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IRS Provides Relief to Domestic Partnerships Caught in GILTI Conundrum
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The IRS has provided filing relief to U.S. partnerships caught betwixt and between proposed and final guidance that required very different approaches to the reporting of a key income item. The relief should prevent many partnerships from having to make a difficult choice between the headache and expense of re-issuing K-1s or the threat of facing penalties.

The Problem: Proposed vs. Final GILTI Regulations

The issue necessitating relief potentially arises in situations where a domestic partnership owns shares in an offshore corporation that is characterized as a controlled foreign corporation (a "CFC") for U.S. tax purposes, and the CFC has items of global intangible low-taxed income ("GILTI") in a tax year ending before June 22, 2019. Under proposed regulations issued in October 2018, if the domestic partnership was a "U.S. shareholder" in the CFC – meaning, it owned 10 percent or more of the CFC – then the partnership itself was required to calculate a GILTI inclusion amount, and each partner was allocated its distributive share of that amount, which was to be reported on K-1s distributed to partners. The proposed regulations required any partner that would not independently test as a U.S. shareholder in the CFC – for example, a foreign individual – to take into account its distributive share of the partnership's GILTI amount. In contrast, any partner that itself would be considered a U.S. shareholder in the CFC would ignore its distributive share of the partnership's GILTI amount, and instead would be treated as if it directly owned its proportionate share of the CFC for purposes of calculating a GILTI inclusion.

Final regulations issued on June 21, 2019, adopted a different approach, providing instead that the domestic partnership in this situation would not have a GILTI inclusion amount, and thus no partner in the partnership would have a distributive share of such amount. Instead, whether a partner has a GILTI inclusion is analyzed as if the partner held its pro rata portion of the partnership's CFC shares directly. The final regulations are consistent with the statute in that a person that is not a "U.S. shareholder" cannot have a GILTI inclusion, not even by virtue of its distributive share of domestic partnership items.

What Relief?

The need for relief addressed by last week's IRS guidance, Notice 2019-46, arises because the final regulations apply to tax years of foreign corporations beginning after December 31, 2017, and to tax years of U.S. shareholders in which or with which such tax years end. As a result, absent relief, domestic partnerships that file their income tax returns for the 2018 tax year after June 21, 2019, would be required to file consistently with the final regulations and – importantly –would be required to furnish consistent schedules K-1 to their partners or risk penalties for inconsistent reporting.

However, by June 21, many calendar-year partnerships had already provided K-1s to their partners – K-1s that were based on the GILTI allocation approach dictated by the proposed regulations, because that was the only guidance available at the time. So, under the threat of penalties, a domestic partnership would have had to adopt the final regulations for purposes of its own return and re-issue K-1s to partners based on the approach in the final regs.

In the Notice, the IRS expressed sympathy for the administrative burden that partnerships would face if they had to re-issue K-1s at this relatively late stage (for calendar-year taxpayers) in the compliance process. As a result, the Notice (1) allows domestic partnerships to follow the proposed regulations for any tax year that ends before June 22, 2019, and (2) waives inconsistent reporting penalties if affected taxpayers follow the final regulations in filing the partnership returns but have already issued K-1s that follow the proposed regulations. The relief also applies to S corporations caught by the same facts.

The Notice requires partnerships to meet specific notification requirements to ensure they can qualify for relief, so affected taxpayers should discuss the best approach with their outside tax advisors.