IRS Gives Partnerships a Break on Application of GILTI Regs

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By Andrew Velarde

Practitioners are welcoming IRS relief for some partnerships that had relied on previously proposed guidance under the global intangible low-taxed income provision for tax years ending before June 22.

Notice 2019-46, released August 22, announces the IRS's intention to issue rules for domestic partnerships and S corporations that are U.S. shareholders of a controlled foreign corporation, allowing them to apply proposed section 1.951A-5 for those tax years. The notice also provides guidance on relief from penalties for those entities that acted consistently with that proposed provision before June 22 but filed a tax return under the final rules under section 1.951A-1(e).

The notice's relief comes as the IRS and Treasury seek to prevent a compliance burden that would otherwise be imposed on taxpayers.

"In the absence of relief, to avoid potential penalties under section 6698, 6699, or 6722, these domestic partnerships and S corporations could be required to file returns for the 2018 taxable year consistent with the Final Regulations, and furnish Schedules K-1 consistent with their Form 1065 (Schedule K) or Form 1120S (Schedule K)," the notice states. "The issuance of corrected Schedules K-1 consistent with the Final Regulations under these circumstances may result in significant additional costs to these domestic partnerships and S corporations and significant burden to the IRS related to processing amended returns based on corrected Schedules K-1."

Glenn Dance of Holthouse Carlin & Van Trigt LLP was encouraged by the relief, noting that the IRS may have tried to address the issue earlier with Rev. Proc. 2019-32, which also provided relief to partnerships relying on the proposed regs when issuing Schedules K-1.

"But that relief would have required partnerships to reissue such K-1s prior to September 15, 2019, which for many partnerships would have resulted in administrative costs, etc. that would have made reissuing such K-1s hard to justify. This notice provides welcome relief by allowing the partnership to stand by its previously issued K-1s, without having to risk penalties for failure to disclose that such K-1s are not consistent with the final regulations," Dance said.

Dance added that partnerships "aren't getting a free pass" because they would still need to notify partners before September 15. "Nonetheless, providing notification generally would seem to be far less costly than filing amended K-1s, so I'm thinking most partnerships will say 'giddyup' on this approach," he said.

The notice states that notification may be provided by any reasonable method such as mail,

email, or website posting ordinarily used to disseminate tax information. The partnership or S corporation also needs to attach the notification to its return.

Not Fond of Two Wrongs Make a Right

The IRS released final GILTI regs (T.D. 9866) in June, which followed up on proposed regs (REG-104390-18) from September 2018. The final rules came just before the 18-month deadline from enactment of the Tax Cuts and Jobs Act to allow for retroactivity of the rules.

The proposed regs took a hybrid approach to the treatment for domestic partnerships that are a U.S. shareholder of a CFC, which practitioners had labeled as schizophrenic. Under that combined entity and aggregate approach, the proposed regs treated a domestic partnership as an entity for partners that are not U.S. shareholders of any CFC owned by the partnership, but as an aggregate for partners that are themselves U.S. shareholders of one or more CFCs owned by the partnership.

The final regs, however, adopt more of an aggregate approach. When determining a GILTI inclusion, each partner is treated as proportionately owning the stock of the CFC owned by the partnership as if the domestic partnership were foreign. The final regs are applicable to tax years after December 31, 2017. Practitioners remarked at the time that the rule change was one of the most significant pivots in the GILTI guidance.

According to Joseph Calianno of BDO USA LLP, many partnerships and S corps had already issued Schedules K-1 consistent with the proposed regs before the move away from the hybrid approach.

“This reverse in course as to the treatment of domestic partnerships and their partners for purposes of GILTI created significant administrative issues and burdens for domestic partnerships, especially given that the final regulation addressing this issue applies for tax years of foreign corporations beginning after December 31, 2017,” Calianno said.

Part of Monte Jackel’s focus was on what was not in the notice: guidance on what partners should do for years before 2018 related to subpart F income.

"The assumption by the government is that a complete distributive share regime applies for subpart F inclusions, which are parallel to GILTI inclusions," said Jackel of Jackel Tax Law. “The notice could have said something about what to do about positions on subpart F, as those regulations were proposed at the same time the GILTI regs went final.”

Jackel also wondered about the handling of U.S. partners who were not U.S. shareholders being treated as owning CFC stock in 2018 and then in 2019 not having tax consequences.

“Is there some kind of sale by the non-U.S. shareholder partners to the U.S. shareholder partners?” Jackel wondered. “I think not, but those small U.S. partners could end up with an unrecovered stock basis because their basis in the stock is never zeroed out. What then?”

According to Dance, future partnership filing may be “somewhat complicated” because taxpayers will need to separate out the amount of earnings and profits distributions from CFC

investments already subject to GILTI tax.

“Some in the industry were hoping for more generous relief, such as merely reversing the effect of the unnecessary 2018 income inclusion with an allocation of a ‘random’ loss amount in a future year. But the government is not fond of the use of such ‘two wrongs make a right’ approaches, so I’m not surprised that they didn’t allow that approach to be used here,” Dance said.

Since the notice asks for comments, Dance said he was hopeful that the forthcoming regs would also address how partnerships will deal with the treatment of undistributed CFC E&P as a section 751 hot asset.

“Presumably, to the extent the partners picked up a GILTI inclusion amount in 2018, if they subsequently sell their interest in the partnership, they’ll be able to make a corresponding reduction in the amount that would otherwise be treated as a hot asset,” Dance surmised.