

**AMERICAN BAR ASSOCIATION
SECTION OF TAXATION**

Comments on Proposed Regulations Addressing Section 951A

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

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Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments. Additionally, while the Section’s diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

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I. Executive Summary

Section 951,¹ as part of Subpart F of the Code,² provides rules for when a “U.S. shareholder” (within the meaning of section 957 (a “U.S. Shareholder”)) of a controlled foreign corporation (within the meaning of section 957(a) (a “CFC”)) is required to include in U.S. taxable income on a current basis the income of the CFC.³ Section 951 was amended as part of Public Law 115-97 (the “Act”), enacted on December 22, 2017.⁴ In addition, sections 951A and 250 were enacted as part of the Act. Similar to section 951, section 951A requires certain U.S. persons to include in U.S. taxable income a portion of the income of CFCs on a current basis. Section 951A is known as “GILTI,” for global intangible low-taxed income, the title of the section. On October 10, 2018, the Internal Revenue Service (the “Service”) and the Department of Treasury (“Treasury”) published Proposed Regulations under section 951, 951A, 1502, and 6038 (the “Proposed Regulations”).⁵

We applaud Treasury and the Service for issuing the Proposed Regulations, and appreciate the guidance. There are, however, certain portions of the Proposed Regulations that we recommend be reconsidered, and there are areas in which additional clarification would be helpful. To provide context for our recommendations, we provide a detailed summary of sections 951, 951A, and other relevant Code sections, as well as the Proposed Regulations in Part II.A-C of this letter.

Our recommendations are summarized below and discussed in more detail in Part II.D of this letter.

1. Proposed Regulation section 1.951-1 – Pro Rata Share Rules

We recommend that the language of Proposed Regulation section 1.951-1(e)(4)(iii) be clarified to identify specifically which provisions of Proposed Regulation section 1.951-1(e)(4)(ii) represent the “time value of money principles” referenced in Proposed Regulation section 1.951-1(e)(4)(iii) and how those principles are to be applied.

2. Proposed Regulation section 1.951A-1(e)(6) – Anti-Abuse Rule for Pro Rata Share

- a. We recommend that the final Regulations clarify that the anti-abuse rule in Proposed Regulation section 1.951A-1(e)(6) (the “Pro Rata Share Anti-Abuse Rule”) is limited to the allocation of “Subpart F income” within the meaning of section 952 (“Subpart F Income”) and GILTI among a CFC’s classes of stock

¹ References to a “section” or “I.R.C. §” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), and regulation references are to the Regulations promulgated thereunder (the “Regulations” or “Reg. §”), unless otherwise indicated.

² Subpart F consists of sections 951 through 959.

³ A U.S. person is a U.S. shareholder if it owns ten-percent or more of the stock of a CFC, by vote or value, directly, indirectly or through attribution. I.R.C. § 957.

⁴ An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. No. 115-97, 131 Stat. 2054 (2017).

⁵ See Notice of Proposed Rulemaking, Guidance Related to Section 951A (Global Intangible Low-Taxed Income), 83 Fed. Reg. 51072 (Oct. 10, 2018).

with respect to those shareholders that actually own, directly or indirectly, shares in the CFC on the last day of the taxable year on which such entity is a CFC, and that the rule cannot be used to deem a U.S. Shareholder to own shares in the CFC on such day if such U.S. Shareholder is not otherwise properly treated as owning the shares on that day.

- b. We recommend that the final Regulations narrow the Pro Rata Share Anti-Abuse Rule to address only non-economic allocations that shift Subpart F Income or GILTI inclusions away from a U.S. Shareholder.
 - c. We recommend that the final Regulations clarify that the Pro Rata Share Anti-Abuse Rule applies only to transactions or arrangements that occur on or after the date the Proposed Regulations were published in the Federal Register (*i.e.*, October 10, 2018).
3. Proposed Regulation section 1.951A-1 – General Rules for Determining GILTI

To conform the Proposed Regulations to the statutory language in section 951A(e)(1), we recommend that the term “CFC inclusion date” as currently defined in Proposed Regulation section 1.951A-1(e)(1) (the “CFC Inclusion Date”) not be defined by reference to the status of the relevant foreign corporation as a CFC, but only by reference to the last day of the CFC’s taxable year.

4. Proposed Regulation sections 1.951A-2(c)(4) and 1.951A-6(d) – Interaction of GILTI Rules with section 952

- a. We recommend that the final Regulations define “gross income taken into account in determining the subpart F income” (within the meaning of section 951A(c)(2)(A)(II)) as any category of Subpart F Income as determined under section 954(a) or 953, as the case may be, determined without regard to the application of section 952(c)(1) (which limits Subpart F Income based on the earnings and profits (“E&P”) of the CFC) but with regard to the application of sections 952(c)(2) and 954(b)(3) (which provide rules for *de minimis* exclusions, and full inclusion over certain thresholds) in order to avoid potential double taxation.
- b. We recommend that the final Regulations, notwithstanding Congress’s failure to include a reference to section 952(c)(1)(B) in section 951A(c)(2)(B)(ii), should deny a U.S. Shareholder the ability to (i) offset Tested Income with “tested loss” within the meaning of section 951A(c)(2)(B) (a “Tested Loss”) and (ii) also allow that U.S. Shareholder to create or increase a “qualified deficit” as defined under section 952(c)(2) with the same economic loss.
- c. If Treasury and the Service choose not to adopt recommendation 4(a), we recommend, in the alternative, that the final Regulations:
 - i. provide rules that reduce a CFC’s Subpart F recapture amount for income that would otherwise be Subpart F Income as a result of the recapture rule of section 952(c)(2) to the extent such income also constitutes “tested income” within the meaning of section 951A(c)(2)(A) (the “Tested Income”); or

- ii. determine gross Subpart F Income after the application of section 952(c)(2) to the extent of balances in section 952(c)(2) recapture accounts that existed prior to the Act’s enactment (“Pre-2018 Recapture Accounts”).
 - d. We recommend that the final Regulations clarify the application of the Subpart F high-tax exclusion to Tested Income, such that “gross Tested Income” within the meaning of Proposed Regulation 1.951A-2(c)(1) (“Gross Tested Income”) and allowable deductions are determined without regard to section 952(c)(1), even if the U.S. Shareholder makes a high-tax exception election.
- 5. Proposed Regulation section 1.951A-3 – Qualified Business Asset Investment (“QBAI”) Calculations
 - a. We recommend that the final Regulations modify the definition of “qualified business asset investment” in Proposed Regulation section 1.951A-3(c)(1) (“QBAI”) to include “specified tangible property” within the meaning of Proposed Regulation section 1.951A-3 (“Specified Tangible Property”) held by a “tested loss CFC” within the meaning of Proposed Regulation section 1.951A-2(b)(2) (a “Tested Loss CFC”). Further, we recommend that the final Regulations eliminate the Tested Loss CFC QBAI exclusion.
 - b. We recommend that the final Regulations contain additional examples for computing QBAI for “dual use property” where (i) the dual use asset becomes or ceases to be Specified Tangible Property during the course of the “CFC inclusion year” within the meaning of Proposed Regulation section 1.951A-1(e)(2) (“CFC Inclusion Year”), and (ii) the dual use asset gives rise to increasing or decreasing Gross Tested Income across quarters in a year.
 - c. Regarding the use of the “alternative depreciation system” within the meaning of section 168(g) (the “ADS”), we recommend that the final Regulations permit taxpayers to elect to compute Tested Income or Tested Loss using the adjusted basis of their Specified Tangible Property determined under the depreciation method used by the CFC.
- 6. Proposed Regulation section 1.951A-3(h)(1) – Anti-Abuse Rule for Temporarily Held Property

We recommend that the final Regulations allow taxpayers to rebut the presumption that Specified Tangible Property held for less than a 12-month period that includes at least one quarter close is temporarily held property for purposes of the Proposed Regulation section 1.951A-3(h)(1) anti-abuse rule, in order to prevent non-abusive transactions from being treated as abusive under the rule.
- 7. Proposed Regulation section 1.951A-3(h)(2) – Disqualified Basis
 - a. We agree with Treasury’s and the Service’s scope for the rules for “disqualified transfer” within the meaning of Proposed Regulation section 1.951A-3(h)(2)

(“Disqualified Transfer”) and recommend that they continue to be limited to transfers between related persons.

- b. We recommend that the final Regulations provide for coordination of the Disqualified Transfer rules with the covered asset acquisition rules of section 901(m) in order to avoid a double penalty for taxpayers, such that deductions or loss attributable to “disqualified basis” (within the meaning of Proposed Regulation section 1.951A-3(h)(2)) also be disregarded for purposes of section 901(m).
8. Proposed Regulation section 1.951A-4 – Tested Interest Expense and Tested Interest Income
- a. We recommend that the definitions of the terms “interest expense” within the meaning of Proposed Regulation section 1.951A-4(b)(1)(ii) (“Interest Expense”) and “interest income” within the meaning of Proposed Regulation section 1.951A-4(b)(2)(ii) (“Interest Income”) be revised to remove references to the concepts of “predominately incurred in consideration of the time value of money” and “predominately derived from consideration of the time value of money,” respectively, as well as references to “transaction or series of integrated or related transactions,” and to replace these with references to Interest Expense or Interest Income arising by reason of the Code or the Regulations thereunder or as a consequence of issuing or holding an instrument that is treated as debt for U.S. federal income tax purposes.
 - b. We recommend that Treasury and the Service remove the proposed rule requiring the use of Interest Expense and Interest Income of a Tested Loss CFC in the determination of “specified interest expense” within the meaning of Proposed Regulation section 1.951A-1(c)(3)(iii) (“Specified Interest Expense”).
9. Proposed Regulation section 1.951A-6, E&P and Basis Rules
- a. We recommend that the basis adjustment rule in Proposed Regulation section 1.951A-6(e) applicable to dispositions of the section 958(a) stock of a CFC (such stock, “Specified Stock,” and such rule, the “Stock Basis Adjustment Rule”) not be included in the final Regulations.
 - b. If Treasury and the Service choose not to withdraw the Stock Basis Adjustment Rule, we recommend that the rule be revised so that it operates only to eliminate any potential duplicated tax benefit from the use of a Tested Loss (by annually adjusting the used Tested Loss and “offset Tested Income” (within the meaning discussed in Part I.10 below (“Offset Tested Income”)) amounts by the Tax Effectuated Basis Reduction Percentage set forth in Part II.D.9.A below), and, in any event, we recommend that the Stock Basis Adjustment Rule not reduce basis in Specified Stock by more than 50% of the used Tested Loss amount.
 - c. We recommend that the definitions of “used Tested Loss amount” within the meaning of Proposed Regulation section 1.951A-6(e)(2)(i) (“Used Tested Loss Amount”) and “net Offset Tested Income amount” within the meaning of Proposed Regulation section 1.951A-6(e)(3)(ii) (“Net Offset Tested Income Amount”) be revised to solely take into account reductions of Tested Income that

reduce GILTI and not reductions by Tested Loss of the portion of Tested Income that do not exceed the “deemed tangible income return” within the meaning of Proposed Regulation section 1.951A-1(c) (“DTIR”).

- d. We recommend that the final Regulations permit taxpayers to make an annual election for each Tested Loss CFC to forego use of the Tested Loss against Tested Income and thus avoid having to make a stock basis reduction with respect to such Tested Loss.
- e. We recommend that the final Regulations provide that any basis increases for lower-tier CFCs made pursuant to section 961(c) be taken into account in applying the Stock Basis Adjustment Rule.

10. Consolidated Return Rules

- a. We recommend that the final Regulations adopt a hybrid approach under which: (1) both the “GILTI inclusion amount” within the meaning of Proposed Regulation section 1.951A-1(c)(1) (“GILTI Inclusion Amount”) and the section 960(d) foreign tax credit are determined under an aggregate approach so as to preserve neutrality; and (2) the GILTI Inclusion Amount and the net basis increase resulting from the section 960(d) foreign tax credit are allocated based on a netting approach.
- b. We recommend that the final Regulations provide that a basis increase for a Tested Income CFC whose Tested Income is offset by the Tested Loss of a Tested Loss CFC (the “Offset Tested Income”) be made on an annual basis to avoid a timing mismatch when a basis reduction is made for used Tested Losses.
- c. Regarding basis adjustments for dispositions of consolidated group members with who own stock of a CFC whose Tested Income is offset by the Tested Loss of another CFC, we recommend that the final Regulations adopt a basis adjustment method that provides sufficient basis increase in the member stock in order to achieve parity with the sale of the underlying CFC stock. Alternatively, we recommend that the final Regulations provide for a rule under which the underlying CFC is deemed to distribute a dividend equal to the amount of gain that would be recognized without tax if the group member sold the stock of the underlying CFC, which would result in a basis increase in the stock of the member owning the stock of the CFC.
- d. Regarding intercompany transactions, we recommend that the final Regulations:
 - i. clarify that the scope of the special rule for intercompany nonrecognition transactions within the meaning of section 7701(a)(45) in Proposed Regulation section 1.1502-51(c)(5) (the “Special Rule for Intercompany Nonrecognition Transactions”) is limited only to exchanged basis property received as part of an exchange under section 351, or under sections 354 or 356, as the case may be, but only to the extent that such exchanged basis property received by an exchanging shareholder would otherwise not reflect the net used tested amount of the transferred CFC;
 - ii. clarify that the Special Rule for Intercompany Nonrecognition Transactions similarly applies with respect to a member’s “net used Tested

Loss amount” (“Net Used Tested Loss Amount”) with respect to lower-tier CFCs that are indirectly transferred in an intercompany nonrecognition transaction; and

- iii. clarify that the Special Rule for Intercompany Nonrecognition Transactions requires a basis reduction in exchanged basis property only for a proportionate amount of Net Used Tested Loss Amount, in cases in which a member transfers less than all of its interest in a CFC in an intercompany nonrecognition transaction.
- e. Regarding the anti-duplication rules of Proposed Regulation section 1.1502-32(b)(3)(iii)(C), we recommend that the final Regulations:
- i. confirm that member stock basis is not further reduced as a result of a CFC disposition described in Proposed Regulations sections 1.951A-6(e) and 1.1502-51(c)(1), where such basis attributable to used Tested Loss of the CFC has already resulted in member stock basis reductions under Proposed Regulation section 1.1502-32(b)(3)(iii)(C); and
 - ii. limit stock basis adjustments in Proposed Regulation section 1.1502-32(b)(3)(ii) and (iii) to aggregate amounts for a “U.S. Shareholder inclusion year” within the meaning of Proposed Regulation section 1.951A-1(b) (the “U.S. Shareholder Inclusion Year”) that coincides with a member’s affiliation with a particular consolidated group, rather than the member’s history, as a U.S. Shareholder, with a particular CFC.

11. Section 245A

- a. We recommend that the final Regulations provide that the section 245A dividends received deduction (the “245A DRD”) be available to a CFC in calculating its Subpart F Income.

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foreign corporation shall include in his gross income for his taxable year in which or with which such taxable year of the corporation ends—

(A) his pro rata share (determined under paragraph (2)) of the corporation’s [Subpart F Income] for such year, and

(B) the amount determined under section 956 with respect to such shareholder for such year (but only to the extent not excluded from gross income under section 959(a)(2)).⁸

In addition, the Act expanded the definition of a “U.S. Shareholder” to include a U.S. person who owns (within the meaning of section 958(a) or (b)) ten-percent (by vote *or* value) of the stock in a foreign corporation;⁹ prior law required ten-percent ownership by vote.¹⁰

The Act also amended section 958. Section 958(a) and (b) provide rules for determining ownership for Subpart F. Section 958(a) treats a U.S. person as owning stock owned directly or indirectly through foreign entities (*i.e.*, a foreign corporation, foreign partnership, or foreign trust or estate). Subject to certain modifications, section 958(b) applies the attribution rules of section 318 to determine stock ownership. The Act modified section 958(b) by repealing section 958(b)(4), which prevented the downward attribution of stock owned by a foreign corporation from being treated as constructively owned by its domestic subsidiary.¹¹

3. Section 951A

Newly-enacted section 951A requires a U.S. Shareholder of a CFC to include GILTI in a manner similar to Subpart F Income for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. Shareholders in which or with which such taxable years of foreign corporations end.

Section 951A(b)(1) defines GILTI as any U.S. Shareholder’s “net CFC tested income” within the meaning of section 951A(c) (“Net CFC Tested Income”) over such shareholder’s “net deemed tangible income return” within the meaning of section 951A(b) (“NDTIR”) for the taxable year.

Net CFC Tested Income is, with respect to any U.S. Shareholder for any taxable year of such U.S. Shareholder, the excess (if any) of (A) the aggregate of such shareholder’s pro rata share of the Tested Income of each CFC with respect to which such shareholder is a U.S. Shareholder for the shareholder’s taxable year, over (B) the aggregate of such shareholder’s pro

⁸ I.R.C. § 951(a), as revised by the Act, Pub. L. No. 115-97, § 14215, 131 Stat. 2054 (2017). This provision is effective for tax years of foreign corporations beginning after December 31, 2017, and for tax years of U.S. Shareholders within which or with which such tax years of foreign corporations end.

⁹ I.R.C. § 951(b). Section 951(b) (as revised by the Act) is effective for tax years of foreign corporations beginning after December 31, 2017, and to taxable years of U.S. Shareholders with or within which such taxable years of foreign corporations end. The Act, Pub. L. No. 115-97, § 14214(b), 131 Stat. 2054 (2017).

¹⁰ A U.S. person generally includes, among other things, a citizen or resident of the United States, a U.S. partnership, and a U.S. corporation. I.R.C. § 7701(a)(30) (“United States person”).

¹¹ The repeal of section 958(b)(4) is applicable to the last taxable year of a foreign corporation beginning before January 1, 2018, and all subsequent taxable years of such foreign corporations, and for the tax years of U.S. Shareholders in which or with which such taxable years of foreign corporations end. The Act, Pub. L. No. 115-97, § 14213(b), 131 Stat. 2054 (2017).

rata share of the Tested Loss of each with respect to which such shareholder is a U.S. Shareholder for the shareholder's taxable year.¹²

Tested Income with respect to any CFC is the excess (if any) of (A) its gross income determined without regard to (i) effectively connected income, (ii) any income taken into account in determining its Subpart F Income, (iii) any gross income excluded from its foreign base company income (as defined by reason of section 954) and insurance income (within the meaning of section 953) by reason of section 954(b)(4), (iv) any dividend received from a related person,¹³ and (v) its foreign oil and gas extraction income (within the meaning of section 907(c)(1)) over (B) the deductions (including taxes) properly allocable to such gross income under rules similar to the rules of section 954(b)(5) (or to which such deductions would be allocable if there were such gross income).¹⁴ Similarly, a Tested Loss with respect to any CFC is the excess of the amount described in (B) above over (A) above.¹⁵ To the extent that a CFC has a Tested Loss, section 952(c)(1)(A) is applied by increasing the E&P of the CFC by the Tested Loss of such corporation.¹⁶

A U.S. Shareholder's NDTIR is the excess of (A) ten-percent of the aggregate of its pro rata share of the QBAI of each CFC with respect to which such shareholder is a U.S. Shareholder for such taxable year over (B) the amount of interest expense taken into account in computing Net CFC Tested Income for the taxable year.¹⁷

QBAI is defined as the average of a CFC's aggregate adjusted bases, as of the close of each quarter of such taxable year, in tangible property used in the production of Tested Income (*i.e.*, Specified Tangible Property) that is depreciable and used in a trade or business of the CFC.¹⁸

A U.S. Shareholder's pro rata share of QBAI, Tested Income, and Tested Loss are determined under the rules of section 951(a)(2) in the same manner as Subpart F Income.¹⁹ In addition, a person will be treated as a U.S. Shareholder of a CFC required to include GILTI

¹² I.R.C. § 951A(c)(1).

¹³ For these purposes, a related person is as defined in section 954(d)(3).

¹⁴ I.R.C. § 951A(c)(2)(A).

¹⁵ I.R.C. § 951A(c)(2)(B)(i).

¹⁶ I.R.C. § 951A(c)(2)(B)(ii). Very generally, section 952(c)(1)(A) limits a CFC's Subpart F Income to its current E&P.

¹⁷ I.R.C. § 951A(b)(2). Interest expense is not included in computing NDTIR if the interest income attributable to such expense is taken into account in determining such shareholder's Net CFC Tested Income. I.R.C. § 951A(b)(2)(B).

¹⁸ I.R.C. § 951A(d)(1). *See also* I.R.C. § 951A(d)(2) (Specified Tangible Property). In the case of property used in both the production of Tested Income and other income, such property shall be treated as Specified Tangible Property in the same proportion that the Tested Income bears to total gross income. I.R.C. § 951A(d)(2)(B).

Adjusted basis for purpose of section 951A is determined under section 168(g) (*i.e.*, the alternative depreciation system) and by allocating the depreciation deduction with respect to such property ratably to each day during the taxable year. I.R.C. § 951A(d)(3).

¹⁹ I.R.C. § 951A(e)(1). Such amounts are taken into account in the taxable year of the U.S. Shareholder in which or with which the taxable year of the CFC ends. I.R.C. § 951A(e)(1).

amounts in income only if such person owns (within the meaning of section 958(a)) stock in such corporation on the last day in the taxable year of such foreign corporation on which such foreign corporation is a CFC.²⁰ Section 951A(e)(3) provides that a foreign corporation is a CFC for any taxable year if such foreign corporation is a CFC at any time during such taxable year.

Except as otherwise provided by Regulations, GILTI included in gross income is treated in the same manner as Subpart F inclusions under section 951(a)(1)(A) for purposes of applying sections 168(h)(2)(B), 535(b)(10), 851(b), 904(h)(1), 959, 961, 962, 993(a)(1)(E), 996(f)(1), 1248(b)(1), 1248(d)(1), 6501(e)(1)(C), 6654(d)(2)(D), and 6655(e)(4).²¹ For purposes of these sections, if a CFC has no Tested Income, its portion of a U.S. Shareholder's GILTI is zero. If a CFC has Tested Income, its portion of a U.S. Shareholder's GILTI is the amount of GILTI that bears the same ratio as such U.S. Shareholder's pro rata amount of the Tested Income bears to the aggregate Tested Income of all Tested Income CFCs.²²

4. Section 250

The Act also added section 250, which provides domestic corporations a deduction equal to 50% of their GILTI, subject to a taxable income limitation.²³ The deduction is reduced to 37.5% for tax years beginning after December 31, 2025.²⁴

5. Section 245A

Newly enacted section 245A provides a domestic corporation with a 100% dividends received deduction (*i.e.*, the "245A DRD") for the "foreign sourced portion," within the meaning of section 245A(c), of dividends received from specified ten-percent owned foreign corporations, provided certain other requirements are met. To that end, the domestic corporate shareholder must hold the stock of the specified ten-percent owned foreign corporation for 365 days or more during the 731-day period beginning on the date that is 365 days before the ex-dividend date.²⁵ The foreign corporation must maintain its status as a specified ten-percent owned foreign corporation, and the domestic corporation must qualify as the foreign corporation's U.S. Shareholder, for the requisite period of time during the 731-day period.²⁶ The dividend paid by the specified ten-percent owned foreign corporation must also not be a "hybrid dividend" within the meaning of section 245A(e).

²⁰ I.R.C. § 951A(e)(2).

²¹ I.R.C. § 951A(f)(1).

²² I.R.C. § 951A(f)(2).

²³ I.R.C. § 250(a)(1)(B). Section 250(a)(1) also provides a deduction equal to 50% of the section 78 gross-up related to GILTI and 37.5% of foreign-derived intangible income of the domestic corporation. *See* I.R.C. § 250(b) (defining foreign-derived intangible income). The deductions are reduced to 37.5% and 21.875%, respectively, for tax years beginning after December 31, 2025. I.R.C. § 250(a)(3).

The deduction for GILTI under section 250 is limited when the GILTI inclusion and foreign-derived intangible income exceed the corporation's taxable income, determined without regard to the deductions under section 250(a)(1). I.R.C. § 250(a)(2).

²⁴ I.R.C. § 250(a)(3).

²⁵ I.R.C. § 246(c)(5)(A).

²⁶ I.R.C. § 246(c)(5)(B).

Under section 245A(e), dividend receiving corporations cannot apply the 245A DRD to offset hybrid dividend income. A hybrid dividend is defined as a dividend (1) distributed by a CFC, (2) which would be otherwise eligible for the 245A DRD, and (3) for which the distributing CFC received a deduction or other tax benefits in any foreign country or possession of the United States.²⁷ Section 245A(e)(2) also expressly extends the 245A DRD disallowance to hybrid dividend income received by CFCs.

In section 245A(g), Congress delegated Treasury a specific grant of authority to “prescribe such regulations or other guidance as may be necessary or appropriate to carry out the provisions of [section 245A].”

B. Sections 904(d)(1)(A) and 960(d)(1)(A)

The Act also added two new foreign tax credit provisions relating to GILTI: section 904(d)(1)(A) and section 960(d)(1)(A).

Section 904(d)(1)(A) creates a new basket for GILTI for purposes of determining the limitation on foreign tax credits under section 904.

Section 960(d) provides a foreign tax credit for taxes properly attributable to the Tested Income of a CFC included in income by a domestic corporation under section 951A. Specifically, if a domestic corporation has GILTI and elects to credit foreign taxes, the corporation is treated as having a “deemed paid” foreign tax credit equal to the product of (1) 80% of the aggregate “tested foreign income taxes” within the meaning of section 960(d)(3) (the “Tested Foreign Income Taxes”) paid or accrued by the CFCs owned by the corporation, and (2) the domestic corporation’s “inclusion percentage” within the meaning of section 960(d)(2) (the “Inclusion Percentage”). Tested Foreign Income Taxes are foreign income taxes paid or accrued by a CFC that are attributable to the Tested Income of the CFC taken into account by the U.S. Shareholder in calculating its GILTI. However, foreign taxes paid by a CFC without Tested Income for that year do not give rise to Tested Foreign Income Taxes for the year. A domestic corporation’s Inclusion Percentage is a fraction, the numerator of which is its GILTI and the denominator of which is the aggregate Tested Income of all “tested income CFCs” within the meaning of Proposed Regulation section 1.951A-2(b)(1) (“Tested Income CFCs”).

C. Proposed Regulations

On October 10, 2018, Treasury and the Service published a notice of proposed rulemaking providing rules for the pro rata allocation of Subpart F Income, the pro rata allocation of GILTI, the computation of GILTI, and the application of the GILTI rules in the consolidated return context (*i.e.*, the Proposed Regulations).²⁸ However, the Proposed Regulations do not include any rules relating to foreign tax credits or the deduction under section 250. Instead, Treasury and the Service indicated that those subjects will be addressed in separate guidance. We discuss the Proposed Regulations, as relevant to our Comments, in detail below in Part II.D.

²⁷ I.R.C. § 245A(e)(4).

²⁸ Notice of Proposed Rulemaking, Guidance Related to Section 951A (Global Intangible Low-Taxed Income), 83 Fed. Reg. 51072 (Oct. 10, 2018).

D. Comments

1. Proposed Regulation Section 1.951-1, Pro Rata Share Rules Comment Relating to the Time Value of Money

Proposed Regulation section 1.951-1(e)(4)(iii) provides that the amount of any arrearage is determined by taking into account the time value of money principles in Proposed Regulation section 1.951-1(e)(4)(ii). Presumably this is a reference to the language of Proposed Regulation section 1.951-1(e)(4)(ii) that requires the calculation of the present value of the unpaid current dividends, but that is not clear as Proposed Regulation section 1.951-1(e)(4)(ii) does not specifically define “time value of money principles.” We recommend that the language of Proposed Regulation section 1.951-1(e)(4)(iii) be clarified to reference the calculation of the present value of the unpaid current dividends in Proposed Regulation section 1.951-1(e)(4)(ii).

2. Proposed Regulation Section 1.951-1(e)(6), the Pro Rata Share Anti-Abuse Rule

a) Background

Proposed Regulations section 1.951-1(e)(6) provides for a new anti-abuse rule that would disregard certain tax-motivated transactions and arrangements in determining a U.S. Shareholder’s pro rata share of Subpart F Income, Tested Income, and certain other items (*i.e.*, the Pro Rata Share Anti-Abuse Rule).

All of the examples in Proposed Regulations section 1.951-1(e)(7) address more general rules relating to the allocation of Subpart F Income, Tested Income, and Tested Loss among classes of stock. Proposed Regulations section 1.951-1(e) contains no examples illustrating the Pro Rata Share Anti-Abuse Rule and thus provides no further clarity on the rule’s mechanics or scope.

The preamble to the Proposed Regulations (the “Preamble”) states that the scope of the Pro Rata Share Anti-Abuse Rule is limited to the allocation of Subpart F Income and GILTI amounts among classes of stock. Specifically, the Preamble describes the Pro Rata Share Anti-Abuse Rule in the context of changes made more generally by the Proposed Regulations to the rules in Proposed Regulation section 1.951-1 (the “Pro Rata Share Rules”). The Preamble states that changes made to Regulation section 1.951-1(e) are generally aimed at avoidance structures where E&P is improperly allocated among classes of shares in a manner that avoids an inclusion with respect to a U.S. Shareholder by uneconomically allocating Subpart F Income or GILTI amounts to non-U.S. Shareholders of CFCs (and thus leaving less Subpart F Income or GILTI to be allocated to the U.S. Shareholders). In describing this proposed amendment, the Preamble notes the inclusion of the Pro Rata Share Anti-Abuse Rule, indicating that the rule is focused on any transaction or arrangement with a principal purpose to reduce a U.S. Shareholder’s pro rata share of Subpart F Income or GILTI by allocating E&P among share classes.

Moreover, the placement of the Pro Rata Share Anti-Abuse Rule in Proposed Regulation section 1.951-1(e) suggests that its scope should be limited to transactions relating to the allocation of Subpart F Income and GILTI amounts with respect to a U.S. Shareholder that holds shares in a CFC, directly or indirectly (*i.e.*, as a shareholder of Section 958(a) Stock (a “Section 958(a) Shareholder”). Furthermore, the language of the Pro Rata Share Anti-Abuse Rule itself

is limited to disregarding transactions only in determining a U.S. Shareholder's pro rata share of Subpart F Income and GILTI amounts.

Although we are sympathetic to Treasury's and the Service's concern regarding the above transactions, we are concerned that, as drafted, the Pro Rata Share Anti-Abuse Rule is vague and could, therefore, have unintended consequences. Of particular concern is the fact that the remedy of the rule's application – disregarding transactions – could result in the creation of a Section 958(a) Shareholder where none actually exists on the last day of the year on which a foreign corporation is a CFC as a result of a bona fide sale of shares of such CFC. For example, X, a domestic corporation, plans to sell 100% of the stock of Y, a CFC, to Z, also a domestic corporation. Each of X, Y, and Z are calendar-year taxpayers. Although the transaction is not connected with any Subpart F or GILTI planning, X and Z decide to complete the transaction on December 29, 2018, with the result that X will not have a Subpart F or GILTI inclusion for 2018 (*i.e.*, X will not be a Section 958(a) Shareholder with respect to Y on the last day of Y's taxable year on which it is a CFC – December 31, 2018). Without clarification, there is a concern that if the transaction was found to be part of a plan a principal purpose of which is to reduce X's Subpart F or GILTI Inclusion with respect to Y, the sale would be disregarded for purposes of determining Subpart F Income or GILTI. If such a transaction was disregarded, it is unclear whether X would be treated as a Section 958(a) Shareholder on the last day of Y's 2018 taxable year and further, whether such treatment would carry on in perpetuity.

Additionally, the scope of the Pro Rata Share Anti-Abuse Rule is more expansive than necessary to manage the concerns expressed by Treasury and the Service. The rule potentially applies to any "transaction or arrangement" that has a principal purpose of avoidance of U.S. federal income tax to the extent that the transaction or arrangement affects a shareholder's pro rata share allocation under Regulation section 1.951-1(e) and Proposed Regulation section 1.951A-1(d). For example, if a transaction changes the treatment of a CFC's income from Tested Income to Subpart F Income (or Subpart F Income to Tested Income), the language of the Pro Rata Share Anti-Abuse Rule could be read to apply. Other transactions, such as the liquidation of a second-tier CFC into a first-tier CFC, might also alter the treatment of foreign earnings without changing a U.S. Shareholder's pro rata share of the foreign earnings.

Finally, the Pro Rata Share Anti-Abuse Rule does not contain a temporal restriction. As a result, as currently drafted, the rule could apply to transactions or arrangements dating back to the enactment of Subpart F in 1962.

b) Comments

We recommend that Treasury and the Service clarify that the scope of the Pro Rata Share Anti-Abuse Rule is limited to the allocation of Subpart F Income and GILTI among a CFC's classes of stock with respect to those shareholders that actually own, directly or indirectly, shares in the CFC on the last day of the year on which such entity is a CFC, and that the rule cannot be used to deem a U.S. Shareholder to own shares in the CFC on such day when it no longer owns them. We also propose narrowing the scope of the Pro Rata Share Anti-Abuse Rule to cover only non-economic allocations resulting in a shift in Subpart F Income or section 951A inclusions away from a U.S. Shareholder. We further recommend that Treasury and the Service clarify that the Pro Rata Share Anti-Abuse Rule will apply only to transactions or arrangements occurring in taxable years ending on or after the date the Proposed Regulations were published in the Federal Register (*i.e.*, October 10, 2018).

3. Proposed Regulation Section 1.951A-1, General Rules for Determining GILTI Comments

a) Definition of U.S. Shareholder Inclusion Year

Section 951A(e)(1) provides that GILTI “shall be taken into account in the taxable year of the U.S. Shareholder in which or with which the taxable year of the CFC ends.” This language is materially the same as the language in section 951(a)(1) that requires each U.S. Shareholder of a CFC to include its respective pro rata share of Subpart F Income “for his taxable year in which or with which such taxable year of the corporation ends.”

However, Proposed Regulation section 1.951A-1(b) requires a U.S. Shareholder to include GILTI income “in the U.S. Shareholder Inclusion Year.” A U.S. Shareholder Inclusion Year is defined “as a taxable year of a U.S. Shareholder that includes ‘a CFC Inclusion Date’ of the relevant CFC.”²⁹ The term “CFC Inclusion Date” is defined as the last day of a CFC inclusion year on *which a foreign corporation is a CFC*.³⁰ Finally, the term “CFC Inclusion Year” means any taxable year of a foreign corporation beginning after December 31, 2017, at any time during which the corporation is a CFC.³¹

Thus, under the Proposed Regulations, a U.S. Shareholder of a CFC is required to include its pro rata share of GILTI in the U.S. Shareholder’s year that includes either the last day of the CFC taxable year or the last day on which the foreign corporation is a CFC (the “CFC Status Termination Date”), whichever occurs earlier. In other words, if there is a CFC Status Termination Date, a U.S. Shareholder must include its pro rata share of the GILTI income related to the CFC in the U.S. Shareholder’s taxable year that includes the CFC Status Termination Date, and not on the date when the CFC taxable year closes under otherwise applicable rules.

This presents a challenge when the U.S. Shareholder and the CFC have different taxable years, and there is a disposition of that CFC (*e.g.*, pursuant to a sale) which results in the CFC losing its CFC status on a day other than the last day of its taxable year, because such disposition accelerates GILTI with regard to that U.S. Shareholder.

It is unclear that Treasury and the Service intended this difference, because it raises the following issues for U.S. Shareholders that own CFCs: (i) the language in the Proposed Regulation deviates from language in section 951A, (ii) it creates asymmetry between the GILTI and Subpart F regimes, (iii) it appears to be incongruent with the legislative history of section 951A, (iv) it appears to lack a strong underlying policy, (v) by definition GILTI excludes Subpart F Income, the calculation and inclusion of which continues to be governed by the CFC year-end inclusion date and is not accelerated to the CFC Status Termination Date, and (vi) it is unclear how this rule would apply where the transferee (in the transaction that caused CFC status termination) itself transfers the CFC to another U.S. person (resulting in the CFC returning to CFC status) prior to the end of the CFC’s taxable year.

As discussed above, section 951A provides that the appropriate inclusion year is to be determined by reference to the date on which the CFC taxable year ends. Section 951A uses, in

²⁹ Prop. Reg. § 1.951A-1(e)(4).

³⁰ Prop. Reg. § 1.951A-1(e)(1) (emphasis added).

³¹ Prop. Reg. § 1.951A-1(e)(2).

the context of GILTI, the same language that section 951(a)(1) uses in the context of Subpart F Income. Thus, the statute appears to provide that the GILTI regime's rules regarding inclusion years be treated in a similar manner to the Subpart F regime.

More specifically, section 951A(e)(1) provides that "the pro rata share of [GILTI] shall be determined under the rules of section 951(a)(2) in the same manner as such section applies to Subpart F income." Further, section 951A(f)(1)(A) provides that any GILTI included in gross income "shall be treated in the same manner as an amount included under section 951(a)(1)(A)" for purposes of applying several other Code provisions.

Similarly, the legislative history to the Senate Committee Report, which was adopted and followed by the Conference Agreement, states:

Although GILTI inclusions do not constitute Subpart F income, GILTI inclusions are generally treated similarly to subpart F inclusions. Thus they are generally treated in the same manner as amounts included under section 951(a)(1)(A) for purposes of applying sections 168(h)(2)(B), 535(b)(10), 904(h)(1), 959, 961, 962, 993(a)(1)(E), 996(f)(1), 1248(b)(1), 1248(d)(1), 6501(e)(1)(C), 6654(d)(2)(D), and 6655(e)(4). However, the Secretary may provide rules for coordinating the GILTI inclusion with provisions of law in which the determination of subpart F income is required to be made at the CFC level.³²

Based on the text of the Senate Committee Report, it appears that Congress intended the Secretary to prescribe Regulations to coordinate GILTI inclusions with the Subpart F rules where the "determination of Subpart F Income is required to be made at the CFC level." This circumscription emphasizes that Congress intended there to be little deviation between the Subpart F and GILTI regimes. As any difference in the "inclusion year" between the Subpart F and GILTI regimes could impact the "determination of Subpart F income at the CFC level," the material deviation in Proposed Regulation section 1.951A-1(e) from the rules applicable to determining Subpart F Income appears inconsistent with Congressional intent.

This is further underscored by the administrative and computational issues created by the rule in the Proposed Regulations. Section 951A(c)(2)(A)(i)(II) provides that Tested Income for purposes of determining GILTI excludes "any gross income taken into account in determining the Subpart F income of such corporation." Thus, the amount of Subpart F Income is a computational component of GILTI income. As the inclusion year rules applicable to Subpart F Income require Subpart F Income inclusion only on the last day of the CFC taxable year, and not on the CFC termination date, there is no requirement to compute Subpart F Income until the end of the CFC taxable year. If the Proposed Regulation related to the GILTI inclusion year were adopted, the amount of Subpart F Income would also have to be computed as of the CFC Status Termination Date. This does not appear to be intended, particularly because no corresponding amendments or regulations are proposed with respect to the Subpart F inclusion year.³³

³² Committee Print, Recommendations Pursuant to H. Con. Res. 71, S. Prt. 115-20, at 373 (December 2017) (emphasis added). See H.R. Rep. No. 115-466, at 642 (2017) (Conf. Rep.). See also Joint Explanatory Statement of the Committee of Conference at 517 (Dec. 15, 2017).

³³ Further, while the foreign tax credit implications arising out of GILTI inclusions that are anticipated to be addressed in upcoming Proposed Regulations are generally out of scope of this letter, differences in the inclusion

Similarly, GILTI income inclusion computations also require “tested interest income” within the meaning of Proposed Regulation section 1.951A-4(b) (“Tested Interest Income”) and “tested interest expense” within the meaning of Proposed Regulation section 1.951A-4(b) (“Tested Interest Expense”) to be computed. Generally, these amounts are computed for the full year, and calculating them at a specific date, such as the date of disposition of the CFC, would cause administrative inconvenience and expense.

Finally, the loss and later requalification of CFC status in the same taxable year raises inclusion year concerns. For example, suppose the transferee (of a transfer which caused the CFC status to terminate, *e.g.*, a non-U.S. buyer with no U.S. subsidiaries that triggers section 958(b) attribution) itself transfers the foreign corporation to another U.S. person, the foreign corporation would again be regarded as a CFC as a result of such second transfer. Under these circumstances, based on the Proposed Regulations, it appears that the GILTI inclusion will be triggered at the end of the CFC taxable year and not on the date of the first disposition. Thus, whether and when to include GILTI income (in the case of a disposition resulting in CFC Status Termination) is dependent on what the transferee does with the CFC prior to the close of the CFC taxable year. Such event could be prior to the close of a taxable year of the U.S. Shareholder or could even be prior to the filing deadline of its tax return. This all said, the original transferor who includes GILTI may not have control (and possibly may not even know) such a subsequent event occurred, and further may not have access to relevant information, at least in a timely manner, with respect to such an event.³⁴ Further, such situations may be more likely to arise due to the repeal of section 958(b)(4).³⁵

For the above reasons, we recommend that the term “CFC Inclusion Date” should not be defined by reference to CFC status, but only by reference to the last day of the CFC taxable year to conform the Proposed Regulation to the statutory language in section 951A(e)(1) (providing that GILTI is taken into account in the taxable year of the U.S. Shareholder in which or with which the taxable year of the CFC ends).

b) Pro Rata Share of Tested Loss

Proposed Regulation section 1.951A-1(d)(4)(i)(C) provides all Tested Losses are allocated to common shareholders absent shortfall amounts or stock with no liquidation value. We believe the Proposed Regulations reasonably reflects the economic reality that common stock bears the risk in such cases and loss allocation follows such risks. It may be argued that Tested Loss should be shared in a different manner, for example, in the exact same manner that the shareholders share losses of their invested capital,³⁶ or in a manner similar to the pro rata share of CFC Tested Income that may be reduced by CFC Tested Loss and may not end up with

year of Subpart F Income and GILTI appear to cause additional complexities without any compelling policy rationale to justify the additional burden imposed on taxpayers and revenue agents.

³⁴ This point should be a realistic and practical concern given that CFC status termination generally occurs in sales to unrelated buyers and thus original sellers would not have information for subsequent dispositions.

³⁵ CFC status may be restored in situations where the foreign buyer owns one or more U.S. corporations (or is owned by a corporation that owns one or more U.S. corporations). CFC status may also be restored if the foreign buyer did not own a U.S. corporation at the time of the acquisition but forms or acquires one after, potentially causing foreign corporations in the foreign buyer’s group to become CFCs under section 958(a) and (b).

³⁶ In most cases, common shareholders may be anticipated to suffer the first losses.

Net CFC Tested Income.³⁷ However, we acknowledge that a relatively simple loss allocation rule avoids unnecessary complexities or an abusive use of loss allocations and thus should lead to more appropriate results. A simple allocation of losses to common stock may generally align with economic reality as common stock bears the risk in most cases. Differences in guiding principles and mechanics between Subpart F Income and GILTI (*e.g.*, an E&P based calculation versus a Tested Income based calculation) may justify different treatment in allocation of losses.

Similarly, where there are multiple classes of stock of a CFC, and some have positive liquidation value while others do not, the Tested Losses are allocated to classes of stock that have positive liquidation value, to the extent of such positive liquidation value, starting with the most junior class, and tiering-up. This appears reasonable and consistent with the economic reality as discussed above.

4. Interaction of GILTI Rules with Section 952

a) Double Inclusion of the Same Income

(1) Background

Despite that many of the exclusions to Tested Income as defined under section 951A(c)(2)(A) have been part of the legislation since the introduction of the Act (as part of the foreign high returns provision),³⁸ there is no substantive discussion of the reasoning behind the exclusions in the legislative history. Nevertheless, we presume that Congress provided these exclusions to prioritize the taxation of Subpart F Income under the otherwise applicable provisions and to remove such income along with the other excluded categories of income from the base upon which GILTI is determined.

Treasury and the Service addressed the application of these provisions in Proposed Regulation section 1.951A-2(c). Proposed Regulation section 1.951A-2(c)(1) repeats the statutory language of section 951A(c)(2)(A) with the exception of certain modifying language related to the exclusion of income qualifying for the high-tax income exception to Subpart F, which is discussed below. Specifically, Proposed Regulation section 1.951A-2(c)(4) introduces a provision that has no statutory precursor and no reference in the legislative history. That provision states that Gross Tested Income and allowable deductions properly allocable to Gross Tested Income of a CFC for a CFC Inclusion Year are determined without regard to the

³⁷ See discussions with respect to pro rata share in qualified deficits in *Comments on Proposed Regulations Governing Pro Rata Share Determinations Under Subpart F*, at 26-27 (Nov. 22, 2004), available at <https://www.americanbar.org/content/dam/aba/administrative/taxation/migrated/pubpolicy/2004/041122f.authcheckdam.pdf>. The relevance or analogies of such discussions to GILTI Pro Rata Share Rules may vary depending on whether net operating losses of CFCs will be taken into account for calculation of GILTI income given GILTI does not have such concepts as qualified deficits.

³⁸ H.R. 1, 115th Cong. § 4301; Joint Explanatory Statement of the Committee of Conference at 509 (Dec. 15, 2017). The categories excluded from Tested Income include (a) any item of income described in section 952(b); (b) any gross income taken into account in determining Subpart F Income; (c) any gross income excluded from foreign base company income and insurance income by reason of the high-tax exception of section 954(b)(4); (d) any dividend received from a related person (within the meaning of section 954(d)(3)); and (e) any foreign oil and gas extraction income (within the meaning of section 907(c)(1)) of such corporation. I.R.C. § 951A(c)(2)(A)(i).

application of section 952(c). Such a rule could result in subjecting some items of income to tax twice, as demonstrated by the example below:

A Corp, a domestic corporation, owns 100% of the shares of FS, a CFC. In Year 1, FS has foreign base company services income of \$100x, a loss in foreign personal holding company income of \$100x, and E&P and Net CFC Tested Income of \$0x. FS has no other income. In Year 2, FS has Tested Income of \$100x which is *not* taken into account in determining the Subpart F Income and E&P of \$100x.

As a result of the current E&P limitation of section 952(c)(1), FS has no Subpart F Income in Year 1. In addition, the Gross Tested Income of FS is determined without regard to section 952(c)(1). Therefore, in determining the Gross Tested Income of FS in Year 1, the \$100x of foreign base company services income of FS in Year 1 is excluded. In Year 2, under section 952(c)(2), FS's current E&P of \$100x in excess of its Subpart F Income of \$0x and is thus treated as Subpart F Income to the extent Subpart F Income was previously limited by E&P. Therefore, FS has Subpart F Income of \$100x in Year 2. In addition, the Gross Tested Income of FS is determined without regard to section 952(c)(2). Accordingly, FS's income in Year 2 is not excluded from Tested Income, and FS has \$100x of Gross Tested Income in Year 2.

The conclusion of this example raises significant equity and policy issues. Over a two-year period, FS earns net income of \$100x. However, if FS's Year 2 Tested Income is GILTI, then its U.S. Shareholder is subject to tax on the same item of income twice in Year 2: (1) \$100x of Subpart F Income resulting from the application of section 952(c)(2) to recharacterize non-Subpart F Income as Subpart F Income; and (2) \$100x of GILTI as a result of Gross Tested Income is determined without regard to the application of section 952(c)(2).

It is also instructive to consider the result were the application of section 952(c) not turned off for the purpose of determining Gross Tested Income. As in the above example, in Year 1, the E&P limitation of section 952(c)(1) would again apply to offset the gross foreign base company services income. In contrast to the above example, however, because FS realized gross foreign base company services income, such income would be considered "gross income taken into account in determining Subpart F income," and therefore would be excluded from Tested Income pursuant to section 951A(c)(2)(i)(II). Accordingly, it would appear that application of section 952(c) to the determination of Gross Tested Income would result in the same outcome in Year 1 on these facts (although it could be argued that "gross Subpart F income" should be determined after the application of section 952(c)(1)).

In Year 2, section 952(c)(2) should apply to recharacterize non-Subpart F E&P as Subpart F Income. However, the question then arises as to whether section 952(c)(2) should be applied in determining whether there is gross Subpart F Income for the purpose of the exclusion from Gross Tested Income under section 951A(c)(2)(A)(i)(II). Arguably, the recapture provision of section 952(c)(2) creates gross Subpart F Income which – absent application of the Proposed Regulations – would then be excluded from Tested Income. Accordingly, over the two-year period, FS would earn \$100x of net E&P and the U.S. Shareholder of FS recognizes \$100x of Subpart F Income, which is the appropriate outcome.

We recognize that there may be more than one way in which to interpret the interaction of section 951A(c)(2)(i)(II) with section 952(c). For example, gross Subpart F Income could be considered to be the Subpart F Income which results after the application of section 952(c)(1), rather than being determined on a category by category basis. Alternatively, gross Subpart F Income could be considered to be determined prior to the application of section 952(c)(2), resulting in the same potential double taxation of income in year 2 as in the example above.

(2) Comments

To avoid double taxation in situations such as that described above and to provide greater certainty as to the application of the Tested Income exclusions, we recommend that Treasury define “gross income taken into account in determining the Subpart F Income” as any category of Subpart F Income as determined under sections 954(a) or 953, as the case may be, determined without regard to the application of section 952(c)(1) but with regard to the application of sections 952(c)(2) and 954(b)(3). This definition would in effect act as an ordering rule, ensuring that Subpart F Income is taxed as such and is not also subject to tax as GILTI.³⁹

Although our recommended approach may result in the recharacterization of Tested Income as Subpart F Income, section 952(c)(2) was designed to recharacterize other income as Subpart F Income to the extent of recapture account balances. In addition, this interpretation appears to reach the correct policy result in that the Act’s revisions to the CFC statutory regime treats GILTI as the residual income category only after accounting for various exceptions, including Subpart F Income. Further, the expressed legislative intent to impose a flat minimum tax on net Tested Income on a world-wide basis is satisfied by applying section 951A(c)(2)(A)(i)(II) after application of section 952(c).⁴⁰ Finally, this result harmonizes the two statutes and avoids double taxation of the same item of income.

We also recognize that the determination of Tested Income is not tied directly to E&P, and concerns have been raised that it may be inappropriate to recharacterize Tested Income because Subpart F Income was previously reduced by an E&P deficit. Therefore, as an alternative to the proposal above, the final Regulations could reduce a CFC’s Subpart F recapture account by an amount equal to the amount of income that would otherwise be Subpart F Income as a result of the recapture rule of section 952(c)(2) to the extent that such income also constitutes Tested Income. This “reduction” would not create Subpart F Income but would reduce the CFC’s recapture account balance, therefore avoiding double taxation of the same item of income, but prioritizes Tested Income characterization over recharacterization of such income as Subpart F Income.

b) Interaction with Qualified Deficit Rule

Section 951A(c)(2)(B)(ii) and Proposed Regulation section 1.951A-6(d) provide that, for purposes of section 952(c)(1)(A) (current E&P limitation), E&P of a CFC will be increased by the amount of its Tested Loss. This statutory language does not refer to the other paragraphs and

³⁹ It is axiomatic that the same item of CFC income should only be taxed once to the U.S. Shareholder. *See* GLAM 2015-001 (Feb. 13, 2015). *See also* *Comm'r v. Wheeler*, 324 U.S. 542 (1945); *Bangor & Aroostok v. Comm'r*, 16 T.C. 578 (1951).

⁴⁰ H.R. Rep. No. 115-466, at 626-27 (2017) (Conf. Rep.). *See also* New York Bar Ass’n Tax Section, *Report on the GILTI Provisions on the Code* (May 4, 2018) at 15-17.

subparagraphs of section 952(c). Therefore, a literal reading of the statutory language does not preclude the possibility that a Tested Loss could qualify in a subsequent year as a qualified deficit under section 952(c)(1)(B). Also note neither section 951A(c)(2)(B)(ii) nor Proposed Regulation section 1.951A-6(d) refer to sections 959 or 964 and there is no implication that E&P should be increased in the amount of the Tested Loss for purposes of those sections. As such, section 951A(c)(2)(B)(ii) should be construed as increasing current E&P only for the purpose of avoiding a section 952(c)(1)(A) limitation so that a Tested Loss cannot be used to both reduce Tested Income and Subpart F Income.

The example below illustrates the application of section 952(c)(1)(B):

A Corp, a domestic corporation, owns 100% of the shares of FS, a CFC. In Year 1, FS has a Tested Loss of (\$15x) from services-related activities. FS has no other income or expense. Thus FS has a Net CFC Tested Loss of (\$15x) and a current E&P deficit of (\$15x). In Year 2, FS has foreign base company services income of \$8x and current E&P of \$8x from the same type of activities that gave rise to losses in Year 1.

In this example, in Year 1, FS's net CFC Tested Loss of (\$15x) is taken into account at the level of U.S. Shareholder to calculate its GILTI inclusion.⁴¹ Further, the E&P deficit of (\$15x) may be carried over as a qualified deficit in Year 2, depending on whether the loss is attributable to the same activity as the activities giving rise to the foreign base company services income. This would reduce A Corp's foreign base company services income inclusion from \$8x to zero. Although in most cases, qualified deficits under section 952(c)(1)(B) generally will not also constitute Tested Losses because the deductions and losses that make up the deficit will not be properly allocable to Tested Income, the standards are not identical and therefore, particularly in start-up years before any income has been earned by the CFC, there may be overlap.

As illustrated above, a Tested Loss in a CFC Inclusion Year may result in a section 952(c)(1)(B) qualified deficit in the next year and may therefore decrease future Subpart F inclusions. This result does not appear to be changed by Proposed Regulation section 1.951A-2(c)(4). As a result, a plain reading of the statute provides for the same loss to be used to reduce GILTI and Subpart F inclusions in different tax years, even though it could not do so in the same year. Although section 951A(c)(2)(B)(ii) prohibits Tested Losses from reducing current earnings and profits for purpose of Subpart F calculations, the provision is specific to the application of section 952(c)(1)(A), and does not prevent a Tested Loss from creating a qualified deficit under section 952(c)(1)(B)—again, under a plain reading of the statute.

Just as we do not believe that the same earnings should be subject to multiple inclusions—once as GILTI and a second time as Subpart F Income as a result of the recapture rules under section 952(c)(2)—we note that from a tax policy perspective we also believe that the same economic loss should not result in multiple deductions. Notwithstanding the plain reading of the statute and Congress's failure to cross-reference section 952(c)(1)(B) in addition to section 952(c)(1)(A) in section 951A(c)(2)(B)(ii), we believe such a double benefit is

⁴¹ Note that a Tested Loss CFC must increase its earnings and profits by the amount of Tested Loss regardless of whether the Tested Loss actually reduced Tested Income.

inappropriate.⁴² Thus, considering the above, we recommend that the final Regulations, notwithstanding Congress’s failure to include a reference to section 952(c)(1)(B) in section 951A(c)(2)(B)(ii), should deny a U.S. Shareholder the ability to (i) offset Tested Income with Tested Loss and (ii) also allow that U.S. Shareholder to create or increase a “qualified deficit” as defined under section 952(c)(2) with the same economic loss.

c) Pre-2018 Recapture Account

It is not clear to us whether and how Proposed Regulation section 1.951A-2(c)(4) and section 951A(c)(2)(A)(i)(II) should apply to section 952(c)(2) recapture accounts that existed prior to the Act’s enactment (*i.e.*, the Pre-2018 Recapture Account). We believe it would be inappropriate to subject income that is subject to taxation as Subpart F Income by reason of section 952(c)(2) to tax again under the GILTI rules where such recapture results because of a Pre-2018 Recapture Account balance. Since GILTI did not exist prior to 2018, no Tested Loss resulted in the reduction of Subpart F Income. In fact, pursuant to section 951A(c)(2)(B)(II), no Tested Loss can reduce Subpart F Income under section 952(c)(1)(A).

For this reason, if our suggestions in Part II.D.4.A are not adopted, we recommend that gross Subpart F Income be determined after the application of section 952(c)(2) to the extent of Pre-2018 Recapture Account balances.

d) Clarification of “Solely” Rule

Another interesting issue arises as to the application of the high-tax exclusion from Tested Income. As noted above, section 951A(c)(2)(A)(III) excludes from the definition of Tested Income any gross income excluded from foreign base company income and insurance income by reason of the high-tax exception of section 954(b)(4). The Proposed Regulations clarified the scope of the exclusion by providing that high-taxed income is excluded from Tested Income only if such income is excluded from foreign base company income solely by reason of an election made under section 954(b)(4) and Regulation section 1.954-1(d)(5). The Preamble explains that the insertion of the word “solely” was intended to clarify that “the exclusion does not apply to income that would not otherwise be Subpart F income or to categories of income that do not constitute Subpart F income due to exceptions other than the high-tax exception (for example, as a result of an exception to foreign personal holding company income under section 954(c)(6) or section 954(h)).”⁴³

In general, clarifying that the high-tax exception to Tested Income applies only to income qualifying for an exclusion from Subpart F Income solely by reason of an election under section 954(b)(4) is an appropriate interpretation of the statute. Had Congress intended to except income that did not constitute Subpart F Income as a result of another exception in the Code, it could

⁴² We note that if Treasury and the Service decide to deny such a double benefit through regulations (and not look to Congress to amend section 951A(c)(2)(B)(ii) to include a reference to section 952(c)(1)(B)), such a rule should ensure that any reduction in the CFC’s qualified deficit should be tax effected to take into account the difference between the 10.5% rate on GILTI and the 21% rate on Subpart F Income, each with respect to corporate U.S. shareholders, as well as other variables including the availability of foreign tax credits. For a more detailed explanation of how such a regime could be drafted, *see* Part II.D.9 of this letter *infra* (relating to the basis reduction rules under Proposed Regulation section 1.951A-6(e)).

⁴³ 83 Fed. Reg. 51072, 51075 (2018) (Preamble).

have referenced those exceptions or broadened the exclusion to apply to all high-taxed income rather than just income excepted from foreign base company income as a result of section 954(b)(4). However, the interaction between the high-tax income exclusion and section 952(c)(1) should be addressed. If a CFC's income is subject to a high effective tax rate and its U.S. Shareholder makes a high-tax election, a question is raised as to the coordination of the exclusions for gross Subpart F Income and the exclusion for Subpart F Income eligible for the high-tax exception.

In the example set forth in Part II.D.4.A, in Year 1, FS earns \$100x of foreign base company services income and generates a foreign personal holding company loss of (\$100x). FS has no net E&P, and, pursuant to the E&P limitation of section 952(c)(1)(A), would have no net Subpart F Income. However, if a high-tax exception election is made, then FS's gross foreign base company services income is not taken into account in determining Subpart F Income and would therefore not be excluded from Tested Income under section 951A(c)(2)(A)(II). In addition, under the Proposed Regulations, the exclusion of high-tax exception income from Tested Income applies only to income that is excluded from foreign base company income solely by reason of an election made to exclude the income under the high-tax exception of section 954(b)(4). However, because FS's foreign base company services income was offset by its foreign personal holding company loss, such income was arguably not excluded from foreign base company income solely by reason of the high-tax exception. Accordingly, the Proposed Regulation could be interpreted as providing that neither the gross Subpart F Income exclusion nor the high-tax exclusion would apply and such income would not be excluded from Tested Income. This results in effectively recharacterizing \$100x of high-tax foreign base company services income with regard to which an election was made as Tested Income, despite the CFC having no net earnings.

In addition, in the example, in Year 2, since Subpart F Income was reduced as a result of the E&P limitation of section 952(c)(1)(A), section 952(c)(2) would apparently apply in Year 2, resulting in \$100x of foreign base company services income. Under the Proposed Regulations, this income would also constitute Tested Income for the reasons noted above. In our view, as in the earlier example, this result is inappropriate as a matter of policy (or a matter of equity), because it results in \$100x of CFC income over the two-year period potentially being taxed at least twice.⁴⁴ In our view, this is an unnecessary trap for the unwary.

Based on the foregoing, we recommend that Treasury and the Service clarify that Gross Tested Income and allowable deductions are determined without regard to section 952(c)(1) even if the U.S. Shareholder makes a high-tax exception election. Under this approach, income would

⁴⁴ In the example set forth above, over the 2-year period, FS has \$0x of net income in Year 1 (*i.e.*, foreign base company services income of \$100x, and a loss in foreign personal holding company income of (\$100x)). In Year 2, FS has Tested Income of \$100x and therefore net income over the 2-year period of \$100x. If the \$100x of foreign base company services income is recharacterized as a CFC Tested Income in Year 1 because of the application of the "solely" rule as illustrated above, FS's U.S. Shareholder would be subject to tax under the GILTI rules. Then in Year 2, FS's U.S. Shareholder is apparently taxed twice on its \$100x of CFC Tested Income: Once because such income is recharacterized as foreign base company services income under the section 952(c) recapture rule and once again because such foreign base company services income remains Tested Income since the Proposed Regulations determine CFC Tested Income without excluding income recharacterized under section 952(c)(2) pursuant to Proposed Regulation section 1.951A-2(c)(4). As a result, FS's U.S. Shareholder arguably ends up subject to triple tax on the total net income over the 2-year period of \$100x.

be considered excluded from foreign base company income and insurance income “solely” by reason of the high-tax exception even if the income would not have been included into the U.S. Shareholder’s income by reason of section 952(c)(1)(A) had the high-tax exception election not been made.

5. Proposed Regulation Section 1.951A-3, QBAI Calculations

a) Definition of QBAI

Proposed Regulation section 1.951A-3(b) states that a Tested Loss CFC has no QBAI, and Proposed Regulation section 1.951A-3(c) provides that none of the tangible property of a Tested Loss CFC is Specified Tangible Property (such rules, the “Tested Loss CFC QBAI Exclusion”).⁴⁵

The Preamble does not give a reason for the Tested Loss CFC QBAI Exclusion. Presumably, Treasury and the Service are interpreting the legislative history to make this determination. In the U.S. House of Representatives’ version of what became the GILTI regime, Specified Tangible Property was defined to specifically include tangible property to the extent such property was used in the production of Tested Income *or Tested Loss*.⁴⁶ Although the U.S. Senate struck the reference to a Tested Loss in the same definition in its version of the provision, the Senate Finance Committee noted in a footnote in its report that “[s]pecified tangible property does not include property used in the production of a tested loss, so that a CFC that has a tested loss in a taxable year does not have QBAI for the taxable year.”⁴⁷

While we understand the inclination of Treasury and the Service to defer to the interpretation of the statute offered in the Senate Committee Report, the text of the statute as enacted itself is ambiguous and the Tested Loss CFC QBAI Exclusion is otherwise inconsistent with the scheme of the GILTI regime.⁴⁸ As is clarified in the Proposed Regulations, GILTI is a shareholder-level computation serving as a proxy for a tax on a CFC’s intangible assets; embedding a CFC-level calculation into a shareholder-level calculation distorts the calculation of the shareholder’s return. For example, assume U.S. Shareholder purchases and contributes to CFC1 new manufacturing equipment (basis: \$120x; 10-year life) that will be placed in service abroad to manufacture and sell goods to customers in Country X. Simultaneously, U.S. Shareholder contributes used equipment (basis: \$0x) to CFC2 to manufacture and sell the same goods to customers in Country Y. CFC1 and CFC2 each have the same amount of net operating income (\$10x) in year 2. If CFC1 has, in addition, \$12x of depreciation, then CFC1 will be a Tested Loss CFC with (\$2x) of Tested Loss; CFC 2 will have \$10x of Tested Income. U.S. Shareholder will have Net CFC Tested Income of \$8x. U.S. Shareholder will have no NDTIR or DTIR because its pro rata share of the QBAI of its Tested Income CFC (CFC2) is zero. Therefore, U.S. Shareholder will have a GILTI Inclusion Amount of \$8x. However, when

⁴⁵ Specified Tangible Property is property with respect to which a deduction is allowable under section 167 or 197. Prop. Reg. § 1.951A-2(c)(5)(ii).

⁴⁶ H.R. 1, 115th Cong. § 4301(a) (2017) (including then-section 951A(d)(2)) (emphasis added).

⁴⁷ Committee Print, Recommendations Pursuant to H. Con. Res 71, S. Prt. 115-20, at 373 n. 1206 (December 2017); H. R. Rep. No. 115-466, at 642 n. 1536 (2017) (Conf. Rep.); *see also* S. 1, 115th Cong. § 14201 (2017).

⁴⁸ *See* I.R.C. § 951A(b)(1) (contains no mention of QBAI limitation); I.R.C. § 951A(c)(1) (providing for a CFC by CFC calculation of Tested Income to arrive at “net CFC tested income”).

viewed at the shareholder-level, U.S. Shareholder has made an investment in assets of \$120x and earned a net return of \$8x—less than the ten-percent DTIR on its \$120x investment in Year 1. By contrast, if CFC1 were to have earned \$13x of operating income and CFC2 were to have earned \$7x of operating income, U.S. Shareholder’s Net CFC Tested Income would not have changed (\$8x), but U.S. Shareholder would now have NDTIR determined by reference to the \$120x investment and therefore would have no GILTI Inclusion Amount. Put another way, in Congress’s calculation, U.S. Shareholder has not earned a super-normal return and yet is charged under the GILTI regime as if it earned intangible income solely as a result of the Tested Loss CFC QBAI Exclusion. Further, the Tested Loss CFC QBAI Exclusion may be easily avoided by combining operations in a single CFC (which could be effected as easily as changing an entity’s U.S. federal tax classification) because there is no corollary to the Tested Loss CFC QBAI Exclusion for partnerships or disregarded entities. In the original example above, were the equipment instead contributed to a single CFC (or operated in disregarded entities of a single holding company CFC), U.S. Shareholder’s Net CFC Tested Income would remain \$8x, but its NDTIR would be determined by reference to the \$120x investment and therefore U.S. Shareholder would have no GILTI Inclusion Amount.

In light of the foregoing, we recommend that Treasury and the Service should consider eliminating the Tested Loss CFC QBAI Exclusion. In our view, the result under this exclusion is not compelled by the statute because it reaches different results based on the location of relevant income and expense among related CFCs.

Proposed Regulation section 1.951A-3(g)(1) states that “[a] tested loss CFC has no partnership QBAI for a CFC inclusion year.”⁴⁹ If the Tested Loss CFC QBAI Exclusion is to remain, we recommend that it be similarly clarified in Proposed Regulation section 1.951A-3(b) and Proposed Regulation section 1.951A-3(c) that the Tested Loss CFC QBAI Exclusion applies only for a CFC Inclusion Year with respect to which a CFC is a Tested Loss CFC.

b) Dual Use Property

In Proposed Regulation section 1.951A-3(d), Treasury and the Service proposed rules for computing QBAI with respect to “dual use property.” QBAI for “dual use” Specified Tangible Property (*i.e.*, tangible property of the CFC used in the production of Gross Tested Income and gross income that is not Tested Income) is determined by multiplying the average of the Tested Income CFC’s adjusted basis in the dual use Specified Tangible Property by a “dual use ratio,” which varies depending on whether the Specified Tangible Property produces directly identifiable income.⁵⁰

The Proposed Regulations would apply the “dual use” ratio to the average of the Tested Income CFC’s adjusted basis, which average is determined under the rules of Proposed Regulation section 1.951A-3(b), (e), and (f) based on the Specified Tangible Property held as of the close of each quarter of a CFC inclusion year (with modifications for short taxable years). While the Proposed Regulations present a reasoned and administrable application of the section 951A(d)(2)(B), the statute does not address how the average is computed when property becomes or ceases to be Specified Tangible Property during the year (including across a quarter

⁴⁹ (Emphasis added).

⁵⁰ Prop. Reg. § 1.951A-3(d)(1), -3(d)(2).

end), nor to what extent, if any, changes in the amount of Tested Income produced by property are taken into account. The implication of the Proposed Regulation section 1.951A-3(d) is that property that produces Tested Income at any point in a CFC Inclusion Year is treated as Specified Tangible Property for the entire year (and across the close of all quarters) for purposes of computing the average of the Tested Income CFC's adjusted basis in Specified Tangible Property.

We recommend that the final Regulations include examples concluding that the analysis in the example in Proposed Regulations section 1.951A-3(d)(3) would be the same if the machine produced only foreign base company sales income for the first three quarters of Year 1 and only gross tested income for the last quarter of Year 1, or if the machine produced only minimal gross tested income in the first three quarters of Year 1 and produced the balance of its tested income in the final quarter of Year 1. We would also welcome examples demonstrating the opposite (*e.g.*, that the analysis in the example is the same if the machine produced its \$750x of gross tested income on the first day of Year 1).

Thus, we recommend that the final Regulations include the following examples in addition to the current example in Proposed Regulation 1.951A-3(d):

Example 2: Same facts as Example 1,⁵¹ except that FS's taxable year is the calendar year and the machine produces only foreign base company sales income of \$250x from January 1 through September 30, and produces only gross tested income of \$750x from October 1 through December 31. The analysis is the same as in Example 1.

Example 3: Same facts as Example 1,⁵² except that FS's taxable year is the calendar year and the machine produces gross tested income of \$10x in each of the quarters ending March 31, June 30, and September 30, and \$720x of gross tested income in the quarter ending December 31. The analysis is the same as in Example 1.

c) Alternative Depreciation System

(1) Election for All Taxpayers to Use Depreciation Method Used by the CFC in Computing Tested Income or Tested Loss

Proposed Regulation section 1.951A-3(e) provides that the adjusted basis in Specified Tangible Property is determined by using the ADS under section 168(g), even if the basis of the property is determined using another depreciation method for other purposes of the Code.

We believe that, in some circumstances, the Proposed Regulations as written may present an administrative burden on some taxpayers. We recommend that the final Regulations provide an election to allow taxpayers to use the adjusted basis of its Specified Tangible Property determined under the depreciation method used by the CFC in computing its Tested Income or Tested Loss.

⁵¹ Prop. Reg. § 1.951A-3(d)(3)(i)(A).

⁵² *Id.*

Because the ADS is less accelerated than other depreciation methods, including the Modified Accelerated Cost Recovery System (the “MACRS”), the use of the ADS should generally result in the adjusted basis of a CFC’s Specified Tangible Property for purposes of determining QBAI being higher than the adjusted basis of such Specified Tangible Property determined under the method used by the CFC in computing its Tested Income or Tested Loss. We would expect that the vast majority of a CFC’s Specified Tangible Property is used predominantly outside of the United States and therefore is already subject to the ADS under section 168(g)(1)(A). Thus, the difference between the adjusted basis of its Specified Tangible Property determined using the ADS and the adjusted basis of such Specified Tangible Property under the depreciation method used by the CFC in computing its Tested Income or Tested Loss should not be significant. We believe that requiring a CFC to recompute depreciation on Specified Tangible Property and maintain a record of such depreciation for each item of Specified Tangible Property, particularly when there may only be a few items that are not already depreciated under the ADS, could present an administrative burden on some taxpayers. Providing a taxpayer with an election to use the adjusted basis of its Specified Tangible Property determined under the same depreciation method used by the CFC in computing its Tested Income or Tested Loss, when such amount is likely to reduce the amount of a CFC’s QBAI and increase a U.S. Shareholder’s GILTI Inclusion Amount, provides a reasonable alternative that should be available to a taxpayer that finds the administrative task of recomputing depreciation of Specified Tangible Property using the ADS and maintaining an additional set of depreciation records to be unduly burdensome.

6. Proposed Regulation Section 1.951A-3(h)(1), Anti-Abuse Rule for Temporarily Held Property

The Proposed Regulations include a general anti-abuse rule that disregards the tax basis of Specified Tangible Property for purposes of determining QBAI if the property was acquired with a principal purpose of reducing the GILTI Inclusion Amount of a U.S. Shareholder and the CFC holds the property temporarily but over at least the close of one quarter.⁵³ In addition, Specified Tangible Property that is held for less than a 12-month period that includes at least the close of one quarter is treated as temporarily held and acquired with a principal purpose (the “12-Month Rule”).⁵⁴

We support the general principal purpose rule because we believe it is necessary to prevent a taxpayer from artificially increasing its share of QBAI. The rule is also consistent with section 951A(d)(4), which calls for Regulations to address property that “is transferred, or held, temporarily” or situations where “the avoidance of the purposes of this paragraph is a factor in the transfer or holding of such property.” The Conference Report states: “[t]he conferees intend that non-economic transactions intended to affect tax attributes of CFCs and their U.S. Shareholders (including amounts of tested income and tested loss, tested foreign income taxes, net deemed tangible income return, and QBAI) to minimize tax under this provision be disregarded.”⁵⁵

⁵³ Prop. Reg. § 1.951A-3(h)(1).

⁵⁴ *Id.*

⁵⁵ H.R. Rep. No. 115-466, at 645 (2017) (Conf. Rep.).

The 12-Month Rule, however, will potentially disallow the tax basis of property acquired and sold in ordinary course (*i.e.*, commercial transactions that are not tax motivated). In addition, a taxpayer may not know whether the tax basis of Specified Tangible Property held by a CFC at year end should be computed in QBAI or not. If, for instance, a calendar year CFC purchases Specified Tangible Property on June 15 of Year 1 for valid business reasons without any plan to transfer it, holds it over year end, and then (again, for valid business reasons) sells it on June 1 of Year 2, a U.S. Shareholder's calculation of QBAI for Year 1 will likely be incorrect in the first instance under the 12-Month Rule. The U.S. Shareholder may need to amend its Year 1 tax return to address a transaction that occurs in Year 2.

Based on the foregoing, we believe that the burdens imposed by the 12-Month Rule outweigh the benefits of having a bright line rule, and we recommend that the 12-Month Rule be eliminated. Alternatively, if Treasury and the Service are concerned that the general anti-abuse rule will be too difficult to police without a more specific time-related governor, we recommend that the 12-Month Rule be reformulated as (i) a presumption that can be rebutted in all cases involving Specified Tangible Property held for less than a 12-month period, or (ii) keeping the 12-Month Rule as currently proposed when Specified Tangible Property is sold to a related party, but allow taxpayers to rebut the presumption for other sales within the 12-month period that are accompanied with a required disclosure, such as that provided in Regulation section 1.707-8.⁵⁶ This would allow a taxpayer to provide evidence that the Specified Tangible Property was not acquired with a tax-motivated principal purpose.

Finally, we recommend that if a 12-month holding period is retained (whether as the currently formulated 12-Month Rule or as a rebuttable presumption), Treasury and the Service adopt the tacking rules of section 1223 in calculating the holding period. In a situation, for instance, where Specified Tangible Property is obtained with a carryover basis, the property should not be treated as newly acquired for purposes of the 12-Month Rule.

7. Proposed Regulation Section 1.951A-3(h)(2), Anti-Abuse Rule for Disqualified Period Transfers

a) Background

The Proposed Regulations include rules to disallow the taxpayer's use of disqualified basis in determining QBAI and in determining Tested Income or Tested Loss. "Disqualified basis," as discussed below, is basis created by transfers of property among related persons where due to the effective date of section 951A, the gain giving rise to the basis is not taken into account in computing the seller's GILTI.⁵⁷ In the case of such a Disqualified Transfer of property, the Proposed Regulations would prevent a taxpayer from using the basis created in the acquisition of the property for purposes of reducing GILTI, except to the extent that the

⁵⁶ Regulation section 1.707-8 requires disclosure of certain information related to transactions that may fall under the section 707 disguised sales rules. The disclosure includes (i) a caption identifying the statement as a disclosure under section 707; (ii) an identification of the item (or group of items) with respect to which the disclosure is made; (iii) the amount of each item; and (iv) the facts affecting the potential tax treatment of the item(s) under section 707. Reg. § 1.707-8(b).

⁵⁷ Prop. Reg. § 1.951A-3(h)(2).

transferring CFC's gain on the sale was subject to U.S. tax as effectively connected income or was taken into account in determining Subpart F Income.⁵⁸

The possibility for a Disqualified Transfer to occur without U.S. tax to the shareholder under GILTI or section 965 is a product of the statutory effective dates. Regardless of a CFC's taxable year, section 965 measures deferred foreign income as of either November 2, 2017, or December 31, 2017.⁵⁹ By contrast, the GILTI rules are generally effective for the taxable years of CFCs beginning after December 31, 2017, and the taxable years of U.S. Shareholders in which or with which such taxable years end.⁶⁰ Thus, in the case of a fiscal year CFC, a portion of its last taxable year beginning before December 31, 2017, is subject to neither GILTI nor section 965 (such period, the "disqualified period" within the meaning of Proposed Regulation section 1.951A-3(h)(2)(ii)(D) (the "Disqualified Period")). A CFC with a calendar year as its taxable year, by contrast, has no Disqualified Period because the first day after December 31, 2017, is in a year to which section 951A applies.⁶¹ The legislative history is silent as to why Congress staggered the effective dates of GILTI and section 965 in this manner; however, it may have been to avoid the complexity of coordinating GILTI and section 965 in a taxable year that straddles the old and the new rules.

The Proposed Regulations contain two parallel sets of rules limiting the taxpayer's use of disqualified basis arising as a result of a Disqualified Transfer (discussed below).⁶² Both rules operate based on defined terms in the portion of the Proposed Regulations addressing QBAI. Disqualified basis is defined as the excess of adjusted basis of property after a Disqualified Transfer (discussed below), minus the "qualified gain amount" with respect to the transfer.⁶³ The Proposed Regulations provide that disqualified basis in the property may be reduced or eliminated through events such as depreciation or amortization of the property, as well as sales, exchanges, or other transactions that result in recovery or elimination of basis.

"Disqualified Transfer" is defined broadly to mean any disposition by a CFC during the Disqualified Period to any related person.⁶⁴ Indirect transfers, such as a sale of a partnership interest with a section 754 election, are also included in the definition of a Disqualified Transfer.⁶⁵ Although described in Preamble as an "anti-abuse provision,"⁶⁶ the Disqualified Transfer rules operate mechanically without regard to the taxpayer's intent.

⁵⁸ Prop. Reg. § 1.951A-3(h)(2)(ii)(B) (qualified gain amount).

⁵⁹ I.R.C. § 965(a)(1), (a)(2).

⁶⁰ The Act, Pub. L. No. 115-97, § 14201(d), 131 Stat. 2054 (2017).

⁶¹ See Prop. Reg. § 1.951A-3(h)(2)(ii)(D), 83 Fed. Reg. 51072 (2018).

⁶² Prop. Reg. § 1.951A-3(h)(2) (QBAI); Prop. Reg. § 1.951A-2(c)(5) (Tested Income or Tested Loss).

⁶³ Prop. Reg. § 1.951A-3(h)(2)(ii)(A). The "qualified gain amount" in turn means (i) the amount of gain subject to U.S. federal income tax under section 882 as effectively connected income (after taking into account treaty reductions) and (ii) any U.S. Shareholder's pro rata share of the gain recognized by the transferor that is taken into account in determining the shareholder's Subpart F Income inclusion. See Prop. Reg. § 1.951A-3(h)(2)(ii)(B).

⁶⁴ Prop. Reg. § 1.951A-3(h)(2)(ii)(C).

⁶⁵ *Id.*

⁶⁶ 83 Fed. Reg. 51072, 51077 (2018) (Preamble).

Where a CFC has disqualified basis in property, the effects are two-fold. First, if the property with disqualified basis is Specified Tangible Property, the disqualified basis is not taken into account for purposes of determining QBAI or the NDTIR.⁶⁷ Second, and more broadly, any deduction or loss attributable to disqualified basis of any Specified Property that is allocated and apportioned against Gross Tested Income is disregarded for determining Tested Income or Tested Loss.⁶⁸ As previously discussed, Specified Tangible Property is any property of a type that is amortizable under section 167 or 197.⁶⁹ As illustrated by the Example in Proposed Regulation section 1.951A-2(c)(5), the latter rule would disregard for Tested Income purposes the amortization of a step up in basis of an intangible sold from CFC1 to CFC2 during the Disqualified Period, except to the extent that CFC1's gain recognized was subject to U.S. tax as income effectively connected with a U.S. trade or business ("ECI") or Subpart F Income.⁷⁰

b) Comments

We do not discuss here whether the Disqualified Transfer rules should be included in the final Regulations for GILTI. Rather, assuming the Disqualified Transfer rules are retained, we offer the following recommendations for improvement of the rules.

First, we recommend that the Disqualified Transfer rules should not be expanded beyond the scope set out in the Proposed Regulations. For example, we recommend against extending the Disqualified Transfer rules to transfers of property between *unrelated* persons. Even if an unrelated party sale gives rise to basis in the hands of the purchaser that is not included in GILTI or Subpart F Income of the seller, third party sales are fundamentally different from the "non-economic transactions intended to affect tax attributes . . . to minimize tax under [GILTI]" referenced in the Conference Report.⁷¹ A permanent sale to an unrelated person will by its nature be motivated predominantly by non-tax considerations. Such a transaction, including a sale of CFC stock with a section 338(g) election, is not likely to be undertaken to manipulate tax attributes of the taxpayer's CFCs, since the additional amortization and QBAI will inure to the buyer. Moreover, a transfer of property to an unrelated person is not materially different from the earning of operating income by a fiscal year CFC during the Disqualified Period, which Congress, by staggering the effective date of section 951A and the measurement date under section 965, necessarily provided would not be subject to GILTI tax. Therefore, we recommend the Disqualified Transfer rules continue to be limited to transfers between related persons and that our recommendation be implemented by amending the current Proposed Regulation section, not by adding another section to the final Regulations (under section 951A or another section of the Code).

Second, we recommend that the disqualified basis rules for Tested Income or Tested Loss should be coordinated with the covered asset acquisition rules under section 901(m) to avoid the application of two anti-abuse rules on the same transaction. Depending on the structure, a

⁶⁷ Prop. Reg. § 1.951A-3(h)(2)(i).

⁶⁸ Prop. Reg. § 1.951A-2(c)(5)(i).

⁶⁹ Prop. Reg. § 1.951A-2(c)(5)(ii).

⁷⁰ If the transferring CFC has a calendar year as its taxable period, there is no Disqualified Period and the Disqualified Transfer rules would not apply. See Prop. Reg. § 1.951A-2(h)(2)(iii), Ex. (2).

⁷¹ H.R. Rep. No. 115-466, at 645 (2017) (Conf. Rep.).

Disqualified Transfer may also have constituted a “covered asset acquisition” under section 901(m) (e.g., a sale of an interest in a disregarded entity). In such a case, the deductions for amortization of the disqualified basis that are disregarded for determining Tested Income or Tested Loss would seem nonetheless to constitute an “aggregate basis difference” for purposes of section 901(m).⁷² More specifically, the Disqualified Transfer rules (i) do not take into account certain basis step ups for purposes of determining QBAI of a Tested Income CFC for a CFC inclusion year,⁷³ and (ii) disregard certain deductions and losses attributable to qualified basis of any Specified Property allocated and apportioned to Gross Tested Income under Proposed Regulation section 1.951A-2(c)(3).⁷⁴ Those rules, however, do not appear to have any impact on the application of section 901(m) and its denial of certain section 960 foreign tax credits with respect to foreign income taxes paid by a CFC.⁷⁵ In general, under section 901(m), when a target corporation, for example, is acquired for purposes of a local jurisdiction’s tax law but is treated as an acquisition of foreign assets for U.S. federal income tax purposes (a type of “covered asset acquisition”),⁷⁶ the “disqualified portion” of any foreign income determined with respect to the income or gain attributable to those acquired foreign assets is not taken into account for purposes of the section 960 foreign tax credit. The term “disqualified portion” with respect to any taxable year, refers to the ratio of the “aggregate basis differences” of the foreign assets divided by the income of which the foreign income taxes paid by the acquiring CFC.⁷⁷ The term “aggregate basis difference” refers to the excess of the adjusted basis of an asset immediately after the covered asset acquisition over the adjusted basis of that asset immediately before the acquisition.⁷⁸ Importantly, the definition of disqualified portion does not appear to take into account whether the basis step up resulted in deductions that actually reduced U.S. federal income tax. Further, the definition of “basis difference,” appears to apply for all U.S. federal income tax purposes compared to the Disqualified Transfer Rules which only deny the benefits of a basis step up for certain section 951A-related purposes.

As a result, arguably a portion of the CFC’s Tested Foreign Income Taxes would be disallowed as a foreign tax credit under section 901(m). The concurrent application of section 901(m) and Proposed Regulation section 1.951A-2(c)(5) would unduly penalize the taxpayer by disallowing the depreciation or amortization deductions in computing Tested Income or Tested Loss, while also reducing the taxpayer’s foreign tax credits to neutralize the effect of those depreciation or amortization deductions even though they did not actually reduce the CFC’s income to which those foreign tax credits relate. Accordingly, we recommend that the

⁷² See I.R.C. § 901(m)(3)(C) (basis difference); Temp. Reg. § 1.901(m)-5T(b) (providing that the basis difference allocated to a year is generally determined by applying the applicable cost recovery method to the basis difference in the relevant foreign asset).

⁷³ Prop. Reg. § 1.951A-3(h)(2).

⁷⁴ Prop. Reg. § 1.951A-2(c)(5).

⁷⁵ See I.R.C. § 901(m)(1)(B).

⁷⁶ I.R.C. § 901(m)(2)(B).

⁷⁷ I.R.C. § 901(m)(3)(A).

⁷⁸ I.R.C. § 901(m)(3)(C)(i).

Regulations provide that deductions or loss attributable to disqualified basis also be disregarded for purposes of section 901(m).

8. Proposed Regulation Section 1.951A-4, Tested Interest Expense and Tested Interest Income

As discussed above, a shareholder's GILTI Inclusion Amount is the excess of its Net CFC Tested Income over its NDTIR, with the definition of the latter dependent, in part, upon the amount of the U.S. Shareholder's Specified Interest Expense. To calculate a U.S. shareholder's Specified Interest Expense, one must determine how much CFC interest income is "attributable" to CFC interest expense. Observing that the amount of interest income "attributable" to interest expense is not defined in section 951A(b)(2)(B), the Proposed Regulations adopted a netting approach, rather than a tracing approach, to attribute interest income to interest expense under section 951A(b)(2)(B). Under the netting approach, a U.S. Shareholder's Specified Interest Expense is equal to the excess of the U.S. Shareholder's aggregate pro rata share of each CFC's Tested Interest Expense over the U.S. Shareholder's aggregate pro rata share of each CFC's Tested Interest Income.⁷⁹

Determining a U.S. Shareholder's pro rata share of Tested Interest Expense and Tested Interest Income is essential to the application of this netting approach. The Proposed Regulations generally provide that the term Tested Interest Expense means interest expense paid or accrued by a CFC and taken into account in determining the Tested Income or Tested Loss of the CFC for the CFC Inclusion Year under Proposed Regulation section 1.951A-2(c), and that the term Tested Interest Income means interest income included in the Gross Tested Income of a CFC for the CFC Inclusion Year. For these purposes, the terms "Interest Expense" and "Interest Income" mean any expense or loss, on the one hand, or any income or gain, on the other hand, that is treated as such by reason of the Code or the Regulations. But the Proposed Regulations also include a broader definition in each case, so that the terms include any other expense or loss incurred (or any other income or gain recognized) "in a transaction or series of integrated or related transactions" in which the use of funds is secured for a period of time if such expense or loss is "predominately incurred in consideration of the time value of money" (or in which the forbearance of funds is secured for a period of time if such income or gain is "predominately derived from consideration of the time value of money").⁸⁰

We agree that the proposed netting approach to resolve the meaning of "attributable to." Notwithstanding the above, however, we do recommend reconsideration with respect to two positions: (i) the breadth of the terms "Interest Expense" and "Interest Income," and (ii) the treatment of Interest Expense and Interest Income of a CFC with a Tested Loss.

As discussed above, the term "Interest Expense" is initially defined to mean "any expense or loss that is treated as interest expense by reason of [the Code] or the [R]egulations thereunder," while "Interest Income" is initially defined to mean "any income or gain that is treated as interest income by reason of [the Code] or the [R]egulations thereunder." Left in such a state, such definitions might be too narrow, and we think it appropriate to include all amounts

⁷⁹ Prop. Reg. § 1.951A-1(c)(3)(iii).

⁸⁰ Prop. Reg. § 1.951A-4(b)(1)(ii), -4(b)(2)(ii).

properly treated as interest for tax purposes. However, we suggest that the currently proposed final clauses of the two definitions may introduce significant challenges, uncertainties, and confusion with respect to the application of section 951A(c)(2)(A)(ii).⁸¹

As a starting point, the concepts of “predominately incurred in consideration of the time value of money” and “predominately derived from consideration of the time value of money” may be argued to introduce new concepts. While their general intention may be clear, their actual meaning is not and would appear to lack clear analogies in other authorities relating to the characterization of items of income or loss as interest income, interest expense, or otherwise. This introduction of a new, uncertain standard is further complicated by references to “transaction or series of integrated or related transactions.” The closest analogy to this language appears to be portions of the Temporary Regulations addressing the allocation and apportionment of interest expense and focusing specifically on expenses or losses relating to certain interest equivalents. But those Regulations only address the allocation and apportionment of such expenses and losses, they do not provide characterization of actual expenses, let alone income. It can further be argued that the potential costs associated with such uncertainty is greater in the case of the definitions of “Interest Expense” and “Interest Income,” as those items will uniquely impact the calculation of NDTIR.

Based on the foregoing, we recommend that the definitions of “Interest Expense” and “Interest Income” be revised to remove references to the concepts of “predominately incurred in consideration of the time value of money” and “predominately derived from consideration of the time value of money,” respectively, as well as references to “transaction or series of integrated or related transactions,” and to replace these with references to expense or income arising by reason of the Code or the Regulations or as a consequence of issuing or holding an instrument that is treated as debt for U.S. federal income tax purposes, such as instruments that are characterized as debt under judicial factors, instruments that are characterized as debt under administrative guidance (*e.g.*, secured financing arrangements under the principles of Revenue Ruling 74-27),⁸² or payments “equivalent to interest”.⁸³

We also recommend that Treasury and the Service reconsider its position, stated in the Preamble, regarding comments received requesting clarification of whether the interest expense of a Tested Loss CFC is used in the determination of Specified Interest Expense. Some public comments have noted that including interest expense of a Tested Loss CFC for the purposes of section 951A(b)(2)(B) while excluding that CFC’s Specified Tangible Property (and, thus, its QBAI) from the determination of a U.S. Shareholder’s DTIR may lead to anomalous results. The Preamble responded to these comments by stating that “[r]egardless of whether interest

⁸¹ Such definitions are as follows: “any other expense or loss incurred in a transaction or series of integrated or related transactions in which the use of funds is secured for a period of time if such expense or loss is predominately incurred in consideration of the time value of money” in the case of Interest Expense, and “any other income or gain recognized in a transaction or series of integrated or related transactions in which the forbearance of funds is secured for a period of time if such income or gain is predominately derived from consideration of the time value of money” in the case of Interest Income. Prop. Reg. § 1.951A-4(b)(1)(ii) (interest expense); Prop. Reg. § 1.951A-4(b)(2)(ii) (interest income).

⁸² Rev. Rul. 74-27, 1974-1 C.B. 24.

⁸³ See, *e.g.*, Reg. § 1.954-2(h)(2).

expense increases Tested Loss or reduces Tested Income, the expense is ‘taken into account . . . in determining the shareholder’s net CFC tested income’ within the meaning of section 951A(b)(2)(B)” and also by voicing the concern that “if a tested loss CFC’s interest expense were not taken into account for purposes of determining specified interest expense, a taxpayer could easily avoid specified interest expense by incurring offshore debt through a tested loss CFC.” Accordingly, the Proposed Regulations provide that any interest expense taken into account for purposes of determining the Tested Income or Tested Loss of a CFC is also taken into account in determining a U.S. Shareholder’s Specified Interest Expense.

We recommend that Treasury and the Service reconsider this position. It is true, as discussed in the Preamble, that the Conference Report notes that “specified tangible property does not include property used in the production of tested loss, so that a CFC that has a tested loss in a taxable year does not have QBAI for the taxable year.”⁸⁴ But the Conference Report does not appear to compel the same strict reading of the phrase “taken into account . . . in determining the shareholder’s net CFC tested income” that the Proposed Regulations adopt. A general exclusion of the interest expense and interest income of a Tested Loss CFC for the purposes of calculating Specified Interest Expense, coupled with an anti-abuse rule, if necessary, would produce more appropriate results.

We believe that the position taken by Treasury and the Service create a cliff effect that, like most cliff effects, can lead to vastly different results based on minor differences in inputs. To illustrate this concern, consider the following example:

A Corp, a domestic corporation, owns 100% of the single class of stock of each of FS1 and FS2, each a CFC. A Corp, FS1, and FS2 all use the calendar year as their taxable year. In Year 1, FS1 and FS2 each pay \$100x of interest to a bank that is not related to A Corp, FS1, or FS2. The interest paid by each of FS1 and FS2 is taken into account in determining the Tested Income and Tested Loss of FS1 and FS2 under Proposed Regulation section 1.951A-2(c). For Year 1, before taking into account interest expense, FS1 has \$600x of Tested Income and no expenses other than the \$100 of interest expense, and FS2 has \$700x of income and \$599x of deductible expenses in addition to the \$100x of interest expense. FS1 has QBAI of \$1,000x and FS2 has QBAI of \$2,000x. Neither FS1 nor FS2 is a qualified CFC.⁸⁵

In this example, both FS1 and FS2 are Tested Income CFCs, and thus Specified Tangible Property of each may be used to calculate QBAI. A Corp should have Net CFC Tested Income of \$501x, Specified Interest Expense of \$200x, and NDTIR of \$100x, and a GILTI inclusion of \$401x.

If, however, the facts are the same as in the prior example, except that FS2 has \$601x of deductible expenses, rather than \$599x, in addition to the \$100x of interest, FS2’s Specified Tangible Property may not be used to calculate QBAI. If its \$100x of interest expense is still

⁸⁴ See H.R. Rep. No. 115-466, at 642, fn. 1536 (2017) (Conf. Rep.). Alternately, see the suggestion discussed in Part II.D.5.A of these Comments.

⁸⁵ A “qualified CFC” means an eligible CFC within the meaning of section 954(h)(2) or a qualifying insurance company within the meaning of section 953(e)(3). Prop. Reg. § 1.951A-4(b)(iv).

Adjustment rule and, if added, how it should be designed in order to ensure it is limited in its reach to the prevention of a double deduction. Treasury should not craft a rule that imposes an additional tax burden on taxpayers beyond that contemplated by Congress and prevents taxpayers from realizing the full economic benefit of a loss. The federal courts have in the past rejected Treasury efforts to prevent taxpayers from recognizing a duplicated loss when the Treasury rule was insufficiently narrow to ensure that a taxpayer benefitted from at least one economic loss. Even though the anti-loss duplication provisions of former Regulation section 1.1502-20 were intended to prevent a double benefit from a single economic loss, the Court of Appeals for the Federal Circuit, in *Rite-Aid Corp. v. United States*,⁸⁸ invalidated those Regulations, which limited a consolidated group member's ability to recognize a loss in the stock of another member upon its disposition to the extent of the aggregate inside built-in loss in the assets of that other member, because the Regulation eliminated the selling member's ability to fully recognize an economic loss pursuant to section 165 without express Congressional authority to issue Regulations to that effect. Similarly, the proposed Stock Basis Adjustment Rule in its operation goes beyond the stated goal of preventing a double deduction. Because it applies whether or not the taxpayer receives any benefit from the Tested Loss, it deprives the taxpayer the full use of its economic loss and operates as a penalty for those taxpayers who have Tested Losses.

As an initial matter, the benefit derived by a domestic corporate U.S. Shareholder from the application of a Tested Loss is limited in comparison to the potential benefit from an equal amount of basis. Stock basis reduces gain or increases a loss at an effective tax rate of 21% (the U.S. corporate tax rate). Tested Income, however, is taxed at an effective rate of 10.5% as a result of the section 250 deduction available to domestic corporate taxpayers equal to 50% of the sum of GILTI and the section 78 amount attributable to GILTI.⁸⁹ Thus, a U.S. Shareholder's benefit derived from the future ability to reduce gain or increase loss through its CFC stock basis exceeds the benefit such shareholder would enjoy using that CFC's Tested Loss to reduce another CFC's Tested Income. This benefit disparity indicates that, at most, only one half of the benefit received from Tested Loss CFC basis is a duplicative benefit.

Neither does Tested Income give rise to GILTI to the extent of the NDTIR. Accordingly, when a Tested Loss reduces Tested Income, it will not affect the U.S. Shareholder's GILTI inclusion to the extent that the Tested Loss reduces Tested Income not in excess of NDTIR, and no benefit is derived by the U.S. Shareholder by that reduction of Tested Income.

Further, it is generally the case that, in practice, a taxpayer frequently derives an even lower benefit from the reduction of Tested Income (and reduction of GILTI) as a result of the availability of credits for deemed paid foreign taxes, pursuant to section 960(d), that offset the U.S. corporate tax imposed on GILTI. In many cases, Tested Income is effectively exempt from U.S. tax as a result of the section 960(d) deemed paid foreign taxes and, in such cases, the application of Tested Losses against Tested Income provides no benefit—especially taking into account the inability to carry forward section 960(d) foreign tax credits.

⁸⁸ 255 F.3d 1357 (Fed. Cir. 2001).

⁸⁹ The section 250 deduction decreases to 37.5% for tax years beginning after December 31, 2025. For simplicity, we generally refer to the 50% deduction in this discussion but, where relevant, the recommended approach is intended to take into account this decrease in the section 250 deduction for future years in which it comes into effect.

A further important consideration is that the Stock Basis Adjustment Rule imposes on domestic corporations a complex regime of annually computing for each CFC in which it is a U.S. Shareholder the used Tested Loss or Offset Tested Income amount and accumulating such amounts for each CFC year by year. It also imposes a complex set of rules applicable upon a direct or indirect disposition of a CFC, frequently requiring adjustments to basis up through tiers of CFCs, giving rise to potential gain at intermediate levels if there is insufficient basis to cover the basis reduction, requiring consideration of the application of section 964(e), computation of Subpart F Income and GILTI arising from gain recognition on lower-tier CFC stock, as well as the making of basis adjustments up through the tiers under section 960(a) and (c), to simply name a few of the potential consequences. Thus, not only are domestic corporations required to maintain a complex set of computations through the years for each of their CFCs, but there would be significantly increased complexity to determining the consequences of a disposition of CFC stock (particularly in multi-tier structures) than there is under current law.

In the context of a rule that was not expressly sanctioned by Congress in its crafting of the GILTI regime, these two considerations, first, the breadth of the rule, which goes beyond the goal of preventing a double benefit (and perhaps beyond authority conferred under the relevant case law to prevent double deductions), and, second, the increased complexity and burden imposed on taxpayers by the rule, we recommend that Treasury withdraw the rule from future Regulations.

In the event that Treasury does not accept this recommendation and decides to include a stock basis adjustment rule in final Regulations, we believe the rule should be revised to bring into conformity with Treasury's stated goal of preventing a duplicative benefit of a Tested Loss, such that the rule operate to solely eliminate any potential duplicated tax benefit from the use of a Tested Loss.

Specifically, we recommend that any stock basis adjustment pursuant to the rule should not exceed the amount that will offset the tax effected benefit actually derived from the application of Tested Loss to Tested Income. To this end, we recommend that the Stock Basis Adjustment Rule included in the final Regulations include a tax effected benefit computation mechanism such as the one we describe below.

As indicated above, the maximum basis adjustment that would achieve this result would be 50% of the Used Tested Loss Amount (in the case of Tested Income that does not give rise to deemed paid foreign taxes). In the case of Tested Income that gives rise to deemed paid foreign taxes, the percentage would be lower, including a percentage of zero for Tested Income that gives rise to deemed paid taxes at a rate of 10.5%.⁹⁰ The fact that section 951A computes GILTI by aggregating Tested Income and Tested Loss facilitates the computation of this percentage. For a taxpayer that has net GILTI (*i.e.*, aggregate Tested Income exceeds aggregate Tested Loss), the tax effected benefit of a used Tested Loss in a given tax year generally should be the amount of the used Tested Loss in such year multiplied by the percentage for such year (but at a minimum percentage of zero) equal to:

⁹⁰ Section 960(d) gives rise to deemed paid foreign taxes equal to the U.S. Shareholder's pro rata portion of 80% of the aggregate tested foreign income taxes paid or accrued by the CFC. As such, the CFC's Tested Income would generally need to be taxed at a rate of 13.125% in order to give rise to deemed paid foreign taxes at a rate of 10.5%.

further consideration should be given to the question of whether, and how, to adjust the “50%” factor in the TEBRP formula in such cases.

Neither do we take into account limitations on the creditability of section 960(d) as a consequence of the foreign tax credit limitation (because of interest expense allocable to GILTI, for example). Treasury has not yet issued Proposed Regulations or other guidance on the operation of the foreign tax credit limitation of section 904 with respect to GILTI. Accordingly, it is difficult to comment on the effect if any that the foreign tax credit limitation, to the extent it limits the availability of section 960(d) deemed paid foreign taxes, should have on the computation of the TEBRP. If it is determined that the tax effected benefit of a used Tested Loss should take into account the potential application of the foreign tax credit limitation to section 960(d) deemed paid foreign taxes, the TEBRP could be adjusted to take into account the effect of the foreign tax credit limitation by performing a hypothetical limitation computation to determine if the full amount of the section 960(d) taxes would have been creditable had Tested Losses not been applied to Tested Income. The section 960(d) taxes in the numerator of the TEBRP formula could be adjusted accordingly.

The computation of a TEBRP facilitates the computation of tax effected Net Used Tested Loss Amounts for each CFC. Each year, the domestic corporate shareholder would compute the TEBRP for the year using the method described above. Each year, the tax effected Used Tested Loss Amount or Offset Tested Income amount would be computed for each CFC by multiplying the Used Tested Loss Amount or the Offset Tested Income amount, as the case may be, for such CFC by that year’s TEBRP. Thus, the tax effected computations are the same as the non-tax effected computations currently set forth in the Proposed Regulations, but merely adjusting the non-tax effected amounts of used Tested Loss and Offset Tested Income each year by the TEBRP for the year and accumulating the tax effected Used Tested Loss Amount accordingly over time to arrive at a tax effected Net Used Tested Loss Amount. As discussed in Part II.D.10 below, in the case of consolidated group computations, the provisions of Proposed Regulation sections 1.1502-51(c) and 1.1502-32 can be coordinated with the tax effected used Tested Loss and tax effected Offset Tested Income amounts computed for purposes of Proposed Regulation section 1.951A-6(e).

In the case of a U.S. Shareholder that has aggregate Tested Losses that equal or exceed the amount of aggregate Tested Income minus the NDTIR, there will be no GILTI, section 250 deduction, or section 960(d) deemed paid taxes. In such cases, the taxpayer can do a hypothetical computation of TEBRP by determining what the GILTI, section 250 deduction, and the section 960(d) deemed paid taxes would have been in the event that there had been no Tested Loss amount and computing the TEBRP using these hypothetical figures.

In any case, however, in which aggregate Tested Losses exceed aggregate Tested Income minus the NDTIR, some portion of the aggregate Tested Loss applied to aggregate Tested Income is reducing aggregate Tested Income that did not exceed the NDTIR. Use of such portion of a Tested Loss does not result in a tax benefit to the domestic corporate shareholder because aggregate Tested Income up to the amount of the NDTIR does not give rise to GILTI, pursuant to section 951A(b)(1).⁹⁴ Under the proposed Stock Basis Adjustment Rule, however, the definition of a used Tested Loss treats the full amount of a Tested Loss that reduces Tested

⁹⁴ GILTI is the excess of net CFC Tested Income over NDTIR.

account only tax effected basis adjustment amounts, such an election would be even more necessary if Treasury and the Service were to decide to issue a non-tax effected stock basis adjustment rule. In that case, the election would be the only mechanism for many taxpayers, particularly those with high-taxed foreign income, through which they could give tax effect to their economic losses in CFCs upon disposition.

The Stock Basis Adjustment Rule should also address the consequences of a mid-year sale of a Tested Loss CFC. If a Tested Loss CFC maintains its status as a CFC after the sale, the Stock Basis Adjustment Rule may give rise to an uneconomic gain to the purchasing U.S. Shareholder. Because the selling U.S. Shareholder will not hold the stock as of the CFC Inclusion Date (*i.e.*, the last day of the CFC's year on which a foreign corporation is a CFC), the seller will not get the benefit of the Tested Loss applied against its Tested Income. The seller might, however, get the benefit of the loss in the computation of its taxable income or loss on the sale of the stock. The buyer will be obtaining fair market value basis on the stock but will have to make an adjustment to stock basis (to be made immediately before a future disposition) to the extent that it applies the Tested Loss against Tested Income of its other CFCs for the year of the purchase. Thus, the buyer may have an inherent noneconomic built-in gain in the stock, taxable at 21%, to be recognized at some future point under the currently proposed Stock Basis Adjustment Basis Rule even if the Tested Loss produces little to no appreciable tax benefit. This result can be mitigated by providing the buyer the option to elect not to apply the Tested Loss of the purchased CFC against Tested Income of other CFCs. Further, the tax-effected basis adjustment rules described above will mitigate any potential whipsaw by equalizing the tax effect of the reduction of Tested Income by the Tested Loss with the tax effect of any potential built-in gain in the stock produced by the Stock Basis Adjustment Rule. In any event, we recommend that Treasury and the Service clarify in final Regulations the operation of the Stock Basis Adjustment Rule to purchasers of CFCs with Tested Losses in the year of purchase.

b) Recommendations Related to Lower-Tier Basis Adjustments

The Stock Basis Adjustment Rule applies to both direct and indirect dispositions of lower-tier CFC stock. Thus, in a two-tier CFC structure in which a domestic corporation owns all of the stock of CFC1 and CFC1 owns all of the stock of CFC2, the disposition of CFC1 stock by the domestic corporation is a disposition of the stock of CFC2 as well for purposes of the Stock Basis Adjustment Rule. The Proposed Regulations provide that basis adjustments under the Stock Basis Adjustment Rule are deemed to occur at the lowest tier CFC first and, thereafter, up the chain of ownership until adjustments are made to the Specified Stock directly owned by the person making the disposition (whether that is the domestic corporation or a higher tier CFC).

The Proposed Regulations apparently contemplate that, to the extent that there is insufficient basis at any tier as to which an adjustment is made, gain from the sale or exchange of stock is deemed to occur in the amount by which the basis reduction amount exceeds available basis. The Proposed Regulations, however, do not address whether section 961(c) basis (*i.e.*, deemed basis in the stock of a CFC held by another CFC taken into account in computing the Subpart F Income of the U.S. Shareholder solely for Subpart F purposes) should be taken into account in applying the stock basis reduction rule. In light of the treatment of GILTI as Subpart F Income for section 961 purposes (pursuant to section 951A(f)), we think it is appropriate that basis reductions take into account prior basis increases for GILTI computation purposes under section 961(c). Section 961(c) basis is intended to prevent duplicative Subpart F Income or

GILTI upon the disposition by one CFC of another CFC's stock as it relates to prior Subpart F or GILTI inclusions of the lower tier CFC. Likewise, such basis should be taken into account in applying the stock basis adjustment rule. Accordingly, we recommend that the final Regulations clarify that any basis increase under section 961(c) to stock in one CFC held by another CFC be taken into account in applying the Stock Basis Adjustment Rule.

c) Recommendations Related to Section 381 Transactions

Proposed Regulation section 1.951A-6(e)(5) addresses adjustments related to Net Used Tested Loss in section 381 transactions. As written, the Proposed Regulation requires that if a CFC — with respect to which a U.S. Shareholder has a Net Used Tested Loss Amount or a “net used tested income amount” (“Net Used Tested Income Amount”) — is a distributor or transferor corporation in a section 381(a) transaction (an “Acquired CFC”) in which a CFC is the acquiring corporation (the “Acquiring CFC”), the corporate U.S. Shareholder's Net Used Tested Loss Amount or Net Used Tested Income Amount (with respect to the acquiring CFC) “is *increased* by the amount” of the Net Used Tested Loss Amount or Net Used Tested Income Amount of the acquired CFC.⁹⁶ This language is consistent with the possibility that both the Acquired CFC and Acquiring CFC have a Net Used Tested Loss Amount *or* Net Used Tested Income Amount. Combining an Acquired CFC's Net Used Tested Loss Amount with an Acquiring CFC's Net Used Tested Loss Amount, for example, would logically increase the corporate U.S. Shareholder's resulting Net Used Tested Loss Amount.

This language does not, however, appear to create a logically consistent result if one CFC in a section 381(a) transaction has a Net Used Tested Loss Amount while the other CFC has a Net Used Tested Income Amount. For example, if the Acquired CFC has a Net Used Tested Loss Amount and the Acquiring CFC has a Net Used Tested Income Amount, Proposed Regulation section 1.951A-6(e)(5) as written seems to require an increase in the corporate U.S. Shareholder's Net Used Tested Income Amount with respect to the Acquiring CFC. The more logical computation in this situation would be to decrease the corporate U.S. Shareholder's Net Used Tested Income Amount with respect to the Acquiring CFC by the Net Used Tested Loss Amount of the Acquired CFC.

Accordingly, we recommend that the final Regulations remove the word “increased” and instead address netting the Acquired CFC's Proposed Regulation section 1.951A-6(e)-related attributes with the Acquiring CFC's in section 381(a) transactions.

10. Consolidated Return Rules

The Proposed Regulations also provide rules for applying section 951A to affiliated groups electing to file consolidated returns for U.S. Federal income tax purposes (each, a “Consolidated Group”). The Proposed Regulations generally provide that a Consolidated Group's GILTI Inclusion Amount is calculated on an aggregate (*i.e.*, single-entity) basis. The stated intent of this aggregate approach is to ensure that a Consolidated Group's GILTI Inclusion Amount is the same regardless of which members of the group own CFCs with GILTI-relevant items. As explained below, the aggregate approach largely achieves that neutrality goal, but the Proposed Regulations create distortions in the basis of the stock of the members owning those

⁹⁶ Prop. Reg. § 1.951A-6(e)(5) (emphasis added).

CFCs. As further explained below, we believe the neutrality can be preserved in a manner that does not create basis distortions.

a) Possible Hybrid Approach to Allocated GILTI Inclusion Amount and Foreign Tax Credit Basis Adjustments

(1) Background

Under Proposed Regulation section 1.1502-51, a member's GILTI Inclusion Amount is determined by reference to the relevant items of each CFC owned by members of the same Consolidated Group. The Proposed Regulations set forth a three-step process to determine a member's GILTI Inclusion Amount. First, each member determines its "Aggregate Tested Income" (which is the aggregate of the member's pro rata share of the Tested Income of each Tested Income CFC with respect to which the member has a U.S. Shareholder Inclusion Year).⁹⁷ Second, the pro rata shares of Tested Loss, QBAI, Tested Interest Expense, and Tested Interest Income of each member are aggregated. Third, the aggregate pro rata shares of Tested Loss, QBAI, Tested Interest Expense, and Tested Interest Income of each member are allocated to each member that is a U.S. Shareholder of a Tested Income CFC based on the proportion of such member's aggregate pro rata share of Tested Income to the total Tested Income of the Consolidated Group (the "GILTI Allocation Ratio").⁹⁸ Importantly, if a member owns the stock of a CFC with Tested Loss and a CFC with Tested Income, the Tested Loss is not first netted against the Tested Income in determining the member's Aggregate Tested Income and its resulting GILTI Allocation Ratio.

The fact that the Tested Loss is not netted against Tested Income in determining a member's Aggregate Tested Income creates economic distortions in the respective stock basis of members of a Consolidated Group. We believe that there are ways a hybrid netting approach at the member level could preserve neutrality. For instance, consider alternative approaches to the basis adjustments in Proposed Regulation section 1.1502-51(f), Example 3:

P is the common parent of the P Consolidated Group. P owns all of the single class of stock of subsidiaries USS1, USS2, and USS3, all of whom are members of the P Consolidated Group. USS1 owns all of the single class of stock of CFC1. USS2 owns all of the single class of stock of each of CFC2 and CFC3. USS3 owns all of the single class of stock of CFC4. The taxable year of each corporation is the calendar year.

In Year 1, CFC1 has \$100x of Tested Loss, no QBAI, and \$25x of Tested Interest Expense (which is taken into account in determining the \$100x Tested Loss). CFC2 has \$200x of Tested Income, \$500x of QBAI, and no Tested Interest Expense or Income. CFC3 has \$200x of Tested Loss, no QBAI, and no Tested Interest Expense or Income. CFC4 has \$600x of Tested Income, \$2,000x of QBAI, and \$25x of Tested Interest Expense (which is taken into account in determining the \$600x of Tested Income).⁹⁹

Under the aggregate approach of the Proposed Regulations, the respective GILTI Allocation Ratios are zero-percent for USS1, 25% for USS2, and 75% for USS3 (based on the

⁹⁷ Prop. Reg. § 1.1502-51(e)(1).

⁹⁸ Prop. Reg. § 1.1502-51(e)(10).

⁹⁹ Prop. Reg. § 1.1502-51(f), Ex. (3).

proportionate amounts of Aggregate Tested Income). After allocating the Tested Losses, QBAI, and Tested Interest Expenses by those GILTI Allocation Ratios, the P Consolidated Group's \$300x GILTI Inclusion Amount is allocated \$75x to USS2 and \$225x to USS3. Under current Regulation section 1.1502-32(b)(3), P increases its basis in the stock of USS2 by \$75x and increases the basis of the stock of USS3 by \$225x.¹⁰⁰

Alternatively, if CFC3's \$200x of Tested Loss were netted against CFC2's Tested Income to determine the respective GILTI Allocation Ratios, those ratios would be zero-percent for USS1, zero-percent for USS2, and 100% for USS3. In such case, the P Consolidated Group's entire \$300x GILTI Inclusion Amount would be allocated to USS3 and P would increase its basis in the stock of USS3 by \$300x under current Regulation section 1.1502-32(b)(3). This netting approach would more properly reflect the relative economic income of USS2 and USS3 insofar as USS2 would not have a GILTI Inclusion Amount if determined on a single-entity basis. Further, on these basic facts, the netting approach would not violate neutrality principles because changing the ownership of the CFCs with Tested Losses (CFC1 and CFC3) would not change the P Consolidated Group's \$300x GILTI Inclusion Amount.

One possible complexity of the netting approach is demonstrated when the GILTI foreign tax credit is introduced. Section 960(d) provides a foreign tax credit for taxes properly attributable to Tested Income of a CFC taken into account by a domestic corporation under section 951A. Specifically, if a domestic corporation has a GILTI Inclusion Amount, and elects to credit foreign taxes, the corporation is treated as having a "deemed paid" foreign tax credit equal to the product of (1) 80% of the aggregate Tested Foreign Income Taxes paid or accrued by the CFCs owned by the corporation, and (2) the domestic corporation's Inclusion Percentage.¹⁰¹

To the extent that the final Regulations determine a Consolidated Group's section 960(d) foreign tax credit on an aggregate basis, the location of a Tested Loss CFC will not affect the group's ability to utilize the foreign tax credits of its Tested Income CFC. For example, assume the same facts of Proposed Regulation section 1.1502-51(f), Example 3, except that in Year 1, CFC2 pays \$20x of foreign income taxes (which is taken into account in determining its \$200x of Tested Income). Assume further that CFC4 pays no foreign income taxes in Year 1. Under an aggregate approach to determining the P Consolidated Group's foreign tax credit,¹⁰² the P Consolidated Group's Inclusion Percentage would be 37.5%, which is equal to the group's GILTI Inclusion Amount (\$300x) over the Aggregate Tested Incomes of all the group's CFCs

¹⁰⁰ The GILTI Inclusion Amount should be treated as taxable income under Regulation section 1.1502-32(b)(3)(i) or tax-exempt income under Regulation section 1.1502-32(b)(3)(ii) if offset by a section 250 deduction (*see, e.g.*, Reg. § 1.1502-32(b)(3)(ii)(B) (treating S's taxable income that is permanently offset by a deduction as tax-exempt income)). The additional basis adjustments provided for under the Proposed Regulations are discussed below.

¹⁰¹ Tested Foreign Income Taxes are foreign income taxes paid or accrued by a CFC that are attributable to the Tested Income of the CFC taken into account by the U.S. Shareholder in calculating its GILTI Inclusion Amount. However, foreign taxes paid by a Tested Loss CFC for that year do not give rise to Tested Foreign Income Taxes for the year.

A domestic corporation's Inclusion Percentage is a fraction, the numerator of which is its GILTI Inclusion Amount and the denominator of which is the Aggregate Tested Incomes of all Tested Income CFCs.

¹⁰² *See, e.g.*, Reg. § 1.1502-4 (determining Consolidated Group's foreign tax credit on an aggregate basis for purposes of former sections 901-905 and section 960).

(\$800x). The Inclusion Percentage multiplied by 80% is 30%. Multiplying that percentage by CFC2's \$20x of foreign income taxes yields \$6x of taxes deemed paid by the P Consolidated Group. Under section 78, the P Consolidated Group would "gross up" its income by the 37.5% Inclusion Percentage multiplied by the \$20x of foreign income taxes, or \$7.50x.

How those items should be allocated among the P Consolidated Group's members is not immediately clear. Under current Regulation section 1.1502-32(b)(3)(i), the section 78 gross up is included in the taxable income of the member owning the CFC's stock, which results in an increase in the member's stock basis. However, under current Regulation section 1.1502-32(b)(3)(iii)(B), the gross up is treated as a noncapital, nondeductible expense, which results in a corresponding decrease in the member's stock basis. Thus, the member's stock basis is increased by the same amount as the CFC's stock basis under section 961(a).¹⁰³

Because under new section 960(d), the section 78 gross up is greater than the allowable foreign tax credit, the difference should increase the basis of the stock of the CFCs owned by the Consolidated Group. Under the modified facts of Proposed Regulation section 1.1502-51(f), Example 3 posited above, the difference is \$1.50x. Under the general aggregate approach of the Proposed Regulations, that difference would be allocated \$0.375x to USS2 and \$1.125x to USS3, based on their respective GILTI inclusion ratios of 25% and 75%.

Alternatively, if a netting approach were adopted to allocate a Consolidated Group's GILTI Inclusion Amount, the first question in determining the application of section 960(d) is whether each member must calculate its own Inclusion Percentage on a stand-alone basis. Under the modified facts of Proposed Regulation section 1.1502-51(f), Example 3 posited above, USS2's Inclusion Percentage would be zero-percent (because its GILTI Inclusion Amount would be \$0x). In such case, the P Consolidated Group would not be entitled to any section 960(d) foreign tax credit. That would prompt the group to shift the ownership of CFC3 to USS1, where its losses would not dilute CFC2's taxes. The incentive to shift ownership of Tested Loss CFCs would violate the neutrality principle set forth in the Proposed Regulations.

We believe it is possible to devise a hybrid approach under which: (1) both the GILTI Inclusion Amount and the section 960(d) foreign tax credit are determined under an aggregate approach so as to preserve neutrality; and (2) the GILTI Inclusion Amount and the net basis increase resulting from the section 960(d) foreign tax credit are allocated based on a netting approach. Under the modified facts of Proposed Regulation section 1.1502-51(f), Example 3 posited above, the P Consolidated Group's \$300x GILTI Inclusion Amount would be allocated solely to USS3, resulting in a basis increase of \$300x under hybrid approach in the stock of USS3 under current Regulation section 1.1502-32(b)(3). Further, the \$1.50x net basis increase resulting from the section 960(d) foreign tax credit would be allocated to the stock of USS3. Another possibility would be to allocate the net basis increase resulting from the section 960(d) foreign tax credit based on the relative amounts of foreign taxes paid by the respective CFCs owned by a member. Under that approach, the \$1.50x net basis increase resulting from the section 960(d) foreign tax credit would be allocated to the stock of USS2 (because CFC2 was the only CFC that paid foreign income taxes in that year). While either hybrid approach would be

¹⁰³ See, e.g., Reg. § 1.1502-32(b)(5)(ii), Ex. (9).

complex, it would in most cases result in less economic distortions than the current Proposed Regulations. We believe that the Service should consider such hybrid approaches.

(2) Comment

Based on the foregoing, we recommend that Treasury and the Service adopt a hybrid approach under which: (1) both the GILTI Inclusion Amount and the section 960(d) foreign tax credit are determined under an aggregate approach so as to preserve neutrality; (2) the GILTI Inclusion Amount and the net basis increase resulting from the section 960(d) foreign tax credit are allocated based on a netting approach.

b) Timing of Basis Adjustments for Used Tested Loss and Offset Tested Income

(1) Background

Under Proposed Regulation section 1.1502-32(b)(3)(iii)(C), a member's used Tested Loss with respect to a CFC is treated as a noncapital, nondeductible expense. These negative adjustments would be made on an annual basis.

Conversely, under Proposed Regulation section 1.1502-32(b)(3)(ii)(E), a member's Offset Tested Income with respect to a CFC is treated as tax-exempt income to the extent the Offset Tested Income does not exceed the excess of: (1) the member's Used Tested Loss Amounts with respect to the CFC for all of its inclusion years, over (2) the aggregate of the member's Offset Tested Income amounts with respect to the CFC previously treated as tax-exempt income. Thus, the basis increase for a member's Offset Tested Income with respect to a CFC only ever reverses (or offsets) the basis decrease for the member's used Tested Loss with respect to the same CFC.

The combined effect of the annual basis decreases for used Tested Losses under Proposed Regulation section 1.1502-32(b)(3)(iii)(C) and the contingent "wait and see" basis increases for Offset Tested Income under Proposed Regulation section 1.1502-32(b)(3)(ii)(E) creates a timing mismatch. Consider the following simple example:

P is the common parent of the P Consolidated Group. P owns all of the single class of stock of subsidiary USS1 which is a member of the P Consolidated Group. USS1 owns all of the stock of CFC1 and CFC2. The taxable year each corporation is the calendar year.

In Year 1, CFC1 has \$200x of Tested Loss, no QBAI, and no Tested Interest Expense or Income. Also in Year 1, CFC2 has \$200x of Tested Income and no QBAI, and no Tested Interest Expense or Income.

Under the Proposed Regulations, the P Consolidated Group would have no GILTI Inclusion Amount. Under Proposed Regulation section 1.1502-32(b)(3)(iii)(C), P would reduce its basis in the stock of USS1 by \$200x in Year 1, the amount of the USS1's used Tested Loss with respect to CFC1. However, the Proposed Regulations do not allow P in Year 1 to increase the basis of the stock of USS1 by the corresponding \$200x Used Tested Income with respect to CFC2. Instead, such Offset Tested Income could only be used in the future, either (1) to offset up to \$200x of a basis reduction if USS1 has a used Tested Loss with respect to CFC2 under Proposed Regulation section 1.1502-32(b)(3)(ii)(E), or (2) to increase the basis of the stock of

USS1 in the event P disposes of such stock under Proposed Regulation section 1.1502-32(b)(3)(ii)(F), as explained further below.

(2) Comment

The timing mismatch does not preserve any articulable policy and creates an undue recordkeeping burden on taxpayers. Once it is decided that the stock of a member should be reduced for used Tested Losses on an annual basis, the basis increases for Offset Tested Income also should be made on an annual basis. Such annual stock basis increases would preserve timing parity and should increase compliance insofar as contemporaneous increases are likely more accurate than “balloon” increases that may take into account many years of unused Offset Tested Income. We recommend that Treasury and the Service adopt a rule that basis increase for Offset Tested Income be made on an annual basis to avoid a timing mismatch when a basis reduction is made for used Tested Losses.

(3) Interaction with Recommendations Regarding Proposed Regulation sections 1.951A-2(c)(4) and 1.951A-6 – Interaction of GILTI Rules with section 952

As discussed above in Part II.D.9, we recommend that the basis adjustment rule in Proposed Regulation section 1.951A-6(e) be withdrawn or revised in such a manner that it operates only to eliminate any potential duplicated tax benefit from the use of a Tested Loss (by annually adjusting the used Tested Loss and Offset Tested Income amounts by the Tax Effectuated Basis Reduction Percentage set forth in Part II.D.9.A) and that, in any event, it should not reduce basis in CFC stock by more than 50% of the Used Tested Loss Amount. We also recommend that the definitions of “used Tested Loss amount” within the meaning of Proposed Regulation section 1.951A-6(e)(2)(i) and “net Offset Tested Income” amount within the meaning of Proposed Regulation section 1.951A-6(e)(3) be revised to solely take into account Tested Income reductions that reduce GILTI and not reductions of the portion of Tested Income that does not exceed the DTIR.

In the event the Treasury and the Service adopt those recommendations, concomitant adjustments to Proposed Regulation sections 1.1502-32(b)(3)(iii)(C) (regarding basis decreases for used Tested Losses) and 1.1502-32(b)(3)(ii)(E) (regarding basis increases for Offset Tested Income) would be required.

c) Basis Adjustments for Dispositions of Members with Unused Offset Tested Income

(1) Background

Under Proposed Regulation section 1.1502-32(b)(3)(ii)(F), a member is treated as receiving tax-exempt income immediately before another member recognizes income, gain, deduction, or loss with respect to a share of the first member’s stock. The amount of this additional tax-exempt income is the Net Offset Tested Income Amount allocable to the shares of any CFC owned by the first member to the extent that a distribution of such amount would have been characterized as a dividend eligible for a section 245A deduction and not subject to section 1059. The rationale of the basis increase is that in the case of a corporate U.S. Shareholder, gain recognized on the disposition of stock of a CFC attributable to Offset Tested Income would, in most cases, be eliminated as a result of the application of section 964(e)(4) or section 1248(a) and (j), to the extent the gain or income is eligible for the dividends received deduction under

section 245A. The basis increase under Proposed Regulation section 1.1502-32(b)(3)(ii)(F) is intended to not incentivize a sale of the stock of a CFC over a sale of stock of a member owning such stock.

While the fundamental premise of Proposed Regulation section 1.1502-32(b)(3)(ii)(F) is correct, in many cases it will not provide sufficient basis increase in the member stock to achieve parity with the sale of the underlying CFC stock. This can be demonstrated by considering the facts of Proposed Regulation section 1.1502-51(f), Example 3. Assume the following additional facts that explain the USS3-CFC4 chain:

At the beginning of Year 1, P contributed property with \$0x basis to USS3, which then contributed the property to CFC4. USS3 did not recognize any gain on the transfer of the property under section 367. USS3's sole asset is the stock of CFC4, and, immediately after the transfer, CFC4's sole asset was the property contributed to it by USS3. At the end of Year 1, CFC4 sold the property to an unrelated party for \$600x, which is CFC4's Tested Income for that year. (These modified facts ignore the location of the P Consolidated Group's QBAI and Interest Expense because the location is not directly relevant to determine the basis in the stock of CFC4.)

Assume the same other facts as in Proposed Regulation section 1.1502-51(f), Example 3; thus the P Consolidated Group's GILTI Inclusion Amount is \$300x, which is allocated \$75x to USS2 and \$225x to USS3. Under current Regulation section 1.1502-32(b)(3), P would increase its basis in the stock of USS3 from \$0x to \$225x. Under Proposed Regulation section 1.951A-6(b), USS3 would increase its basis in the stock of CFC4 from \$0x to \$225x. At the beginning of Year 2, CFC's sole asset consists of \$600x and its E&P is \$600x.

Next, consider the sale of the stock of CFC4 or USS3 for \$600x at the beginning of Year 2. Under these modified facts, if USS3 were to sell the stock of CFC4 for \$600x, USS3 would recognize \$375x of gain, all of which would be treated as a section 1248 dividend. Thus, USS3 would be entitled to a 100% dividends received deduction under section 245A and would recognize no gain on the sale of the CFC4 stock.

Conversely, if P were to sell the stock of USS3 for \$600x, P would first increase its basis in the stock of USS3 under Proposed Regulation section 1.1502-32(b)(3)(ii)(F) by \$225x, which is USS3's Offset Tested Income with respect to CFC4 from Year 1. That additional basis increase would result in P having a \$450x basis in the stock of USS3, which would result in P recognizing \$150x of gain on the sale. To preserve parity between the sale of the stock of CFC4 and USS3, P should be able to increase its basis in the stock of USS3 to \$600x. There are two possible avenues to achieve this result. First, if the final Regulations adopted a netting method, the entire \$300x GILTI Inclusion Amount would have been allocated to USS3 resulting in a basis of \$300x at the end of Year 1. Further, USS3's unused Offset Tested Income with respect to the stock of CFC4 from Year 1 would be \$300x. Together, those basis increases would result in P having the economically correct \$600x basis in the stock of USS3.

Alternatively, the final Regulations could provide that the basis increase under Proposed Regulation section 1.1502-32(b)(3)(ii)(F) could adopt a deemed dividend approach under which CFC4 would be deemed to distribute \$375x to USS3 (corresponding to the amount of gain that

could be recognized without tax if USS3 sold the stock of CFC4), which would increase P's basis in the stock of USS3 to \$600x.

(2) Comments

We recommend that Treasury and the Service adopt a basis adjustment method that provides sufficient basis increase in the member stock in order to achieve parity with the sale of the underlying CFC stock. Alternatively, we recommend that the final Regulations provide for rule under which the underlying CFC is deemed to distribute a dividend equal to the amount of gain that could be recognized without tax if the group member sold the stock of the underlying CFC and would result in a basis increase in the stock of the group member.

d) Special Rule for Intercompany Nonrecognition Transactions

(1) Background

Proposed Regulation section 1.1502-51(c)(5) provides a special rule for intercompany nonrecognition transactions within the meaning of section 7701(a)(45) (*i.e.*, the Special Rule for Intercompany Nonrecognition Transactions). The Special Rule for Intercompany Nonrecognition Transactions provides that if a member engages in a nonrecognition transaction with another member in which stock of a CFC that has a Net Used Tested Loss Amount is directly transferred, "the adjusted basis of the nonrecognition property (within the meaning of section 358) received in the nonrecognition transaction is immediately reduced by the amount of the net used tested loss amount." The rule also provides that in cases of intercompany transactions that "are governed by" Regulation section 1.368-2(l) (*i.e.*, reorganizations under section 368(a)(1)(D), presumably involving some amount of boot) the reduction in basis pursuant to the special rule "is made prior to the application of [Proposed Regulation section] 1.1502-13(f)(3)."

The only illustration of the rule is by newly added Example 4(c) of Proposed Regulation section 1.1502-13(f)(7), involving an all-cash intercompany reorganization under section 368(a)(1)(D), where S's sole asset is stock of a CFC with respect to which S has a Net Used Tested Loss Amount (within the meaning of Proposed Regulation section 1.1502-51(e)(15)) of \$15x.

(2) Comments

The purpose of the Special Rule for Intercompany Nonrecognition Transactions appears to be an extension of the policy of providing negative adjustments to member stock basis under Proposed Regulation section 1.1502-32(b)(3)(iii)(C) for a member's used Tested Loss with respect to a CFC in the year such used Tested Loss arises. Absent a special rule, a member whose stock was adjusted under Proposed Regulation section 1.1502-32(b)(3)(iii)(C) might avoid replicating such adjustment in the case of a nonrecognition exchange under section 351(a). For example, assume that member M has a Used Tested Loss Amount of \$15x with respect to CFC, in Year 1, and that P, the sole shareholder of M, thus reduces its basis in the stock of M by \$15x at the end of the year, in accordance with Proposed Regulation section 1.1502-32(b)(3)(iii)(C). If, in Year 2, M subsequently transferred the stock of CFC to Newco, a newly formed domestic corporation, solely in exchange for Newco stock in an exchange under section 351(a), M's basis in its Newco stock under section 358(a) would not reflect the \$15x reduction but would instead be made by reference to M's basis in its CFC stock. Thus, a special rule seems appropriate in the case of nonrecognition transactions described in section 351(a) if

the government adopts a generally applicable rule such as Proposed Regulation section 1.1502-32(b)(3)(iii)(C) that requires annual basis adjustments with respect to member stock for such member's Used Tested Loss Amount.

However, in the context of shareholder nonrecognition exchanges under section 354 (which is the apparent level in which that the Special Rule for Intercompany Nonrecognition Transactions is meant to apply in the case of section 368(a) reorganizations, rather than under corporate-level exchanges under section 361), such a rule is duplicative. For example, if the facts of the preceding paragraph were adjusted such that M simply merged, in Year 2, into first-tier member B, wholly owned by P, in a reorganization under section 368(a) in which B stock was issued or deemed issued, P should not have to further reduce its basis in the B stock received. That is, since P already reduced its basis in the M stock by \$15x, to account for the Used Tested Loss Amount with respect to CFC, P's exchanged basis in the B stock received or deemed received, under the normal operation of section 358, will already reflect the Used Tested Loss Amount with respect to CFC; any further reduction would be duplicative.

Further, it is not clear why the Special Rule for Intercompany Nonrecognition Transactions is limited to only those CFCs that are "directly transferred" to another member. For example, if the section 351(a) example above also involved the transfer of a second-tier CFC (*i.e.*, the first-tier CFC owned all of the stock of a second-tier CFC), such lower-tier CFC could have a Net Used Tested Loss Amount with respect to the member that is an exchanging shareholder, and under the Proposed Regulations, any Net Used Tested Loss Amount of such lower-tier subsidiary would also have given rise to a negative basis adjustment to the stock of the transferring member, under Proposed Regulation section 1.1502-32(b)(3)(iii)(C). Under the general "disposition" rule of Proposed Regulation section 1.951A-6(e), the "Specified Stock" of a CFC in which basis is adjusted for a disposition is Section 958(a) Stock of the CFC.¹⁰⁴ Accordingly, we believe a conforming change should be made to the special rule of Proposed Regulation section 1.1502-51(c)(5), so as to clarify and confirm that indirect transfers of lower-tier CFCs are within the scope of such rule, too.

Relatedly, as currently written, the Special Rule for Intercompany Nonrecognition Transactions appears to envision only transfers of entire interests in a CFC, but presumably the goal of capturing Net Used Tested Loss Amounts into the basis of stock of a transferee corporation member would apply to transfers of less than all of an interest in a CFC, too, with the stock basis adjustment by reference to a proportionate amount of the Net Used Tested Loss Amount. For example, assume member M owns all of the stock of CFC, which has a Net Used Tested Loss Amount to M of \$20x, and M transfers 50% of its interest in the CFC to a domestic Newco, a member of the Consolidated Group of which M is a member. In this case, the special rule should confirm that, in addition to the basis adjustment in the Newco stock under section 358(a), M reduces its basis in the Newco stock by an additional \$10x, in proportion to the amount of CFC stock that M transferred to Newco. Special consideration may be necessary as to the proportion of Net Used Tested Loss to be reflected in issuing corporation stock basis for those CFC transfers involving multiple classes of stock, only a portion of which are transferred.

¹⁰⁴ As discussed above, Section 958(a) Stock is stock of a CFC owned "(directly or indirectly) by a United States shareholder." Prop. Reg. § 1.951A-1(e)(3).

Finally, if the Treasury and the Service agree with our observation that requiring basis reductions by the exchanging shareholder in a reorganization exchange is duplicative, then a corollary of such observation would be that no special rule is needed for reorganizations—particularly “all cash” reorganizations—under section 368(a)(1)(D). That is, we recommend that the last sentence of Proposed Regulation section 1.1502-13 (which begins “In cases . . .”) be deleted.

e) Anti-duplication rules

(1) Background

There are additional areas in which duplication concerns may arise under the Proposed Regulations, although perhaps less obvious than the scenarios discussed above. As noted above, basis in member stock is reduced under Proposed Regulation section 1.1502-32(b)(3)(iii)(C) for the Used Tested Loss Amount of a CFC. But if the member that is a U.S. Shareholder later engages in a “disposition” of the CFC, basis of stock of such CFC is adjusted (downward) immediately before its disposition pursuant to Proposed Regulation section 1.951A-6(e), under Proposed Regulation section 1.1502-51(c)(1). Ordinarily, the basis of the member that is the U.S. Shareholder, in such case, would be adjusted downward, too, treating the reduction of basis attributable to the CFC stock as a noncapital nondeductible expense of the member. However, given that Proposed Regulation section 1.1502-32(b)(iii)(C) already provides for a downward investment adjustment for Used Tested Loss Amounts (which would have been reflected in prior annual investment adjustments to the member), any further reduction to basis of member stock, as a result of the CFC basis adjustment under Proposed Regulation section 1.1502-51(c)(1), would be duplicative.

(2) Comments

As a general matter, stock basis adjustments to member stock are not to be made “in a manner that has the effect of duplicating an adjustment.” Indeed, taxpayers may reasonably conclude, in this case, that further investment adjustments to member stock are unwarranted, as a result of the CFC basis adjustment under Proposed Regulation section 1.1502-51(c)(1), “taking into account both the purposes of the Code or regulatory provision resulting in the decrease and the purposes of” the member investment adjustment Regulations. Nevertheless, we believe an explicit “reminder,” or directive to this effect—perhaps as part of the text of Proposed Regulation section 1.1502-32(b)(3)(iii)(C)—is warranted in this case, as many years of investment adjustments under Proposed Regulation section 1.1502-32(b)(3)(iii)(C) may have accumulated before a CFC disposition event arises that presents the possibility of duplication.

Furthermore, duplication concerns may also arise from acquisitive events involving members. For example, assume that S owns a CFC that, over the years, has had a mixture of Used Tested Loss Amounts and Offset Tested Income amounts that are reflected in the stock of S, under Proposed Regulation section 1.1502-32(b)(3)(ii) and (iii). If all of the stock of S is later sold to another Consolidated Group, the acquiring group will also be obligated to continue making investment adjustments to the S stock, attributable to the Used Tested Losses of the CFC that S continues to own. As currently defined, Proposed Regulation section 1.1502-32(b)(3)(ii)(E) provides that S’s tax-exempt income for a taxable year includes the aggregate of S’s Offset Tested Income amounts (within the meaning of Proposed Regulation section 1.1502-51(c)(3)) with respect to a CFC “for all of its U.S. shareholder inclusion years” to the extent such aggregate does not exceed the excess of Used Tested Loss Amount over Offset Tested Income

amounts, with respect to a CFC, “for all of its U.S. shareholder inclusion years.” Under Proposed Regulation section 1.1502-51(e)(25), a “U.S. shareholder inclusion year” has the same meaning as in Proposed Regulation section 1.951A-1(e)(4), which makes no reference to whether a U.S. Shareholder is a member of any Consolidated Group. Taking the definitions provided in the Proposed Regulations at face value, an acquiring group would be “reaching back” for amounts reflecting S’s affiliation with its prior Consolidated Group, to determine continuing basis adjustments to S stock in the new group. Thus, to avoid duplication within a new consolidated group, there should be a “reset” of the S investment adjustment history, once S is part of a new Consolidated Group, with critical consolidated definitions for aggregate amounts and “U.S. shareholder inclusion years” being limited to a particular member’s history within a particular Consolidated Group.

11. Section 245A

In the Preamble, Treasury and the Service have requested comments as to whether the principles in Regulation section 1.952-2 should apply to Subpart F Income, as well as to Tested Income and Tested Losses.¹⁰⁵ They have also asked for feedback concerning whether specific deductions available to domestic corporations should also be available to foreign corporations.¹⁰⁶ Notably, the Preamble notes that questions have arisen whether a CFC could be entitled to a dividends received deduction under section 245A (*i.e.*, the 245A DRD),¹⁰⁷ even though section 245A by its terms applies only to dividends received by a domestic corporation.¹⁰⁸

The language of section 245A(a) itself refers only to domestic corporations as able to benefit from the 245A DRD. Nonetheless, an assessment of the entirety of section 245A and the accompanying legislative history suggests Congress may have intended a more expansive scope. Further, if section 245A(a) were limited to domestic corporations, puzzling practical results would occur. Therefore, we recommend Treasury and the Service allow a 245A DRD for a CFC’s Subpart F dividend income pursuant to the specific grant of authority delegated to Treasury by section 245A(g).¹⁰⁹

¹⁰⁵ 83 Fed. Reg. 51072, 51075 (2018) (Preamble). Regulation section 1.952-2 covers circumstances when foreign corporations are treated as domestic corporations for purposes of calculating gross income. Reg. § 1.952-2(c)(3).

¹⁰⁶ *Id.* (“In particular, comments are requested as to whether these rules should allow a CFC a deduction, or require a CFC to take into account income, that is expressly limited to domestic corporations under the Code.”).

¹⁰⁷ According to the Committee Report accompanying the Act, section 245A “establishes a participation exemption system for foreign income.” H. R. Rep. No. 115-466, at 595 (2017) (Conf. Rep.).

¹⁰⁸ 83 Fed. Reg. 51072, 51075 (2018) (Preamble).

¹⁰⁹ In addition to general authority afforded under section 7805(a), Congress delegated Treasury a specific grant of authority to “prescribe such regulations or other guidance as may be necessary or appropriate to carry out the provisions of [section 245A]” in subsection 245A(g). Perhaps Congress recognized that existing statutory language in section 245A had not addressed each potential circumstance in which applying the 245A DRD is appropriate including (but not limited to) U.S. Shareholders indirectly owning stock through a partnership.

a) Section 245A

(1) 245A DRD, Disallowed DRD for Hybrid Dividends, and Footnote 1486

Section 245A contains a general rule allowing a 245A DRD “[i]n the case of any dividend received from a specified 10-percent owned foreign corporation [a “STPOFC”] by a domestic corporation which is a U.S. Shareholder with respect to such foreign corporation” for “an amount equal to the foreign-source portion of such dividend.”¹¹⁰ This general rule is followed by six modifying subsections. Certain terms contained in the general rule are defined within the modifying sections including “specified ten-percent owned foreign corporation” and “foreign-source portion.”¹¹¹ Section 245A does not define “domestic corporation” as it is used in the general rule.

While the general language of the statute references only domestic corporations, the anti-hybrid provisions in section 245A(e)(2) and the accompanying footnote in the Conference Report suggest that Treasury could take a broader approach when issuing Regulations.¹¹²

(2) Hybrid Dividends

Under the section 245A anti-hybrid provision, a receiving corporation cannot apply the 245A DRD to offset hybrid dividend income.¹¹³ A hybrid dividend is defined as a dividend (1) distributed by a CFC, (2) which would be otherwise eligible for the 245A DRD, and (3) for which the distributing CFC received a deduction or other tax benefit in any foreign country or possession of the United States.¹¹⁴ By disallowing a deduction under section 245A(a), section 245A(e)(1) ensures taxpayers do not claim a U.S. deduction for which the distributing corporation already received a local tax benefit.¹¹⁵

Notably, section 245A(e)(2) expressly extends the 245A DRD disallowance to hybrid dividend income received by CFCs.¹¹⁶ Because only domestic corporations are permitted to deduct foreign source dividend income under section 245A(a), one reading is that this demonstrates Congressional intent for the 245A DRD to apply to foreign corporations. Alternatively, another interpretation could be that the hybrid dividend extension by its own provision in section 245A(e)(2) simply prevents an upper-tier CFC and a lower-tier CFC from both deducting the same income, by stating that if the CFC were a domestic corporation, the dividend would be considered a hybrid dividend. Query whether this alternative view comports with the broader construction of the statute (where section 245A(e) is a straightforward carve-back of the benefit offered in section 245A(a)). Under the alternative view, one would need to

¹¹⁰ I.R.C. § 245A(a).

¹¹¹ I.R.C. § 245A(b)-(c).

¹¹² *The Foreign Dividends Received Deduction*, 2018 TAX NOTES TODAY 59-9 (Mar. 12, 2018) (LEXIS, FEDTAX lib., TNT file, elec. Cit. 2018 TNT 59-9).

¹¹³ I.R.C. § 245A.

¹¹⁴ I.R.C. § 245A(e)(4)(A)-(B).

¹¹⁵ I.R.C. § 245A(e)(1).

¹¹⁶ I.R.C. § 245A(e)(2).

assume that Congress intended to create a new Subpart F inclusion located in section 245A rather than in the more logical location—the Subpart F provisions.

While reasonable minds can disagree, at the very least, the language of section 245A(e) suggests that section 245A is not clear.

b) Transition to Quasi-Territorial System and Accompanying Legislative History

By augmenting the existing Subpart F anti-deferral framework with the new GILTI structure and the 245A DRD, Congress decided to treat separate types of foreign earnings differently pursuant to discrete policy objectives.¹¹⁷

Now, unlike the U.S. tax structure before the Act, Congress has elected to forgo levying tax on a portion of foreign earnings (Tested Income less than NDTIR) while expanding the types of foreign earnings (Tested Income greater than NDTIR) subject to immediate U.S. tax. Accordingly, in describing the general purpose of section 245A, the Conference Agreement states:

The provision . . . allows an exemption for certain foreign income by means of a 100-percent deduction for the foreign-source portion of dividends received from specified 10-percent owned foreign corporations by domestic corporations that are United States shareholders of those foreign corporations within the meaning of section 951(b).¹¹⁸

Footnote 1486 of the Conference Report, inserted after the phrase “by domestic corporations,” reads:

Including a controlled foreign corporation treated as a domestic corporation for purposes of computing the taxable income thereof. See [Regulation section] 1.952-2(b)(1). Therefore, a CFC receiving a dividend from a 10-percent owned foreign corporation that constitutes subpart F income may be eligible for the DRD with respect to such income.¹¹⁹

Under Regulation section 1.952-2(b)(1), foreign corporations are generally treated as domestic corporations for purposes of determining a CFC’s Subpart F Income except as otherwise provided in Regulation section 1.952-2(c). Regulation section 1.952-2(c) makes certain Code subchapters inapplicable for purposes of the Subpart F calculation unless the applicability of such provisions is “otherwise distinctly expressed.”¹²⁰

By incorporating the footnote into the background for statutory language, section 245A(a) thus states: dividends received from STPOFCs by domestic corporations (including a CFC treated as a domestic corporation for purposes of computing the taxable income thereof)

¹¹⁷ Committee Print, Recommendations Pursuant to H. Con. Res 71, S. Prt. 115-20, at 358 (exempt income), 370 (GILTI), 392 (Subpart F) (December 2017). By amending the definition of U.S. Shareholder in section 951(b) and repealing the CFC attribution rules in section 958(b)(4), the Act also broadened the scope of entities classified as CFCs.

¹¹⁸ H. R. Rep. No. 115-466, at 598-99 (2017) (Conf. Rep.).

¹¹⁹ *Id.* at 599 n. 1486.

¹²⁰ Reg. § 1.952-2(c)(1) (subchapters F, G, H, L, M, N, S, T of Chapter 1 and I.R.C. § 103 for CFCs post-March 3, 1997 taxable years).

that are U.S. Shareholders of those foreign corporations are eligible for the 245A DRD. While legislative history is not binding authority,¹²¹ Committee Reports are “the authoritative source for finding the Legislature’s intent,”¹²² and demonstrate “the considered and collective understanding of those Congressmen involved in drafting and studying proposed legislation.”¹²³ Here, given the ambiguity in the statute, the footnote is an indication of legislative intent that 245A DRD is applicable to foreign corporations.

c) Applying the Principles of Regulation Section 1.952-2 to 245A DRD

Under section 245A(a), a dividend receiving entity must satisfy the following three-pronged test to qualify for the 245A DRD. The receiving entity must be: (1) domestic, (2) a corporation, and (3) a U.S. Shareholder in the STPOFC. Therefore, if a CFC is treated as a domestic corporation under Regulation section 1.952-2(b)(1), it is clear that a CFC shareholder meets the first two prongs of the section 245A requirements for recipient corporations.

The third-prong is more ambiguous. As previously discussed, a U.S. Shareholder is a U.S. person who owns ten-percent or more of the vote or value of a foreign corporation.¹²⁴ A U.S. person includes a domestic corporation.¹²⁵ Regulation section 1.952-2(c) turns off certain subchapters for purposes of the Subpart F calculation including subchapter N, unless “otherwise distinctly expressed.” A CFC will not meet the definition of U.S. Shareholder with respect to STPOFC unless it is “otherwise distinctly expressed” that subchapter N should be reactivated, rather than dormant, under Regulation section 1.952-2(c).

While there is little direct guidance defining what constitutes “otherwise distinctly expressed”, a Chief Counsel Memorandum has looked to the “statutory framework” and “legislative intent” as informed by House and Senate reports as illustrative indications of whether there is a distinct expression to apply the otherwise inoperative subchapter N.¹²⁶

Here, footnote 1486 of the Conference Report provides insight into legislative intent to distinguish the types of foreign earnings that are exempt versus those that are taxable.¹²⁷ By exempting certain foreign earnings from U.S. tax at the CFC level, the 245A DRD would ensure such exempted income is not taxed at the shareholder level. As illustrated in examples below, if the DRD does not apply to a CFC’s Subpart F Income from dividends, the Act would not only convert the otherwise exempt foreign earnings into non-exempt status, but would also subject

¹²¹ See, e.g., *Pierce v. Underwood*, 487 U.S. 552, 566 (1988) (holding that a House Committee Report was neither an authoritative interpretation of what a 1980 statute meant, nor an authoritative expression of what the 1985 Congress intended on statutes reenacted by Congress already previously subject to ample judicial review); *Consumer Prod. Safety Comm’n v. GTE Sylvania, Inc.*, 447 U.S. 102, 120 (1980) (holding that a Conference Committee Report was “far from authoritative as an expression of congressional will”).

¹²² *Garcia v. United States*, 469 U.S. 70, 76 (1984).

¹²³ *Zuber v. Allen*, 396 U. S. 168, 186 (1969).

¹²⁴ I.R.C. § 951(b).

¹²⁵ I.R.C. § 7701(a)(30)(C).

¹²⁶ CCA 201240019 (May 23, 2012).

¹²⁷ H. R. Rep. No. 115-466, at 599 n. 1486. (2017) (Conf. Rep.).

those earnings to the full corporate tax rate and disallow any offset for foreign taxes paid at the distributing CFC level.

(1) Other references in Sections 1248 and 964(e)

Both sections 1248 and 964(e), as amended by the Act, directly reference section 245A. Section 1248(a) is applicable to U.S. persons selling stock in a foreign corporation and will recharacterize the gain from the sale as dividend income to the extent of section 1248 E&P.¹²⁸ Section 1248(j) mandates that the “dividend” income received by a domestic corporation under the provision is eligible for the 245A DRD.¹²⁹ New section 964(e) extends this concept and applies when a CFC sells stock of a foreign corporation (*i.e.*, the gain from that sale is also re-characterized as dividend income).¹³⁰ Further, section 964(e)(4) mandates that the section 954(c)(6) look-thru rule does not apply to that “dividend” income; but that the U.S. Shareholder of the CFC can take the section 245A DRD for the amount of the “dividend” income.¹³¹

It is anomalous to permit a U.S. Shareholder a DRD for foreign earnings recognized as a constructive foreign-to-foreign dividend under section 964(e) while subjecting actual foreign-to-foreign dividends to taxation.

d) U.S. Tax Consequences of Limiting 245A DRD to Domestic Corporations

Under a narrow reading of section 245A, a foreign corporation is not eligible for the 245A DRD. In that case, several other Code provisions would be impacted and otherwise exempt foreign earnings would be transformed into taxable earnings. The following illustrations demonstrate the presumably unintended consequences of limiting a section 245A DRD to domestic corporations.

(1) Dividends Paid by Unrelated STPOFCs to CFC Would Constitute Taxable Subpart F Income Starting in 2018

Guidance is needed to determine whether a taxpayer should include as Subpart F Income dividends received by a CFC from a lower-tier unrelated STPOFC. Under section 954(c)(6)(a), a dividend from a lower-tier CFC to an upper-tier CFC is excluded from Subpart F foreign personal holding company income to the extent the dividend is not attributable to income effectively connected with the conduct of a U.S. trade or business or Subpart F Income of the lower-tier CFC.

Example 1: USP, a domestic corporation, owns all shares of CFC 1 and CFC 1 owns 40% of the shares of CFC 2. Z, a domestic corporation otherwise unrelated to USP, has held the other 60% of the CFC 2 stock since CFC 2’s formation. CFC 1 and CFC 2 are incorporated in different foreign countries. Neither CFC 1 nor CFC 2 has any PTI E&P for purposes of section 959.

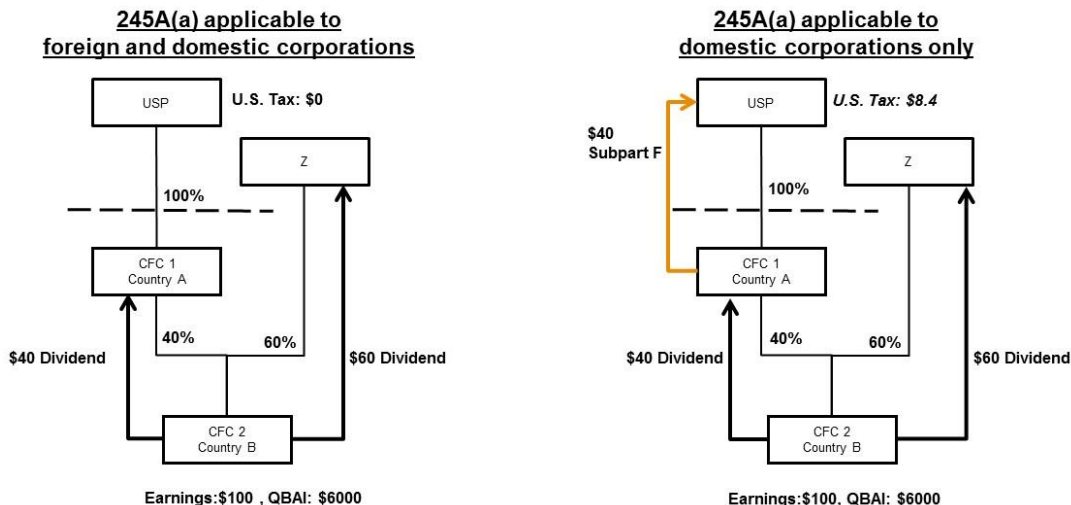
¹²⁸ I.R.C. § 1248(a).

¹²⁹ I.R.C. § 1248(j).

¹³⁰ *See* I.R.C. § 964(e)(1).

¹³¹ I.R.C. § 964(e)(4)(A).

In Year 1, CFC 2 earns non-Subpart F non-effectively connected E&P of \$100x. CFC 2 pays no local tax. CFC 1 has no QBAI and CFC 2 has QBAI of \$6,000x. In Year 2, CFC 2 declares a pro-rata dividend and distributes \$40x to CFC 1 and \$60x to Z. CFC 2 receives no local deduction for the dividend paid.



In Year 1, USP has no Subpart F Income or GILTI inclusion.¹³² In Year 2, USP must include \$40x in its gross income as Subpart F foreign personal holding company income.¹³³ Because USP does not meet the requisite relatedness¹³⁴ standard provided in section 954(d)(3), the \$40x dividend from CFC 2 to CFC 1 is not eligible for section 954(c)(6) look-thru treatment. Accordingly, if the section 245A deduction is not available to offset CFC 1's dividend income, USP's U.S. tax liability in Year 2 would be \$8.40x.

Limiting section 245A to domestic corporations would create a material asymmetry between the treatment of flat and tiered CFC structures. In Year 1, Z has no section 951(a) inclusion for Subpart F or section 951A income because (1) CFC 2's earnings are not attributable to activities described in section 952, and (2) Z's total Tested Income is less than NDTIR.¹³⁵ In Year 2, Z, a domestic corporation, will offset its \$60x of dividend income with the 245A DRD. Therefore, unlike USP, Z has no U.S. tax liability on its pro rata share of foreign earnings.

(2) Dividends Paid by Controlled STPOFCs Create Subpart F Income If CFC Look-Thru Rules Are Not Extended

Due to the section 954(c)(6) look-thru rules, related-party dividends paid to CFCs do not constitute Subpart F Income (regardless of the applicability of the 245A DRD) until tax years

¹³² USP's pro rata Tested Income ($\$100 \times 40\% = \40) is less than USP's NDTIR ($\$6000 \times 40\% \times 10\% = \240).

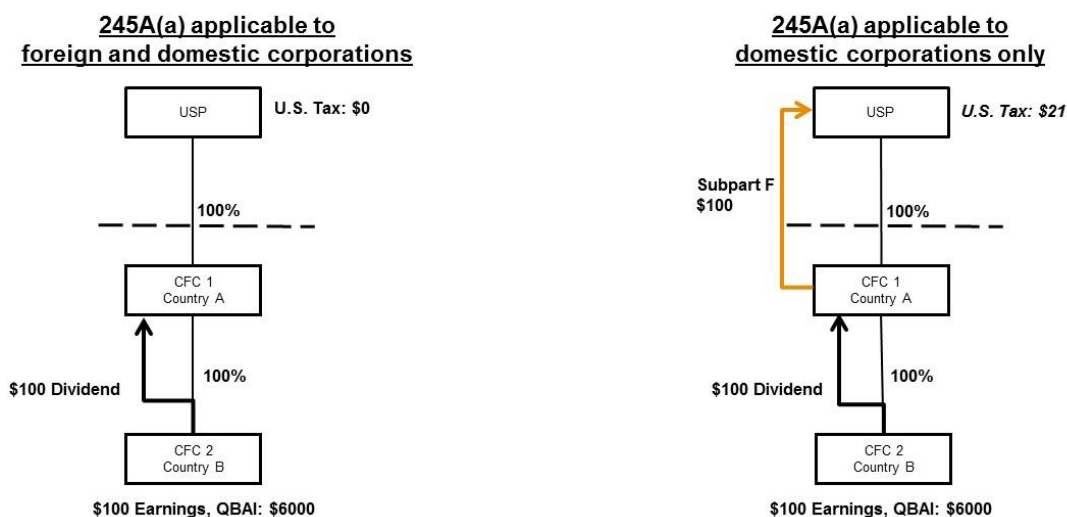
¹³³ I.R.C. § 954(c)(1)(A).

¹³⁴ A related person is an entity that (1) controls the CFC, (2) is controlled by the CFC, or (3) is controlled by an entity that simultaneously controls both the CFC payor as well as the CFC payee. Under section 958, a corporation is considered "controlled" if a single entity holds (either directly or indirectly) greater than 50% of (1) the total value of the corporation or (2) the voting power of all classes of shares.

¹³⁵ Z's pro rata Tested Income ($\$100 \times 60\% = \60) is less than Z's NDTIR ($\$6000 \times 60\% \times 10\% = \360).

commencing after December 31, 2019.¹³⁶ But, if Congress allows section 954(c)(6) to expire, U.S. Shareholders could have Subpart F Income on such dividends starting in 2020.

Example 2: Same facts as Example 1 except for the following: USP owns all shares of CFC 1 and CFC 1 owns all shares of CFC 2. In Year 2, CFC 2 pays a \$100x dividend to CFC 1. All events occur after 2019 and Congress does not extend section 954(c)(6).



In Year 1, USP has no Subpart F Income or GILTI inclusion.¹³⁷ In Year 2, USP must include \$100x in gross income as Subpart F foreign personal holding company income. Due to the expiration of section 954(c)(6), without section 245A(a) there is no available mechanism to exclude CFC 2's \$100x dividend from giving rise to Subpart F Income. Accordingly, USP's U.S. tax liability in Year 2 would be \$21x.

(3) Local Taxes Paid by Lower-Tier CFCs Cannot Offset Subpart F Income Attributable to Upper Tier CFC Dividend Income

Consistent with the shift from a worldwide to a quasi-territorial tax system, Congress also made significant changes to the foreign tax credit regime. First, since certain foreign earnings are now exempt from U.S. tax, section 245A(d) precludes taxpayers from claiming deductions or section 901 foreign tax credits for local taxes associated with foreign income eligible for the 245A DRD.¹³⁸ Next, in recognition that non-exempt foreign income may still be subject to double tax, the Act continues to permit (at least a partial offset) of U.S. tax liability with a credit for local taxes

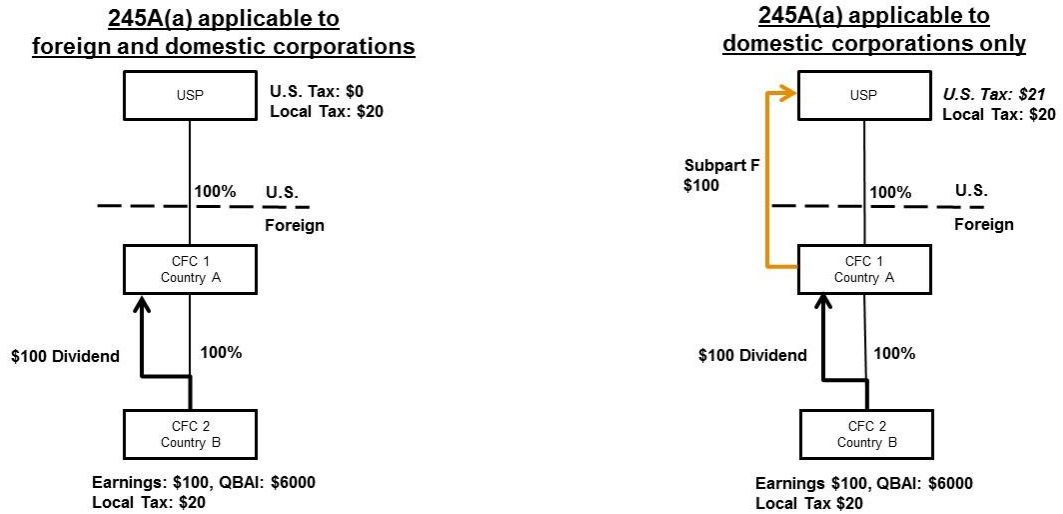
¹³⁶ I.R.C. § 954(c)(6)(C).

¹³⁷ USP's pro rata Tested Income \$100x is less than USP's NDTIR (\$6000 x 10% = \$600).

¹³⁸ I.R.C. § 245A(d).

paid. The Act abandoned the pooling methodology for indirect foreign tax credits when it repealed section 902 and replaced it with the current year structure included in the expanded section 960. Under section 960, when a taxpayer is subject to a deemed inclusion for non-exempt foreign earnings, the U.S. Shareholder is allowed a deemed paid credit for foreign taxes “attributable to” the income inclusion.¹³⁹

Example 3: Same facts as Example 2 except CFC 2 paid \$20x of local tax in Year 1 on \$100x in E&P.



Without section 954(c)(6), USP must include CFC 1’s \$100x dividend received as Subpart F Income in Year 2. Moreover, section 960(a) exclusively permits deemed paid credits solely for current year local taxes paid attributable to the Subpart F Income. Therefore, USP cannot offset CFC 1’s Subpart F Income in Year 2 with taxes paid by CFC 2 in Year 1. Accordingly, USP’s foreign earnings are subject to an effective tax rate of 34.2%.¹⁴⁰

¹³⁹ I.R.C. § 960(a), (d).

¹⁴⁰ $(\$20 \text{ Country B Taxes} + \$21 \text{ U.S. tax}) / \$120 = 34.16\%$.