orta, Mexico City

The Trend Continues; Washington State Legislators May Propose Digital Advertising Tax

Washington legislators may introduce a digital advertising tax bill in the state's upcoming legislative session. H-0028.1 (advance copy; not yet introduced). Currently, digital advertising services are not subject to Washington sales tax. They are only subject to Business and Occupation ("B&O") tax at the "service and other activities" tax rate. However, the new legislation would tax digital advertising services as "digital automated services." Sales of "digital automated services" generally are subject to Washington's sales tax and the B&O tax at the "retailing" tax rate (unless an exception applies, such as Washington's so-called "human effort" exception). While the B&O "retailing" tax rate actually is lower than the "service and other activities" tax rate that currently applies to digital advertising services, the combination of the sales tax and the B&O tax (even at the "retailing" tax rate) would increase the overall tax burden on digital advertising services. Washington's potential legislation is the latest in a recent trend of digital advertising tax proposals (including in the District of Columbia, Maryland, Nebraska, New York, and West Virginia, none of which have become law at this time). As with other digital advertising tax proposals, taxpayers are likely to oppose the Washington proposal on constitutional, Internet Tax Freedom Act, and other grounds.

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For more information on these and other recent state and local tax updates, please see "*The Trend Continues: Washington State Legislators May Propose Digital Advertising Tax*" on the SALT Savvy blog, available at www.saltsavvy.com.

By: Dmitrii Gabrielov, New York

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