

**HIGH TECH TAX INSTITUTE
SAN JOSE STATE UNIVERISTY AND TAX EXECUTIVES INSTITUTE**

U.S. INTERNATIONAL TAX ISSUES AND DEVELOPMENTS

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by

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I. SECTION 965.

A. Final Regulations. Treasury and the IRS adopted the proposed § 965 regulations as final. They made a number of changes in doing so.

1. Treas. Reg. § 1.965-1 – Overview, General Rules, and Definitions. Treas. Reg. § 1.965-1 provides general rules and definitions under § 965, including general rules concerning § 965(a) inclusion amounts, general rules concerning § 965(c) deduction amounts, and rules concerning the treatment of certain specified foreign corporations as CFCs and certain controlled domestic partnerships as foreign partnerships.
2. Exchange Rate for Inclusion Amount. The proposed regulations provided that a § 965(a) inclusion amount is determined by translating a § 958(a) U.S. shareholder’s pro rata share of the § 965(a) earnings amount of a

deferred foreign income corporation (“DFIC”) into U.S. dollars using the spot rate on December 31, 2017. Prop. Treas. Reg. § 1.965-1(b)(1). A commenter suggested that the average exchange rate for the § 958(a) U.S. shareholder’s 2017 fiscal year should be used under § 989(b)(3). The preamble to the final regulations states that while § 989(b)(3) would generally apply the average exchange rate for the inclusion year of the DFIC (not the § 958(a) U.S. shareholder, as the commenter suggested) for purposes of translating an amount included in income under § 951(a)(1)(A), like a § 965(a) inclusion amount, Treasury and the IRS believe that it is appropriate to use its grant of regulatory authority in § 989 to instead provide for translation at the spot rate on December 31, 2017 as it is more administrable and less burdensome on taxpayers.

3. Application of Controlled Domestic Partnership Rule.

- (a) Prop. Treas. Reg. § 1.965-1(e) contained a rule treating certain controlled domestic partnerships as foreign partnerships for purposes of determining the § 958(a) U.S. shareholders of a specified foreign corporation owned by the controlled domestic partnership and the § 958(a) stock owned by those shareholders. A comment was accepted that suggested that because controlled domestic partnership is defined by reference to a specific U.S. shareholder, the rule could be read to apply only regarding that shareholder but not regarding other partners of the controlled domestic partnership, for which it would therefore still be treated as domestic. The definition of controlled domestic partnership was accordingly revised so it is not defined only regarding a U.S. shareholder. Thus, under Treas. Reg. § 1.965-1(e)(2), a controlled domestic partnership is treated as a foreign partnership for all partners if the rule applies.
- (b) The final regulations also adopted another comment to provide that a controlled domestic partnership treated as a foreign partnership is treated as a foreign pass-through entity. Treas. Reg. § 1.965-2(i)(2).

4. Accumulated Post-1986 Deferred Foreign Income.

- (a) PTEP Exception to Non-CFCs.
 - i. Prop. Treas. Reg. §§ 1.965-1(f)(7)(i)(B) and (C) excluded from accumulated post-1986 deferred foreign income certain earnings and profits (“E&P”) described in §§ 959(c)(1) or 959(c)(2) (“PTEP” or “previously taxed earnings and profits”) and amounts that would be treated as PTEP in the case of shareholders that are not U.S. shareholders on an E&P measurement date. These

exclusions (consistent with § 965(d)(2)(B)) apply only to E&P of a CFC.

- ii. A commenter requested that the exclusion be expanded to PTEP and amounts that would be treated as PTEP of specified foreign corporations that are no longer CFCs as of the relevant E&P measurement date, given that § 959 can apply to distributions by foreign corporations that are no longer CFCs. The comment was not accepted.

(b) PTEP Exception to Address Distributions.

- i. A commenter suggested that the final regulations expand on the rationale of § 965(d)(2)(B) and Prop. Treas. Reg. §§ 1.965-1(f)(7)(i)(B) and (C) to provide that accumulated post-1986 deferred foreign income is reduced by post-1986 earnings and profits described in § 959(c)(3) that have been distributed to an unrelated foreign corporation pursuant to a dividend pro rata to that corporation and a specified foreign corporation, given that the “no diminution rule” discussed below would decrease the post-1986 earnings and profits by the amount distributed to the specified foreign corporation but not the unrelated foreign corporation.
- ii. Treasury and the IRS believe that the application of the statutory “no diminution rule” is clear, and the special rules in § 965(d)(2)(B) for PTEP have no bearing on the fact pattern highlighted by the comment. Accordingly, the final regulations did not adopt this comment.

(c) PTEP Exception Applied to § 951(a)(1)(B) Inclusions.

- i. A commenter suggested that a pre-inclusion year inclusion under §§ 951(a)(1)(B) and 956 regarding a DFIC whose inclusion year ends November 30, 2018, may not be properly accounted for in determining accumulated post-1986 deferred foreign income as of the measurement date on November 2, 2017. Accordingly, the E&P would not qualify for the exception from accumulated post-1986 deferred foreign income for PTEP in Treas. Reg. § 1.965-1(f)(7)(i)(B). The commenter suggested that the final regulations provide an additional exception from the definition of accumulated post-1986 deferred foreign income for E&P that would be included in the income of a U.S. shareholder under §§ 951(a)(1)(B) and 956.

- ii. According to Treasury and the IRS, the statutory definition of accumulated post-1986 deferred foreign income is clear in not excluding this E&P. Moreover, they believe that modifications to reduce a § 965(a) inclusion amount to the extent of an inclusion under §§ 951(a)(1)(B) and 956 in these circumstances are not warranted for a variety of reasons.
- iii. A new example in Treas. Reg. § 1.965-2(j)(5) illustrates the treatment of E&P of a specified foreign corporation as of the E&P measurement date on November 2, 2017 which is described in § 959(c)(1) as a result of an inclusion under § 951(a)(1)(B) regarding the specified foreign corporation's taxable year ending on November 30, 2017.

(d) Application of PTEP Exception in the Case of § 962 Elections.

- i. Under § 962(d), E&P giving rise to inclusions under § 951(a)(1) regarding which an election under § 962 applies are, notwithstanding § 959(a)(1), includible in the gross income of a U.S. shareholder when distributed except to the extent of tax paid on the inclusions. Therefore, that E&P (that is, the non-excludable amount) is included in accumulated post-1986 deferred foreign income in an inclusion year. *See* § 965(d)(2)(B) (excluding from accumulated post-1986 deferred foreign income earnings that, if distributed, would be excluded from gross income under § 959).
- ii. A rejected comment suggested that accumulated post-1986 deferred foreign income should exclude all PTEP attributable to a prior year inclusion under § 951(a)(1) by a U.S. shareholder when a § 962 election applied with respect to the prior year inclusion. In the alternative, the commenter suggested that the final regulations allow foreign income taxes deemed paid with respect to the original inclusion under § 951(a)(1) to be treated as deemed paid again with respect to a § 965(a) inclusion with respect to such previously taxed E&P.

5. Foreign Cash Position and Cash Position.

- (a) Prop. Treas. Reg. § 1.965-1(f)(8) defined “aggregate foreign cash position” to mean the greater of the aggregate of a § 958(a) U.S. shareholder's pro rata share of the cash position of each specified foreign corporation determined on the final cash measurement date or the average of the aggregate of a § 958(a) U.S. shareholder's

pro rata share of the cash position of each specified foreign corporation determined as of each specified foreign corporation's first and second cash measurement dates.

(b) For purposes of this calculation, Prop. Treas. Reg. § 1.965-1(f)(16)(i) provided that a specified foreign corporation's cash position consists of cash held by the corporation, the net accounts receivable of the corporation, and the fair market value of the cash-equivalent assets held by the corporation. Cash-equivalent assets include (i) personal property which is of a type that is actively traded and for which there is an established financial market; (ii) commercial paper, certificates of deposit, the securities of the Federal government and of any State or foreign government; (iii) any foreign currency; (iv) any obligation with a term of less than one year ("short-term obligation"); and (v) derivative financial instruments, other than bona fide hedging transactions. Prop. Treas. Reg. § 1.965-1(f)(13).

(c) Exclusions from Cash Position.

- i. Commenters requested changes dealing with the exclusion of certain assets from the cash position of a specified foreign corporation. Specifically, comments recommended that cash subject to local regulatory restrictions, held in a fiduciary or trust capacity, derived from domestic E&P, earmarked to fund a foreign acquisition pursuant to a legal contract entered into before November 2, 2017, obligated to be paid to a third party, or corresponding to previously taxed E&P not be taken into account in determining a specified foreign corporation's cash position.
- ii. Commenters also requested that obligations with respect to which there was an inclusion under §§ 951(a)(1)(B) and 956 be excluded from a specified foreign corporation's cash position. In addition, comments requested guidance exempting certain assets that would otherwise be considered personal property which is of a type that is actively traded and for which there is an established financial market. For example, comments suggested that the stock of a publicly traded company be excluded from a specified foreign corporation's cash position if the stock represents a controlling interest in a corporation, meets an annual trading volume threshold, is the stock of a specified foreign corporation, is held in the ordinary course of a § 958(a) U.S. shareholder's trade or business, or was not reported as a current asset on the audited financial

statements of a § 958(a) U.S. shareholder or its specified foreign corporation.

- iii. Similarly, commenters requested that certain products or raw materials held as inventory that are a type of property that may be actively traded on, for example, commodities markets, and forward contracts with respect to those items be excluded from a specified foreign corporation's cash position if the items are part of the corporation's ongoing operations or are disposed of in the normal course of business.
- iv. One commenter requested guidance that actively traded personal property be presumptively treated as cash, subject to the ability of the taxpayer to rebut the presumption by submitting a statement with its tax return that establishes, based on all of the relevant facts and circumstances, that the property is illiquid. Another commenter stated that the proposed regulations struck an appropriate balance and requested that the exceptions from the definition of cash position be limited to those in the proposed regulations and that no additional exceptions be given.
- v. Treasury and the IRS agreed that a narrow exemption from the definition of "cash position" is appropriate for certain assets held by a specified foreign corporation in the ordinary course of its trade or business as well as for certain privately negotiated contracts to buy or sell those assets. Therefore, the final regulations provide that a commodity that is described in §§ 1221(a)(1) or 1221(a)(8) in the hands of the specified foreign corporation is excluded from the category of personal property which is of a type that is actively traded and for which there is an established market, except with respect to dealers or traders in commodities. *See* Treas. Reg. §§ 1.965-1(f)(13)(i)(A) and (ii).
- vi. Additionally, Treas. Reg. §§ 1.965-1(f)(18)(iii) and (v) exclude forward contracts and short positions with respect to such commodities from the definition of derivative financial instrument to the extent that they could have been identified as a hedging transaction regarding these commodities. This exemption does not raise the administrability concerns that are inherent in a liquidity-based test of widespread applicability.

- vii. However, Treasury and the IRS declined to adopt the recommendations for additional cash position exceptions. Congress developed a statutory definition of “cash position” that includes all cash and certain assets held by a specified foreign corporation regardless of whether the cash or assets are illiquid or were transferred from the U.S. *See* § 965(c)(3)(B). They state that the legislative history is consistent with the unambiguous language in the statute. Therefore, the final regulations continue to provide that, for example, the fair market value of publicly traded stock held by a specified foreign corporation is included in a specified foreign corporation’s cash position, regardless of the specified foreign corporation’s ownership percentage in the publicly traded corporation, because such stock is “of a type” that is actively traded on an established securities market. Accordingly, the final regulations generally retain the definitions of “aggregate foreign cash position” and “cash position” set forth in the proposed regulations. *See* Treas. Reg. § 1.965-1(f)(8) and (16).

(d) Accounts Receivable and Accounts Payable.

- i. Prop. Treas. Reg. §§ 1.965-1(f)(5) and (6) provided that for purposes of determining net accounts receivable taken into account in determining the cash position of a specified foreign corporation, the term “accounts receivable” means receivables described in § 1221(a)(4), and the term “accounts payable” means payables arising from the purchase of property described in § 1221(a)(1) or § 1221(a)(8) or the receipt of services from vendors or suppliers, and only receivables or payables with a term upon issuance that is less than one year are taken into account.
- ii. Commenters unsuccessfully requested that the definition of accounts payable for purposes of determining a specified foreign corporation’s cash position be expanded. Specifically, commenters recommended that accounts payable be defined to include payables to employees in the ordinary course of business, payables arising from the purchase of depreciable property, payables related to the licensing of intellectual property, payables for taxes other than income taxes, payables for debt with a term of less than one year, and payables established under Rev. Proc. 99-32, 1999-2 C.B. 296.

- iii. Although the statute does not define the term “accounts payable,” generally accepted accounting principles define the term to mean amounts owed to vendors and suppliers for the purchase of goods and services on credit, to the exclusion of obligations such as accrued taxes, interest expense, commission or royalty expense, and compensation payable, which are treated as accrued liabilities.
- iv. The definition of accounts payable set forth in the proposed regulations therefore reflects the ordinary meaning of the term, and the final regulations did not adopt these recommendations.

(e) Short-Term Obligations.

- i. Prop. Treas. Reg. § 1.965-1(f)(43) provided that for purposes of determining a specified foreign corporation’s cash position, the term “short-term obligation” means any obligation with a term at issuance that is less than one year and any loan that must be repaid at the demand of the lender (or that must be repaid within one year of such demand) but does not include any accounts receivable. Comments unsuccessfully were submitted requesting that the definition of short-term obligation be modified to allow netting of short-term notes payable against short-term notes receivable for purposes of computing a specified foreign corporation’s cash position.
- ii. The preamble states that statute explicitly allows accounts payable to be netted against accounts receivable for purposes of determining the cash position of a specified foreign corporation but does not provide the same treatment with respect to short-term obligations. *See* §§ 965(c)(3)(B)(ii), (c)(3)(B)(iii)(IV), and (c)(3)(C). The legislative history is consistent with the statute’s plain meaning. Accordingly, the final regulations retained the definition of “short-term obligation” set forth in the proposed regulations. *See* Treas. Reg. § 1.965-1(f)(43).

(f) Cash-Equivalent Asset Hedging Transactions.

- i. For purposes of determining the cash position of a specified foreign corporation, the proposed regulations include special rules regarding the treatment of cash- equivalent asset hedging transactions. The term “cash-equivalent asset hedging transaction” is defined as a bona fide hedging transaction identified on a specified foreign corporation’s

books and records as hedging a cash-equivalent asset. Prop. Treas. Reg. § 1.965-1(f)(14). A bona fide hedging transaction is defined to mean a hedging transaction that meets (or that would meet if the specified foreign corporation were a CFC) the requirements of a bona fide hedging transaction described in Treas. Reg. § 1.954-2(a)(4)(ii) (without regard to the identification requirements, in the case of a specified foreign corporation that is not a CFC). Prop. Treas. Reg. § 1.965-1(f)(12).

- ii. The proposed regulations did not address whether, and the extent to which, a bona fide hedging transaction that hedges an aggregate risk (an “aggregate hedging transaction”), including risks with respect to one or more cash-equivalent assets, may be treated as a cash-equivalent asset hedging transaction. For example, a bona fide hedging transaction may hedge the risk with respect to multiple assets, some of which are cash-equivalent assets and some of which are not cash-equivalent assets. *See generally* Treas. Reg. § 1.954-2(a)(4)(ii)(A) (defining a bona fide hedging transaction, in part, by reference to the requirements of Treas. Reg. § 1.1221-2(a) through (d)); Treas. Reg. § 1.1221-2(c)(3) (providing that a hedging transaction may manage aggregate risk).
- iii. The preamble states that it is appropriate to permit bona fide hedging transactions that are aggregate hedging transactions to be treated as cash-equivalent asset hedging transactions to the extent that the risks managed by the aggregate hedging transaction relate to cash-equivalent hedging transactions. Accordingly, the final regulations provide that an aggregate hedging transaction may be treated as a cash-equivalent asset hedging transaction and allocate the value of an aggregate hedging transaction between cash-equivalent hedging transactions and other assets, if any, being hedged. *See* Treas. Reg. § 1.965-1(f)(14)(ii).

6. Cash Measurement Dates.

- (a) The proposed regulations provided that a specified foreign corporation’s final cash measurement date is the close of the last taxable year of the specified foreign corporation that begins before January 1, 2018, and ends on or after November 2, 2017, if any. Prop. Treas. Reg. § 1.965-1(f)(24). The second cash measurement date of a specified foreign corporation is the close of the last taxable year of the specified foreign corporation that ends after

November 1, 2016, and before November 2, 2017, if any. Prop. Treas. Reg. § 1.965-1(f)(31).

- (b) The first cash measurement date of a foreign corporation is the close of the last taxable year of the specified foreign corporation that ends after November 1, 2015, and before November 2, 2016, if any. Prop. Treas. Reg. § 1.965-1(f)(25). Under the proposed regulations, a § 958(a) U.S. shareholder takes into account its pro rata share of the cash position of a specified foreign corporation as of the close of any cash measurement date of the specified foreign corporation on which the § 958(a) U.S. shareholder is a § 958(a) U.S. shareholder of the specified foreign corporation, without regard to whether the § 958(a) U.S. shareholder is a § 958(a) U.S. shareholder as of any other cash measurement date, including the final cash measurement date of the specified foreign corporation. *See* Prop. Treas. Reg. § 1.965-1(f)(30)(iii).
- (c) A commenter unsuccessfully recommended that the proposed regulations be modified so that a § 958(a) U.S. shareholder would not take into account the pro rata share of the cash position of any specified foreign corporation liquidated before November 2, 2017.

7. Domestic Pass-Through Entities. A commenter made a number of suggestions premised on the assumption that aggregate foreign E&P deficits, § 965(a) inclusion amounts, and § 965(c) deductions are not determined at the § 958(a) U.S. shareholder level when the § 958(a) U.S. shareholder is a domestic pass-through entity, and instead that shares of the components of those amounts (such as specified E&P deficits, § 965(a) earnings amounts, and aggregate foreign cash positions) are taken into account separately by the domestic pass-through owners. Treasury and the IRS believe that the statute clearly provides otherwise, and the proposed regulations and final regulations are consistent with the statute.

8. Post-1986 Earnings and Profits.

- (a) Treatment of Distributions.
 - i. Under the proposed regulations, a specified foreign corporation's post-1986 earnings and profits are determined without diminution by reason of dividends distributed during the last taxable year of the foreign corporation that begins before January 1, 2018, other than dividends distributed to another specified foreign corporation ("no diminution rule"). Prop. Treas. Reg. § 1.965-1(f)(29)(i)(B).
 - ii. Commenters noted that the no diminution rule may result in overinclusion of a specified foreign corporation's post-

1986 earnings and profits and suggested that the final regulations limit the rule's application (that is, to allow diminution of a specified foreign corporation's post-1986 earnings and profits) in the case of dividends to a seller before a sale during the inclusion year. The preamble states that the statute explicitly provides that dividend distributions, other than distributions to another specified foreign corporation, must not be taken into account for purposes of computing a specified foreign corporation's post-1986 earnings and profits. Section 965(d)(3)(B). Therefore, the comments are not adopted.

- iii. Similarly, commenters suggested reducing post-1986 earnings and profits by dividends to a U.S. shareholder between November 2, 2017, and December 1, 2017, by a DFIC with an inclusion year ending November 30, 2018, in order to mitigate double counting of E&P in connection with these dividends. Treasury and the IRS believe that the grant of regulatory authority in § 965 was not intended to address such fact patterns. Further, and as the preamble to the proposed regulations notes, payments by a specified foreign corporation to a U.S. shareholder can have attendant U.S. tax effects that do not occur with respect to payments between specified foreign corporations. Accordingly, these recommendations were not adopted.

(b) Foreign Income Tax Rule.

- i. Prop. Treas. Reg. § 1.965-1(f)(29)(ii) provided that for purposes of determining a specified foreign corporation's post-1986 earnings and profits as of the E&P measurement date on November 2, 2017, in the case in which foreign income taxes (as defined in § 901(m)(5)) of the specified foreign corporation accrue after November 2, 2017, but on or before December 31, 2017, and during the specified foreign corporation's U.S. taxable year that includes November 2, 2017, the specified foreign corporation's post-1986 earnings and profits as of November 2, 2017, are reduced by the applicable portion of such foreign income taxes.
- ii. Commenters unsuccessfully sought to have the rule expanded to permit reduction for foreign income taxes accrued after December 31, 2017, for purposes of determining post-1986 earnings and profits on the measurement dates on both November 2, 2017, and December 31, 2017, and regardless of whether the foreign

corporation's U.S. taxable year includes November 2, 2017.

iii. Another commenter unsuccessfully recommended a modification as to how the applicable portion of foreign income taxes taken into account on November 2, 2017 is determined. For ease of implementation, instead of basing the determination on the portion of the income for the foreign taxable period that includes November 2, 2017, as computed under foreign tax law, that had accrued as of such date, this comment recommended basing the determination on the ratio of the E&P for the U.S. taxable year, as computed under U.S. tax principles, as of November 2, 2017, to that as of December 31, 2017.

(c) Other Exclusions from Post-1986 Earnings and Profits. A commenter unsuccessfully requested a change regarding the definition of post-1986 earnings and profits, i.e., that they exclude cashless earnings generated by foreign corporations while they were not controlled by U.S. shareholders. It also unsuccessfully requested that dividends paid out of earnings earned before a foreign corporation became a specified foreign corporation be excluded from the post-1986 earnings and profits of the recipient specified foreign corporation.

(d) Alternative Measurement Methods. A commenter unsuccessfully requested guidance permitting taxpayers to determine their specified foreign corporations' post-1986 earnings and profits and cash positions using an alternative measurement method. The commenter noted that before the enactment of § 965, foreign corporations other than CFCs or § 902 corporations (as defined under former § 909(d)(5)) had no reason to track E&P under U.S. tax principles; therefore, requiring a U.S. shareholder to obtain information from a foreign corporation that the corporation would not have known to maintain is unduly burdensome.

9. Determination of Pro Rata Share of § 965(a) Earnings Amount.

(a) The proposed regulations provided that a § 958(a) U.S. shareholder's pro rata share of the § 965(a) earnings amount of a DFIC is the portion of the § 965(a) earnings amount that would be treated as distributed to the § 958(a) U.S. shareholder under § 951(a)(2)(A) and Treas. Reg. § 1.951-1(e), determined as of the last day of the inclusion year of the DFIC. Prop. Treas. Reg. § 1.965-1(f)(30)(i).

- (b) Treasury and the IRS now believe that this definition is inconsistent with the statutory language of §§ 951 and 965 in the case in which a specified foreign corporation, whether it is or is not a CFC, ceases to be a specified foreign corporation during its inclusion year.
- (c) A specified foreign corporation is treated as a CFC for purposes of § 951. Thus, they believe that the final regulations should be consistent with § 951 in requiring a § 965(a) inclusion by a § 958(a) U.S. shareholder. It would not be appropriate to prorate a § 965(a) earnings amount based on the portion of the inclusion year that the DFIC is a specified foreign corporation, as the reference in Prop. Treas. Reg. § 1.965-1(f)(30)(i) to § 965(a)(2)(A) might suggest, given that the limitation of post-1986 earnings and profits to E&P accumulated in periods in which the DFIC was a specified foreign corporation would already prevent E&P accrued after the DFIC ceased to be a specified foreign corporation from being taken into account.
- (d) Thus, the definitions of “pro rata share” and “§ 958(a) U.S. shareholder inclusion year” were revised in the final regulations. *See* Treas. Reg. § 1.965-1(f)(30) and (f)(34). The definition of pro rata share continues to preclude reduction by distributions to other owners under § 951(a)(2)(B) in order to be consistent with § 965(d)(3)(B) and prevent double non-taxation in the case of certain 2018 dispositions of specified foreign corporations. *See* Treas. Reg. § 1.965-2(j)(6).

10. Determination of Pro Rata Share of Specified E&P Deficit.

- (a) The proposed regulations provided that, for purposes of determining a § 958(a) U.S. shareholder’s pro rata share of a specified E&P deficit of an E&P deficit foreign corporation, the specified E&P deficit is allocated among the shareholders of the corporation’s common stock in proportion to the value of the common stock held by such shareholders. Prop. Treas. Reg. § 1.965-1(f)(30)(ii). Treasury and the IRS now believe that a specified E&P deficit should be allocated to shareholders of an E&P deficit corporation’s preferred stock in cases involving common stock with no liquidating value.
- (b) The final regulations therefore provide that any amount of a specified E&P deficit that would otherwise be allocated in a hypothetical distribution to a class of common stock that has no liquidation value is instead allocated to the most junior class of equity with a positive liquidation value to the extent of the liquidation value. Treas. Reg. § 1.965-1(f)(30)(ii)(A).

- (c) The final regulations also provide that, in cases in which a corporation's common stock has a liquidation value of zero and there is no class of equity with a liquidation preference relative to the common stock, the specified E&P deficit is allocated among the common stock using any reasonable method consistently applied. Treas. Reg. § 1.965-1(f)(30)(ii)(B).

11. Determination of Specified E&P Deficit.

- (a) The proposed regulations provided that PTEP are not excluded in determining the existence and amount of an E&P deficit foreign corporation's specified E&P deficit. *See* Prop. Treas. Reg. § 1.965-1(f)(22)(ii). Commenters requested that the final regulations provide to the contrary. The comments were not adopted.
- (b) A commenter also requested confirmation that a distribution of PTEP in the last taxable year of a CFC beginning before January 1, 2018, can affect an E&P deficit foreign corporation's specified E&P deficit. Because PTEP can only be distributed pursuant to a dividend, which, pursuant to § 316, requires positive E&P, Treasury and IRS believe that a distribution of PTEP does not affect a specified E&P deficit. Accordingly, the comment was not adopted.

12. Attribution Rules: Foreign Corporation as a specified Foreign Corporation.

- (a) To limit the administrative and compliance difficulties associated with determining whether a foreign corporation is a specified foreign corporation solely by reason of downward attribution of its stock under § 318(a)(3)(A) from a partner to a partnership when the partner has only a de minimis interest in the partnership, Prop. Treas. Reg. § 1.965-1(f)(45)(ii) provided a special attribution rule for purposes of determining whether a foreign corporation is a specified foreign corporation within the meaning of § 965(e)(1)(B) and Prop. Treas. Reg. § 1.965-1(f)(45)(i)(B).
- (b) Specifically, the definition of specified foreign corporation provided that, solely for purposes of determining whether a foreign corporation is a specified foreign corporation within the meaning of § 965(e)(1)(B), stock owned, directly or indirectly, by or for a partner ("tested partner") will not be considered as being owned by a partnership under §§ 958(b) and 318(a)(3)(A) if the tested partner owns less than five percent of the interests in the partnership's capital and profits. Prop. Treas. Reg. § 1.965-1(f)(45)(ii). Similar

rules applied with respect to S corporations. *See* §§ 318(a)(5)(E) and 1373(a).

13. Downward Attribution to Trusts. A commenter requested that the final regulations adopt a similar rule for trusts, noting that downward attribution of stock to trusts is also possible when a beneficiary has a de minimis interest in the trust, unless that interest is a remote contingent interest. *See* § 318(a)(3)(B). Treasury and the IRS agree that downward attribution of stock to a trust from de minimis beneficiaries of the trust presents similar administrative and compliance difficulties to those addressed in the proposed regulations. Accordingly, the final regulations extended the special rules concerning downward attribution (as modified per the discussion immediately below). *See* Treas. Reg. § 1.965-1(f)(45)(ii)(A)(2).
14. Other Relief from Attribution
 - (a) One commenter indicated that, in determining specified foreign corporation status under § 965(e)(1)(B), the final regulations should take into account domestic corporations that are U.S. shareholders only if they own (within the meaning of § 958(a)) stock of the specified foreign corporation. Another commenter suggested that consideration of de minimis constructive ownership exceptions in determining specified foreign corporation status without specifically identifying the nature of such relief. A third commenter recommended that the five percent threshold in Prop. Treas. Reg. § 1.965-1(f)(45)(ii) be increased to a more significant percentage, such as 10%. A similar commenter suggested that the 5% threshold apply only to managing and controlling partners, and that a threshold of 15% apply to partners who have no ability to manage or control the partnership.
 - (b) Treasury and the IRS believe that a 10% threshold for application of the special attribution rules relating to partnerships and trusts would strike the appropriate balance between mitigating administrative and compliance burdens and accurately identifying which foreign corporations are, in fact, specified foreign corporations. Accordingly, the final regulations increased the threshold for application of this special attribution rule for partnerships from 5% to 10%, and similarly use a 10% threshold for the newly-added special attribution rule for trusts.
 - (c) Another commenter suggested that a foreign corporation that is a CFC solely by reason of downward attribution not be treated as a CFC for purposes of determining whether it is a specified foreign corporation with respect to a U.S. shareholder that is not a related person (within the meaning of § 954(d)(3)) regarding to the

domestic corporation to which ownership was attributed. Consistent with the statutory text, the final regulations did not adopt the exclusion from the definition of specified foreign corporation recommended by the comment.

15. Application of § 318(a)(5)(A) and (C). A commenter stated that Example 1 and Example 2 in Prop. Treas. Reg. § 1.965-1(g), which illustrated the special attribution rule, applied § 318(a)(5)(A) and (a)(5)(C) inconsistently with informal advice issued by the IRS. Because the interpretation of those provisions reflected in the examples is irrelevant to the application of the special attribution rule, the final regulations modified the examples to avoid the issue raised by the comment. *See* Treas. Reg. § 1.965-1(g)(1) and (2). No inference was intended regarding the proper interpretation of § 318(a)(5)(A) and (a)(5)(C).
- B. Treas. Reg. § 1.965-2 – Adjustments to E&P and Basis. Treas. Reg. § 1.965-2 contains rules relating to adjustments to E&P and basis to determine and account for the application of §§ 965(a) and (b) and Prop. Treas. Reg. § 1.965-1(b), and a rule that limits the amount of gain recognized in connection with the application of § 961(b)(2).
1. Ordering Rule. The proposed regulations set forth an ordering rule relating to adjustments to E&P for purposes of determining a § 958(a) U.S. shareholder's inclusions under § 951(a)(1) and the treatment of distributions under § 959. *See* Prop. Treas. Reg. § 1.965-2(b).
 - (a) Application in the Case of E&P Measurement Dates in Two Taxable Years.
 - i. Treasury and the IRS believe that the ordering rule's limited application to E&P for a specified foreign corporation's last taxable year beginning before January 1, 2018 was too narrow given that it is intended to apply for purposes of determining post-1986 earnings and profits and accumulated post-1986 deferred foreign income on the E&P measurement date on November 2, 2017. That measurement date may not fall within a specified foreign corporation's last taxable year beginning before January 1, 2018.
 - ii. The final regulations address this issue by providing that the ordering rule applies for the taxable year of a specified foreign corporation in which an E&P measurement date occurs, as well as for the last taxable year of a specified foreign corporation that begins before January 1, 2018.

- (b) Section 1248. Commenters raised questions about the proper point in the sequence at which to determine and take into account inclusions under § 1248. One comment suggested that § 965 should be taken into account before § 1248 amounts are determined. The final regulations provide that for purposes of the ordering rules, § 1248 amounts are determined at the same time as the determination of amounts included under § 951(a)(1)(A) other than amounts included by reason of § 965. As a result, § 1248 amounts are determined before, and may reduce, a buyer's § 965(a) inclusion amount regarding a DFIC. The application of the ordering rule in connection with a sale to which § 1248 applies is illustrated in a new example in Treas. Reg. § 1.965-2(j)(6).
- (c) Interaction of Ordering Rule, Foreign Tax Credit Rules, and Disregard Rules.
- i. Commenters raised questions concerning the interaction of the ordering rule with the rule disregarding payments in Prop. Treas. Reg. § 1.965-4(f) and the determination of the foreign tax credit consequences of inclusions with respect to, and distributions by, a specified foreign corporation.
 - ii. The final regulations provide rules concerning the ordering of the determination of foreign income taxes deemed paid with respect to an inclusion or distribution, after the E&P adjustments are determined in accordance with Treas. Reg. § 1.965-2(b). They provide that for purposes of determining the consequences under §§ 902 and 960 of a dividend or an inclusion under § 951(a)(1), respectively, the ordering rule in Treas. Reg. § 1.960-1(i)(2) applies except that § 902 is applied regarding any distributions from the specified foreign corporation described in Treas. Reg. § 1.965-2(b)(2) that are not disregarded under Treas. Reg. § 1.965-4 before § 960 is applied regarding an inclusion or a distribution described in Treas. Reg. §§ 1.965-2(b)(3), (b)(4), or (b)(5). Treas. Reg. § 1.965-2(b).
 - iii. The final regulations also confirm that the other rules of §§ 902 and 960 apply. *See* Treas. Reg. § 1.965-6(b). In addition, the final regulations provide that the E&P consequences of a distribution between specified foreign corporations that is disregarded for purposes of § 965 pursuant to Treas. Reg. § 1.965-4 are redetermined after adjustments for § 965(a) inclusions, at the same time that the consequences of other distributions are determined. *See* Treas. Reg. § 1.965-2(b)(1) and (4).

- iv. Modified and new examples illustrate the determination of the § 902 consequences of a distribution between specified foreign corporations before November 2, 2017, before the determination of the § 960 consequences of a § 965(a) inclusion and the foreign tax credit consequences of a distribution disregarded pursuant to Treas. Reg. § 1.965-4. *See* Treas. Reg. §§ 1.965-2(j)(1) and (4).

2. Adjustments to the E&P of DFICs.

- (a) Under Prop. Treas. Reg. § 1.965-2(c), the E&P of a DFIC that are described in § 959(c)(3) (or that would be described in § 959(c)(3) but for the application of § 965(a) and the § 965 regulations) are reduced (or, in the case of a deficit, increased) by an amount equal to the DFIC's § 965(a) previously taxed earnings and profits.
- (b) A commenter requested that the final regulations clarify that earnings described in § 959(c)(3) cannot be reduced below zero by reason of the rule in Prop. Treas. Reg. § 1.965-2(c) in order to ensure that the DFIC would be able to make a distribution of the § 965(a) PTEP. Treasury and the IRS have determined that it is appropriate for the reduction provided for in Prop. Treas. Reg. § 1.965-2(c) to create a deficit in E&P described in § 959(c)(3) if there are insufficient E&P to be reclassified and accordingly did not adopt the comment.
- (c) Under Prop. Treas. Reg. § 1.965-2(d)(1), the E&P described in § 959(c)(2) of a DFIC are increased by an amount equal to the reduction to a § 958(a) U.S. shareholder's pro rata share of the § 965(a) earnings amount of the DFIC under § 959(b), "provided the § 958(a) U.S. shareholder includes the § 965(a) inclusion amount with respect to the deferred foreign income corporation in income." A commenter noted that the rule would seem to preclude the creation of § 965(b) PTEP in a DFIC if its § 965(a) earnings amount was completely offset by § 958(a) U.S. shareholders' aggregate foreign E&P deficits. The rule was intended to limit the availability of § 965(b) PTEP to situations in which a § 965(a) inclusion amount was included only if there was a § 965(a) inclusion amount. Thus, the rule was revised to reflect this intent. *See* Treas. Reg. § 1.965-2(d)(1).
- (d) Commenters also requested that the final regulations clarify that § 965(b) PTEPs are treated as E&P attributable to an amount previously included in the income of a person under § 951 for purposes of § 1248(d)(1). The final regulations reflect this comment even though these amounts have not been included in income under § 951 because it is necessary to ensure the ability to

take into account § 965(b) PTEP upon a disposition of specified foreign corporation stock. *See* Treas. Reg. § 1.965-2(d)(1).

3. Basis Election.

(a) Requirements for Making and Revoking Basis Election.

- i. The proposed regulations clarified that, in general, no adjustments to basis of stock or property are made under § 961 (or any other provision of the Code) to account for the reduction to a § 958(a) U.S. shareholder's pro rata share of the § 965(a) earnings amount of a DFIC by a portion of its aggregate foreign E&P deficit. *See* Prop. Treas. Reg. § 1.965-2(f)(1). However, consistent with the legislative history, the proposed regulations allowed a § 958(a) U.S. shareholder to elect to make certain basis adjustments ("specified basis adjustments") with respect to each DFIC and each E&P deficit foreign corporation. Prop. Treas. Reg. § 1.965-2(f)(2).
- ii. Specifically, an election under the proposed regulations allowed a § 958(a) U.S. shareholder's basis in the § 958(a) stock of a DFIC or applicable property with respect to the DFIC to be increased by an amount equal to the § 965(b) previously taxed earnings and profits of the DFIC with respect to the § 958(a) U.S. shareholder. *See* Prop. Treas. Reg. § 1.965-2(f)(2)(ii)(A).
- iii. The basis election also required that the § 958(a) U.S. shareholder's basis in the § 958(a) stock of an E&P deficit foreign corporation or applicable property regarding an E&P deficit foreign corporation be reduced by an amount equal to the portion of the § 958(a) U.S. shareholder's pro rata share of the specified E&P deficit of the E&P deficit foreign corporation taken into account under the reduction rules. *See* Prop. Treas. Reg. § 1.965-2(f)(2)(ii)(B).
- iv. The proposed regulations provided the general rule that the basis election must be made no later than the due date (taking into account extensions, if any) for the later than the due date § 958(a) U.S. shareholder's return for the first taxable year that later than the due date § 958(a) U.S. shareholder's return for the first taxable year that includes the last day of the last taxable year of a DFIC or E&P deficit foreign corporation of the § 958(a) U.S. shareholder that begins before January 1, 2018. Prop. Treas. Reg. § 1.965-2(f)(2)(iii)(B)(1)(i).

- v. If the relevant return was due before September 10, 2018, the proposed regulations provide that the basis election must be made by October 9, 2018 (the “transition rule”). Prop. Treas. Reg. § 1.965-2(f)(2)(iii)(B)(1)(ii). The proposed regulations further required that, in order for the basis election to be effective, a § 958(a) U.S. shareholder and each § 958(a) U.S. shareholder that is related to the § 958(a) U.S. shareholder under § 267(b) or 707(b) (“related § 958(a) U.S. shareholder”) must make the election. Prop. Treas. Reg. § 1.965-2(f)(2)(iii)(A).
- vi. Section 2 of Notice 2018-78 announced that Treasury and the IRS had determined that requiring taxpayers to make a binding basis election before the finalization of the proposed regulations would be too onerous for taxpayers. Consistent with that announcement, the final regulations provide that the transition rule will apply with respect to returns due (determined with regard to any extension) before May 6, 2019, and that in such cases the basis election must be made no later than May 6, 2019. Prop. Treas. Reg. § 1.965-2(f)(2)(iii)(B)(1)(ii). Additionally, as explained in § 2 of Notice 2018-78, the final regulations provide that if a basis election was made on or before Feb. 5, 2019, the basis election may be revoked by attaching a statement to an amended return filed no later than May 6, 2019.
- vii. Clarification was requested regarding whether a basis election must be made by a related § 958(a) U.S. shareholder if that shareholder owns a DFIC but does not own an E&P deficit foreign corporation and does not reduce its pro rata share of any § 965(a) earnings amount under § 965(b), Prop. Treas. Reg. § 1.965-1(b)(2), or Prop. Treas. Reg. § 1.965-8(b). Treasury and the IRS believe that the requirement to make a basis election should not apply to these persons.
- viii. Accordingly, the final regulations provide that the basis election must be made by a § 958(a) U.S. shareholder and any related § 958(a) U.S. shareholder of an E&P deficit foreign corporation or of a DFIC regarding which the § 958(a) U.S. shareholder’s pro rata share of the § 965(a) earnings amount is reduced under § 965(b), Treas. Reg. § 1.965-1(b)(2), or Treas. Reg. § 1.965-8(b). Treas. Reg. § 1.965-2(f)(2)(iii)(A).

- ix. A “correcting amendment” to the final regulations provides that all members of an affiliated group that are U.S. shareholders of a DFIC or E&P deficit foreign corporation are treated as a single U.S. shareholder for purposes of the basis election. *See* 84 Fed. Reg. 14260 (Apr. 10, 2019).

(b) Level and Consequences of Basis Adjustments.

- i. Commenters requested that the final regulations provide that positive basis adjustments regarding § 965(b) PTEP apply down a chain of foreign corporations under § 961(c) and thus that they apply by default so that the basis election and its concomitant downward basis adjustments regarding E&P deficit foreign corporations need not be made. Commenters also suggested that even if downward basis adjustments were required, the final regulations should not require them to be made for the entire amount of a specified E&P deficit taken into account, but instead allow taxpayers to elect an amount of basis that “shifted.” The commenters were particularly concerned that downward adjustments not offset upward adjustments. Finally, commenters recommended that the final regulations not require gain recognition to the extent that downward basis adjustments would exceed basis, and that, if such gain recognition is required, a special reduced rate of tax be provided for such gain.
- ii. Treasury and the IRS believe that it is clear under Prop. Treas. Reg. § 1.965-2(f)(1) that no adjustments are made under § 961 with respect to § 965(b) PTEP, given that § 965(b) PTEP do not represent amounts included in income by a § 958(a) U.S. shareholder, as required by § 961, and that adjustments apply only regarding § 958(a) stock or applicable property owned directly by a § 958(a) U.S. shareholder (or in certain cases, through foreign pass-through entities). Accordingly, the final regulations do not modify the proposed regulations in this regard.
- iii. They also believe it would create economic distortions to provide for upward basis adjustments regarding § 965(b) PTEP without providing for corresponding downward basis adjustments with respect to portions of specified E&P deficits taken into account to reduce § 965(a) inclusion amounts and requiring gain recognition to the extent such adjustments exceed basis.

- iv. Accordingly, the preamble states that it would not be appropriate to provide that § 965(b) PTEP is treated as included in income under § 951 for purposes of § 961, even though the final regulations provide as much for purposes of § 1248(d). Treasury and the IRS also believe that rules coordinating upward and downward tiered-basis adjustments are not warranted. Finally, given the electivity of the specified basis adjustments, the final regulations do not provide rules resulting in the application of a special tax rate to such gain.
- v. However, Treasury and the IRS believe that it is appropriate to not require downward basis adjustments in excess of basis (in order to avoid gain recognition under Treas. Reg. § 1.965-2(h)(3) to the extent of the excess) if the corresponding upward basis adjustments are correspondingly limited. Accordingly, Treas. Reg. § 1.965-2(f)(2)(ii)(B)(2) provides that downward basis adjustments to the stock of, or applicable property regarding, an E&P deficit foreign corporation may be limited to the available basis with the result that gain is not recognized (the “to-the-extent rule”).
- vi. If the to-the-extent rule limits downward basis adjustments, the corresponding upward basis adjustments are similarly limited. *See* Treas. Reg. § 1.965-2(f)(2)(ii)(A)(2)(ii). However, the § 958(a) U.S. shareholder can (subject to certain limitations) designate the stock of, or applicable property regarding, a DFIC with respect to which the upward adjustments are made. A taxpayer may also choose to make the full amounts of the adjustments that would have been required under the proposed regulations and recognize gain under Treas. Reg. § 1.965-2(h)(3) as necessary. *See* Treas. Reg. § 1.965-2(f)(2)(ii)(A)(1) and (f)(2)(ii)(B)(1).

(c) Timing of Basis Adjustments.

- i. The proposed regulations provided that the specified basis adjustments are made as of the close of the last day of the last taxable year of the specified foreign corporation that begins before January 1, 2018. Prop. Treas. Reg. § 1.965-2(h)(1). Questions arose regarding the application of the proposed rules in the case of a specified foreign corporation that ceases to be a CFC during its last taxable year of the specified foreign corporation that begins before January 1, 2018, due to a disposition of its stock.

- ii. Under § 951, a § 958(a) U.S. shareholder of such a specified foreign corporation would generally have an inclusion under § 951 with respect to the corporation if it were a DFIC because it would own stock of the specified foreign corporation on the last day on which the corporation was a controlled foreign corporation. Accordingly, under Treas. Reg. § 1.961-1(a), a basis adjustment would generally be allowed as of the last day in the taxable year of such corporation on which it is a controlled foreign corporation.
 - iii. A specified foreign corporation is treated as a CFC for purposes of Treas. Reg. § 1.965-1(b) and §§ 951 and 961. Treasury and the IRS believe that income inclusion provisions in the final regulations should be consistent with these rules, and thus the basis adjustment provisions should as well, and the relevant rules in the final regulations were revised accordingly. *See* Treas. Reg. §§ 1.965-1(f)(30)(i) and (f)(34) and 1.965-2(h)(1) (providing that a specified basis adjustment is made as of the last day of the last taxable year of the specified foreign corporation that begins before January 1, 2018, on which it is a specified foreign corporation).
- (d) Share-by-Share Requirement for Basis Adjustments. Prop. Treas. Reg. § 1.965-2(h)(3) requires that the specified basis adjustments be made on a share-by-share basis. Commenters suggested that the specified basis adjustments be made in the aggregate to mitigate taxpayer burden in tracking and prevent what it described as inappropriate gain recognition. However, adjustments to basis under § 961 for inclusions under § 951 and distributions of PTEP are generally required to be made on a share-by-share basis, and it will be necessary to have information concerning basis share-by-share going forward. Furthermore, the to-the-extent rule included in the final regulations will provide relief to taxpayers that have low-basis and high-basis shares. Accordingly, this comment was not adopted.
- (e) Basis Adjustments with Respect to Foreign Pass-Through Entity. Commenters suggested that the final regulations provide that for purposes of the specified basis adjustments with respect to foreign pass-through entities, the principles of § 743(b) apply for associating a specified basis adjustment with a § 958(a) U.S. shareholder with respect to whom it is made. The comment also recommended clarification of the basis consequences of a distribution in a structure with a foreign pass-through entity. The preamble states that this comment will be considered in connection

with future guidance concerning the application of §§ 959 and 961 generally.

(f) Section 962 Elections.

- i. The proposed regulations reserved on the issue of basis adjustments regarding a § 958(a) U.S. shareholder that makes a § 962 election. A commenter noted that § 961(a)'s limitation on a basis increase to the amount of tax paid under chapter 1 of the Code regarding amounts required to be included in income under § 951(a) (in the case of a U.S. shareholder who has made a § 962 election for the taxable year) means that a § 958(a) U.S. shareholder that makes a § 965(h) election may only increase its basis as it pays its § 965(h) net tax liability over time. As suggested by the comment, the final regulations include this rule. *See* Treas. Reg. §§ 1.965-2(e)(2) and (h)(1). Consistent with this rule, no adjustments apply for § 965(b) PTEP and the use of specified E&P deficits. *See* Treas. Reg. § 1.965-2(f)(2)(ii)(C).
- ii. A commenter requested that the final regulations provide guidance concerning the consequences if an individual § 958(a) U.S. shareholder that made both a § 962 election and a § 965(h) election that applied to a § 965(a) inclusion with respect to a DFIC disposed of the DFIC stock before all of its § 965(h) net tax liability had been paid, and thus before all corresponding basis adjustments had been made. The commenter recommended that the basis adjustments be treated as made immediately before the disposition. Treasury and the IRS believe that this treatment would not be appropriate because it would allow the shareholder to obtain the benefits of the basis increase without having paid the corresponding tax, and did not adopt the comment.

4. Gain Reduction Rule and Translation Rates.

- (a) The proposed regulations provided that, for purposes of § 986(c), foreign currency gain or loss with respect to distributions of § 965(a) PTEP is determined based on movements in the exchange rate between December 31, 2017, and the date on which such E&P is actually distributed. *See* Prop. Treas. Reg. § 1.986(c)-1(a). The proposed regulations also provided that any gain or loss recognized under § 986(c) regarding distributions of § 965(a) PTEP is reduced in the same proportion as the reduction by a § 965(c) deduction amount of the § 965(a) inclusion amount that gave rise to the § 965(a) PTEP. *See* Prop. Treas. Reg. § 1.986(c)-1(b). Moreover,

Prop. Treas. Reg. § 1.986(c)-1(c) provided that § 986(c) does not apply with respect to distributions of § 965(b) PTEP.

- (b) The proposed regulations also provided that if a § 958(a) U.S. shareholder receives a distribution from a DFIC (including through a chain of ownership described under § 958(a)) during the inclusion year of the DFIC that is attributable to § 965 PTEP of the DFIC, then the amount of gain that otherwise would be recognized under § 961(b)(2) by the § 958(a) U.S. shareholder regarding the § 958(a) U.S. shareholder's § 958(a) stock of the DFIC or interest in applicable property with respect to the DFIC by reason of the distribution is reduced (but not below zero) by an amount equal to the § 965 PTEP of the DFIC regarding the § 958(a) U.S. shareholder. Prop. Treas. Reg. § 1.965-2(g)(1)(i).
- (c) The proposed regulations did not specify the translation rate to be used for purposes of reducing the amount of gain that otherwise would be recognized under § 961(b)(2) when a DFIC that has a functional currency other than the U.S. dollar distributes § 965(b) PTEP. In the absence of a rule providing that § 965(b) PTEP should be translated into U.S. dollars at the spot rate on December 31, 2017, fluctuations in exchange rates would cause distortions in the application of the gain reduction rule to distributions of § 965(b) PTEP.
- (d) For example, distributions of § 965(b) PTEP denominated in a currency other than the U.S. dollar during an inclusion year could result in gain recognition attributable to fluctuations in exchange rates, notwithstanding the fact that Prop. Treas. Reg. § 1.986(c)-1 specifically provides that a taxpayer is not required to recognize foreign currency gain or loss on such distributions.
- (e) To prevent recognition of gain under these circumstances, the final regulations provide that the translation rate to be used with respect to § 965(b) PTEP for purposes of the gain reduction rule is the spot rate on December 31, 2017.
- (f) Treasury and the IRS are considering proposing regulations under § 961 to similarly ensure that a taxpayer is not required to recognize gain by reason of fluctuations in exchange rates on distributions of § 965(b) PTEP in taxable years after the inclusion year. In addition, they intend to study the proper amount of gain or loss, including foreign currency gain or loss, to be recognized on distributions of PTEP, including PTEP other than § 965(a) PTEP and § 965(b) PTEP.

- C. Treas. Reg. § 1.965-3 – § 965(c) Deductions. Treas. Reg. § 1.965-3 provides rules regarding the determination of § 965(c) deductions and § 965(c) deduction amounts.
1. Disregard of Certain Assets to Prevent Double Counting. The proposed regulations contained rules for disregarding certain assets for purposes of determining the aggregate foreign cash position of a § 958(a) U.S. shareholder. *See* Prop. Treas. Reg. § 1.965-3(b).
 - (a) Disregard of Certain Obligations Between Related Specified Foreign Corporations.
 - i. One such rule in the proposed regulations provided that, for purposes of determining the aggregate foreign cash position of a § 958(a) U.S. shareholder, accounts receivable, accounts payable, short-term obligations, and derivative financial instruments between related specified foreign corporations are disregarded, if applicable, on a cash measurement date of the specified foreign corporations to the extent of the smallest of the § 958(a) U.S. shareholder's ownership percentages of § 958(a) stock of the specified foreign corporations owned by the § 958(a) U.S. shareholder on the cash measurement date. Prop. Treas. Reg. § 1.965-3(b)(1).
 - ii. A commenter suggested that the rule in Prop. Treas. Reg. § 1.965-3(b)(1) be extended to permit the same treatment for third-party accounts payable and third-party accounts receivable held by related specified foreign corporations of a § 958(a) U.S. shareholder. The commenter also suggested that all members of a consolidated group that are § 958(a) U.S. shareholders be treated as a single § 958(a) U.S. shareholder for purposes of such a rule. Treasury and the IRS did not adopt this comment. The final regulations therefore do not extend the rule in Prop. Treas. Reg. § 1.965-3(b)(1) to cover third-party accounts payable and third-party accounts receivable held by related specified foreign corporations with a common § 958(a) U.S. shareholder.
 2. Disregard of Other Assets and Double-Counting. A rule in the proposed regulations intended to prevent double counting provides that, in determining the aggregate foreign cash position of a § 958(a) U.S. shareholder, amounts of net accounts receivable, actively traded property, and short-term obligations of a specified foreign corporation are disregarded to the extent such amounts are attributable to amounts taken into account in determining the § 958(a) U.S. shareholder's pro rata share

of the cash position of another specified foreign corporation on the same cash measurement date. Prop. Treas. Reg. § 1.965-3(b)(2). In order for the rule in Prop. Treas. Reg. § 1.965-3(b)(2) to apply, a § 958(a) U.S. shareholder must explain, in a statement attached to its timely filed return for its inclusion year, why there would otherwise be double-counting.

(a) Expansion

- i. Commenters recommended that the rule in Prop. Treas. Reg. § 1.965-3(b)(2) be expanded to cover all assets constituting a specified foreign corporation's cash position, which are enumerated in § 965(c)(3)(B). Under this formulation, a § 958(a) U.S. shareholder would be able to disregard cash held by its specified foreign corporation (or any other asset described in § 965(c)(3)(B)) on a cash measurement date to the extent attributable to amounts already taken into account in determining the § 958(a) U.S. shareholder's pro rata share of the cash position of another specified foreign corporation on such cash measurement date.
- ii. The final regulations did not adopt this recommendation. They do not expand the rule in Prop. Treas. Reg. § 1.965-3(b)(2) to allow a § 958(a) U.S. shareholder to disregard assets other than those specifically enumerated in § 965(c)(3)(D).

(b) Clarification of Cash Measurement Dates.

- i. Commenters also recommended that the rule in Prop. Treas. Reg. § 1.965-3(b)(2) be clarified so that relief from double-counting is available with respect to a specified foreign corporation when an amount is taken into account in determining the § 958(a) U.S. shareholder's pro rata share of the cash position of another specified foreign corporation on such other specified foreign corporation's corresponding cash measurement date even if the cash measurement date is not the same calendar date for both specified foreign corporations.
- ii. Treasury and the IRS believe that § 965(c)(3)(D) allows relief from double counting whenever a § 958(a) U.S. shareholder can establish that net accounts receivable, actively traded property, or short-term obligations are "taken into account . . . with respect to another specified foreign corporation." The statute does not require that an

amount must have been taken into account with respect to another specified foreign corporation on the same day.

- iii. Therefore, the final regulations modified the rule in Prop. Treas. Reg. § 1.965-3(b)(2) to clarify that double-counting relief with respect to a specified foreign corporation is available when an amount is taken into account in determining the § 958(a) U.S. shareholder's pro rata share of the cash position of another specified foreign corporation on the other specified foreign corporation's corresponding cash measurement date. Treas. Reg. § 1.965-3(b)(2). Corresponding clarifications are made for consistency in Treas. Reg. § 1.965-3(b)(1).

- (c) Notional Cash Pooling Arrangements. Commenters requested guidance providing that for purposes of computing a § 958(a) U.S. shareholder's aggregate foreign cash position, notional cash pooling arrangements are treated as creating intercompany receivables. The facts and circumstances of each notional cash pool, including the underlying contractual rights and obligations of the parties to the arrangement and the role of the unrelated cash pool provider in the arrangement, are varied. Whether a notional cash pooling arrangement is treated as in substance creating a loan between and among participants, rather than between the participant and the unrelated cash pool provider, depends on the application of federal income tax principles to the particular facts and circumstances of the arrangement. Accordingly, the final regulations did not adopt these comments.

3. Disregard of Portion of Cash Position of Noncorporate Entities Treated as Specified Foreign Corporations.

- (a) Section 965(c)(3)(E) provides that an entity (other than a corporation) is treated as a specified foreign corporation of a U.S. shareholder for purposes of determining the U.S. shareholder's aggregate foreign cash position if any interest in the entity is held by a specified foreign corporation of the U.S. shareholder (determined after application of the rule in this sentence) and the entity, if it were a foreign corporation, would be a specified foreign corporation of the U.S. shareholder.
- (b) A commenter requested guidance clarifying the application of § 965(c)(3)(E) to noncorporate entities only partially owned by a specified foreign corporation. The legislative history to § 965(c)(3)(E) indicates that it was intended that "the cash position of a U.S. shareholder . . . not generally include the cash attributable to a direct ownership interest in a partnership," and that Treasury

and the IRS “provide guidance for taking into account only the specified foreign corporation’s share of the partnership’s cash position, and not [an] interest directly owned by the U.S. shareholder.”

- (c) Accordingly, the final regulations include a rule in Treas. Reg. § 1.965-3(b)(3) providing that if § 965(c)(3)(E) applies to an entity, the § 958(a) U.S. shareholder’s pro rata share of the cash position of the entity is reduced by the amount attributable to deemed stock of the entity not owned (within the meaning of § 958(a)) by a specified foreign corporation of the § 958(a) U.S. shareholder. This rule is illustrated in the example in Treas. Reg. § 1.965-3(b)(4)(v).

- 4. Increase of Income by § 965(c) Deduction of Expatriated Entity. Under Prop. Treas. Reg. § 1.965-3(d)(1), if a person is allowed a § 965(c) deduction and becomes an expatriated entity, in certain circumstances, the person must pay tax equal to 35% of the person’s § 965(c) deductions. *See also* § 965(l)(1). A commenter recommended clarifying and limiting the definition of expatriated entity to exclude U.S. individuals on the theory that the reference to “entity” in § 965(l)(2) was intended to so provide. Section 965(l)(2) defines expatriated entity by cross-reference to the definition provided in § 7874(a)(2), which includes not only entities but certain persons (which could be individuals) related to the entity at issue. Therefore, Treasury and the IRS have determined that § 965(l)(2) does not apply only to an entity but potentially to any person that is an expatriated entity, and the final regulations are clarified accordingly. *See* Treas. Reg. § 1.965-3(d)(2).

- 5. Treatment of § 965(c) Deductions.

- (a) Under the proposed regulations, a U.S. person that had to pay tax under § 4940 or 1411 on a § 965(a) inclusion cannot take into account a § 965(c) deduction for purposes of determining the amount of such tax. *See* Prop. Treas. Reg. § 1.965-3(f)(3) and (4). A commenter recommended that the § 965(c) deduction be allowed for purposes of computing the amount of tax due under § 1411. It suggested that the rule in Prop. Treas. Reg. § 1.965-3(f)(3) was inconsistent with the rule in Treas. Reg. § 1.1411-4(f)(3)(ii), which takes into account in determining net investment income itemized deductions that are investment expenses (as defined in § 163(d)(4)(C)).
- (b) However, Treas. Reg. § 1.1411-4(f)(3)(ii) is inapplicable because Treas. Reg. § 1.965-3(f)(1) provides that a § 965(c) deduction is not an itemized deduction. Treasury and the IRS believe that the § 965(c) deduction was only intended to reduce the rate of tax

attributable to income taxes contained in chapter 1 of the Code. Accordingly, the final regulations continue to provide that for purposes of § 1411 and Treas. Reg. § 1.1411-4(f)(6), a § 965(c) deduction is not treated as a deduction properly allocable to a corresponding § 965(a) inclusion. Treas. Reg. § 1.965-3(f)(3).

- (c) A commenter also recommended that the final regulations clarify that a § 965(c) deduction is a deduction taken into account under § 62(a) in determining an individual's adjusted gross income. The final regulations were modified to so provide. *See* Treas. Reg. § 1.965-3(f)(1).

D. Treas. Reg. § 1.965-4 – Disregard of Certain Transactions; Anti-Abuse Rules.

1. Prop. Treas. Reg. § 1.965-4 set forth rules that disregard certain transactions for purposes of applying § 965. Specifically, Prop. Treas. Reg. § 1.965-4 provided rules that disregard (i) transactions undertaken with a principal purpose of changing a § 965 element of a U.S. shareholder, (ii) certain changes in method of accounting and entity classification elections, and (iii) certain transactions occurring between E&P measurement dates.
2. Scope and Consequences of Anti-Abuse Rules Generally.
 - (a) The rules under Prop. Treas. Reg. § 1.965-4(b) through (e) (“anti-abuse rules”) relate to transactions undertaken with a principal purpose of changing a § 965 element of a U.S. shareholder and certain changes in method of accounting and entity classification elections. They provide that transactions subject to those rules are “disregarded for purposes of determining the amounts of all § 965 elements” of a U.S. shareholder. Commenters questioned the consequences of disregarding a transaction under these rules, including with respect to certain E&P and foreign tax credit calculations. The final regulations retained the approach in the proposed regulations, which do not describe the consequences of disregarding a transaction other than the consequences with respect to the § 965 elements of a U.S. shareholder.
 - (b) The preamble to the final regulations says that a discussion of, or rules regarding, the consequences of these transactions for other purposes is outside the scope of the final regulations. However, Treasury and the IRS have determined that it is appropriate to mitigate double taxation that could result from the application of the anti-abuse rules to a liquidation. Accordingly, Treas. Reg. § 1.965-4(e)(4) provides that in the case of a liquidation of a specified foreign corporation that is disregarded for purposes of determining the § 965 elements of a U.S. shareholder pursuant to

Treas. Reg. §§ 1.965-4(b) or (c)(2), for purposes of determining the amounts of the § 965 elements of the U.S. shareholder, the date of the liquidation generally is treated as the last day of the taxable year of the specified foreign corporation.

- (c) Special rules apply with respect to liquidations resulting from entity classification elections, including a rule that may defer the date of liquidation for this purpose to the date on which the entity classification election is filed. For example, if a domestic corporation (USP) wholly owns a foreign subsidiary (FS) that has a taxable year ending on November 30, and an entity classification election is filed on November 15, 2017, to treat FS as an entity that is disregarded as an entity separate from its owner for U.S. federal income tax purposes (“disregarded entity”) effective on October 1, 2017, then any transactions undertaken by FS through and including November 15, 2017, would be taken into account for purposes of determining the post-1986 earnings and profits and accumulated post-1986 deferred foreign income of FS, and any transactions involving FS after November 15, 2017, would not be taken into account for such purposes.
- (d) Furthermore, any § 965(a) PTEP and § 965(b) PTEP of FS would be taken into account in determining the all earnings and profits amount under Treas. Reg. § 1.367(b)-3(b) regarding FS.
- (e) Commenters also requested various exceptions from the anti-abuse rules for transactions that do not reduce the overall U.S. federal income tax liability of U.S. persons resulting from the application of § 965. In response to these comments, Treas. Reg. § 1.965-4(e)(3) provides an exception from the anti-abuse rules for certain incorporation transactions. Under the exception, the anti-abuse rules do not apply to disregard a transfer of stock of a specified foreign corporation by a U.S. shareholder to a domestic corporation (for this purpose, including an S corporation), provided that the § 965(a) inclusion amount with respect to the transferred stock of the specified foreign corporation is not reduced and that the aggregate foreign cash position of both the transferor and the transferee is determined as if each had held the transferred stock of the specified foreign corporation owned by the other on each of the cash measurement dates.

3. Transactions with a Principal Purpose of Changing a § 965 Element.

(a) General Rules.

- i. Commenters suggested that the anti-abuse rules be eliminated and that, if retained, the anti-abuse rules in Prop.

Treas. Reg. § 1.965-4(b) not contain rebuttable presumptions or per se rules. Treasury and the IRS have determined that the rebuttable presumptions and per se rules are appropriate for tax administration reasons. They identify situations in which tax avoidance is highly likely or unlikely in order to minimize the number of circumstances in which more detailed facts and circumstances analyses are required.

- ii. A commenter also suggested that ordinary course exceptions be provided for all of the anti-abuse rules, so that the rules would never apply to ordinary course transactions. Treasury and the IRS believe that excluding ordinary course transactions from the presumptions in the anti-abuse rules, rather than the overall application of the rules, while still applying those rules to transactions that were actually undertaken with a principal purpose of changing a § 965 element, strikes the appropriate balance between administrability and taxpayer certainty, and therefore did not adopt the comment.
- iii. A commenter also suggested that the final regulations omit the requirement in Prop. Treas. Reg. § 1.965-4(b)(2) that a taxpayer file a statement indicating that it has taken the position that a presumption in Prop. Treas. Reg. § 1.965-4(b) is rebutted. Treasury and the IRS have determined that it is important for fair and effective tax administration that the IRS be aware of transactions for which there is a presumption of a principal purpose of changing a § 965 element and did not adopt the suggestion.

(b) Cash Reduction Transactions and Specified Distributions.

- i. The proposed regulations provided that a cash reduction transaction is presumed to be undertaken with a principal purpose of changing a § 965 element of a U.S. shareholder unless the cash reduction transaction occurs in the ordinary course of business. Prop. Treas. Reg. § 1.965-4(b)(2)(iii)(A). A cash reduction transaction includes a transfer of cash, accounts receivable, or cash-equivalent assets by a specified foreign corporation to a U.S. shareholder of the specified foreign corporation or a person related to a U.S. shareholder of the specified foreign corporation if the transfer or assumption reduces the aggregate foreign cash position of the U.S. shareholder.

- ii. The presumption may be rebutted only if the facts and circumstances clearly establish that the transaction was not undertaken with a principal purpose of changing the amount of a § 965 element of a U.S. shareholder, and a taxpayer taking the position that the presumption is rebutted must attach a statement to its tax return disclosing that it has rebutted the presumption. Treas. Reg. § 1.965-4(b)(2)(i).
- iii. The proposed regulations also set forth a “per se” rule providing that a cash reduction transaction will be treated per se as being undertaken with a principal purpose of changing the amount of a § 965 element of a U.S. shareholder if it is a specified distribution. Prop. Treas. Reg. § 1.965-4(b)(2)(iii)(B).
- iv. The proposed regulations provided, in part, that a cash reduction transaction that is a distribution by a specified foreign corporation of a U.S. shareholder will be considered a specified distribution if and to the extent that, at the time of the distribution, there was a plan or intention for the distributee to transfer cash, accounts receivable, or cash-equivalent assets to any specified foreign corporation of the U.S. shareholder. Under the proposed regulations, a cash reduction transaction that is a distribution by a specified foreign corporation to a U.S. shareholder of the specified foreign corporation, other than a specified distribution, is treated per se as not being undertaken with a principal purpose of changing the amount of a § 965 element of a U.S. shareholder.
- v. Commenters requested that the final regulations exempt certain transactions from the definition of cash reduction transaction and specified distribution. One commenter requested that a cash reduction transaction not be treated as a specified distribution if, and to the extent that, the distributee does not, within 24 months following the distribution, transfer cash, accounts receivable, or cash equivalents to a specified foreign corporation of the U.S. shareholder.
- vi. Although Treasury and the IRS believe that the amount of time between a distribution and a transfer of cash may be relevant in determining whether there was a plan or intent for the distributee to transfer the cash, they believe that a per se rule disregarding transfers outside of a certain window is not warranted, as long-term plans for a transfer

could exist, and providing such a rule would facilitate tax avoidance.

- vii. Another commenter suggested that the rule be do clarified that any transferred amount disregarded be limited to the amount of the subsequent transfer. Because a specified distribution is defined as a cash reduction transaction “to the extent that” there is a plan or intent to re-transfer cash, Treasury and the IRS believe that it is already clear that the amount of a specified distribution is limited to the amount re-transferred, and accordingly that no additional clarification is necessary.
- viii. Another commenter requested that the per se rule not apply to cash reduction transactions planned before November 2, 2017. The final regulations do not adopt this requested change, as Treasury and the IRS believe that a rule exempting cash reduction transactions in planning stages before November 2, 2017, from the application of the per se rule would necessarily have to account for the possibility of subsequent plan modification or amendment and would require an inquiry regarding a taxpayer’s subjective intent, resulting in a standard that is difficult to administer.
- ix. Comments also suggested that a cash reduction transaction should not be considered a specified distribution to a U.S. shareholder by reason of a transfer of cash to a specified foreign corporation of the U.S. shareholder in the ordinary course of business.
- x. Treasury and the IRS agree that payments pursuant to a legal obligation entered into before the TCJA’s introduction in Congress should not be considered to give rise to a plan or intention for the distributee in a cash reduction transaction to transfer cash, accounts receivable, or cash-equivalent assets to a specified foreign corporation of the distributee.
- xi. Accordingly, Treas. Reg. § 1.965-4(b)(2)(iii)(B) provides that in the case of a cash reduction transaction that is a distribution by a specified foreign corporation of a U.S. shareholder, there is not considered to be a plan or intention for the distributee to transfer cash, accounts receivable, or cash-equivalent assets to any specified foreign corporation of the U.S. shareholder if the transfer is made by the distributee pursuant to a legal obligation entered into before November 2, 2017.

xii. If the taxpayer relies on this rule in determining that a cash reduction transaction is not a specified distribution, it must attach a statement to its return indicating that position.

(c) Pro Rata Share Transactions. The proposed regulations provided that a pro rata share transaction is presumed to be undertaken with a principal purpose of changing the amount of a § 965 element of a U.S. shareholder and treat certain internal group transactions as per se being undertaken with a principal purpose of changing the amount of a § 965 element of a U.S. shareholder. Prop. Treas. Reg. § 1.965-4(b)(2)(v). A commenter requested that internal group transactions not be treated as per se having a principal purpose of changing a § 965 element. The final regulations did not adopt the comment.

(d) E&P Reduction Transactions

i. A commenter noted that dividends paid by one specified foreign corporation to another between E&P measurement dates could potentially be subject to the rules in both Prop. Treas. Reg. § 1.965-4(f) (disregarding specified payments in order to mitigate double-counting) and Prop. Treas. Reg. § 1.965-4(b)(2)(iv) (which can result in disregarding certain transactions that reduce accumulated post-1986 deferred foreign income or post-1986 earnings and profits) and argued that the overlapping rules create a burden on taxpayers that should be ameliorated by exempting dividends between E&P measurement dates from the rules in Prop. Treas. Reg. § 1.965-4(b)(2)(iv).

ii. Treasury and the IRS believe that if such a dividend were disregarded pursuant to Treas. Reg. § 1.965-4(f), then it is clear that it is irrelevant whether it would also be disregarded under Treas. Reg. § 1.965-4(b), applying the presumption in Treas. Reg. § 1.965-4(b)(2)(iv), such that there would be no need for a taxpayer to bear the burden of rebutting the presumption.

iii. If, however, the dividend is not disregarded pursuant to Treas. Reg. § 1.965-4(f), and the taxpayer takes the position that it is also not disregarded under Treas. Reg. § 1.965-4(b), because it can rebut a presumption that applies under Treas. Reg. § 1.965-4(b)(2)(iv), then it is appropriate that the taxpayer be required to document that rebuttal. Accordingly, the comment was not adopted.

4. Changes of Accounting Method and Entity Classification Elections.

- (a) A commenter noted that a positive § 481 adjustment resulting from a change of accounting method could increase the § 965(a) inclusion amount and the amount of foreign income taxes deemed paid by a U.S. shareholder and thus be disregarded for purposes of determining the U.S. shareholder's § 965(a) inclusion amount, allowing some or all of the adjustment to escape taxation under § 965, even though the increase in foreign income taxes deemed paid was minimal.
- (b) Treasury and the IRS believe that this would be inappropriate and modify the rule in Prop. Treas. Reg. § 1.965-4(c)(1) to apply only if there is a reduction in a § 965(a) inclusion amount or an aggregate foreign cash position, or an increase in § 960 deemed paid taxes other than by reason of an increase in a § 965(a) inclusion amount. *See* Treas. Reg. § 1.965-4(c)(1)(i).
- (c) Commenters suggested that the rule in Prop. Treas. Reg. § 1.965-4(c)(1), which applies to changes in methods of accounting, not apply to changes from impermissible methods of accounting to permissible methods of accounting, and that the rule be conditioned on a principal purpose of changing a § 965 element. The preamble states that a principal purpose-based rule would be difficult to administer and unwarranted, given that changes after November 2, 2017, relating to specified foreign corporations, likely would be tax-motivated.
- (d) Treasury and the IRS state that they have determined that allowing changes from impermissible methods of accounting to permissible methods of accounting to be taken into account will allow similarly situated taxpayers to take different positions in a way that is detrimental to the government, as taxpayers will choose to make currently those changes that result in reductions of tax due under § 965 while deferring such changes that would result in increases of tax due under § 965 until later years. Accordingly, the comments were not adopted.
- (e) Another commenter requested that the final regulations permit the taxable year of a specified foreign corporation to be changed to a calendar year taxable year. Because neither the proposed regulations nor the final regulations affect the possibility of changing the accounting period of a specified foreign corporation, the final regulations did not adopt this comment. The preamble, however, cites Rev. Proc. 2018-17, 2018-9 I.R.B. 384 (limiting certain changes in accounting periods of a specified foreign corporation).

- (f) In addition, commenters raised questions regarding the scope of the rule in Prop. Treas. Reg. § 1.965-4(c)(2), which applied to any entity classification election under Treas. Reg. § 301.7701-3 that was filed on or after November 2, 2017, and whether it is appropriate for that rule to be a per se rule that applies to all entity classification elections filed on or after that date. A commenter suggested that the rule would inappropriately apply to a transaction that would have no impact on § 965 elements. Another commenter suggested that certain transactions effectuated by entity classification elections, such as conversion of a U.S. shareholder from a domestic pass-through entity to a C corporation, or vice versa, should be excepted from the application of the rule.
- (g) The preamble states that because an entity classification election is an election made specifically for tax purposes that could be made retroactively to be effective before November 2, 2017, and because the rule would only disregard such an election if it had the effect of changing a § 965 element, the final regulations did not change the rule from the proposed regulations.

5. Application of Specified Payment Rule.

- (a) The proposed regulations provided that certain amounts paid or incurred between related specified foreign corporations of a § 958(a) U.S. shareholder between E&P measurement dates that would otherwise reduce the post-1986 earnings and profits as of December 31, 2017, of the specified foreign corporation that paid or incurred such amounts are disregarded for purposes of determining the post-1986 earnings and profits of both of the specified foreign corporations as of the E&P measurement date on December 31, 2017. *See* Prop. Treas. Reg. § 1.965-4(f)(1).
- (b) Commenters stated that the requirement that the two specified foreign corporations have different tentative measurement dates in order for specified payments to be disregarded results in complexity and inappropriate results when there were multiple payments among specified foreign corporations during the period, such as in a series of dividends up a multi-level chain of specified foreign corporations.
- (c) They also indicated that it was unclear how the tentative measurement date was to be determined in the case of a specified foreign corporation that was neither an E&P deficit foreign corporation nor a DFIC. Moreover, commenters indicated that disregarding specified payments that were deductible payments only for purposes of § 965, but not other purposes, could create unintended foreign tax credit results, which results would not be

remedied by the changes to the ordering rule in Treas. Reg. § 1.965-2(b). One commenter suggested that the specified payment rule should be refined to have an anti-abuse function.

- (d) Treasury and the IRS believe that detailed rules to address the fact patterns raised in the comments, such as rules to determine the extent of double-counting, to except ordinary course payments, or to add ordering rules to determine whether a payment is a specified payment, would introduce more complexity than is warranted and would be difficult to administer.
- (e) However, the final regulations eliminate the requirement that the specified foreign corporations between which a payment is made have different tentative measurement dates in order for the payment to be a specified payment disregarded under the rule and provide that a § 958(a) U.S. shareholder may choose not to apply the rule in Treas. Reg. § 1.965-4(f)(1), provided that it and all related § 958(a) U.S. shareholders do so with respect to all of their specified foreign corporations. Treas. Reg. §§ 1.965-4(f)(1), (2), and (3).

E. Treas. Reg. § 1.965-5 and § 1.965-6 – Foreign Tax Credits.

- 1. Prop. Treas. Reg. § 1.965-5 and § 1.965-6 provided rules with respect to foreign tax credits. The proposed regulations included, in addition to the foreign tax credit-specific rules of § 965, rules coordinating the provisions of § 965 with the foreign tax credit provisions as in effect before their repeal or amendment by the TCJA.
- 2. Application and Determination of the Disallowance of the Applicable Percentage of Foreign Income Taxes.
 - (a) Disallowance of the Applicable Percentage of Foreign Income Taxes Attributable to Distributions of PTEP.
 - i. Under the proposed regulations, no deduction (including under § 164) or credit under § 901 was allowed for the applicable percentage (as defined in Prop. Treas. Reg. § 1.965-5(d)) of any foreign income taxes “paid or accrued” regarding any amount for which a § 965(c) deduction is allowed for a § 958(a) U.S. shareholder inclusion year. Prop. Treas. Reg. § 1.965-5(b).
 - ii. This included foreign income taxes directly paid or accrued by a taxpayer attributable to a distribution of § 965(a) PTEP or § 965(b) PTEP. A similar rule applied to deny the applicable percentage of any foreign income taxes “treated as paid or accrued” with respect to any amount for which a

§ 965(c) deduction is allowed for a § 958(a) U.S. shareholder inclusion year. Prop. Treas. Reg. § 1.965-5(c). For these purposes, foreign income taxes “treated as paid or accrued” included foreign income taxes deemed paid by the taxpayer under § 960 regarding distributions of § 965(a) PTEP or § 965(b) PTEP.

- iii. Commenters recommended that the proposed regulations be modified to allow a credit for the applicable percentage of foreign income taxes directly paid or accrued under § 901 or treated as paid or accrued under § 960 on a distribution of § 965(a) PTEP or § 965(b) PTEP. In general, these commenters asserted that the disallowance of taxes attributable to a distribution of PTEP discourages the distribution of the PTEP, which the commenters assert is inconsistent with the purpose of § 965. Commenters also argued that the rule created administrative complexity and asked for guidance on how to track PTEP for purposes of applying this rule. Other commenters acknowledged that providing a reduction for the foreign tax credits attributable to a distribution of PTEP based on the applicable percentage was appropriate.
- iv. The final regulations did not adopt the recommended changes. As an initial matter, the preamble states that guidance on tracking PTEP is outside the scope of this rulemaking. In addition, Treasury and the IRS believe that the rules under Treas. Reg. § 1.965-5(b) are consistent with the statutory purpose of §§ 960 and 965 and do not discourage the repatriation of PTEP. In any event, the purpose of the foreign tax credit is not to encourage repatriation of E&P to the U.S. but to relieve double taxation. To the extent the income is subject to a lower effective rate of U.S. tax, it is consistent with the purpose of § 965(g) to reduce the credits allowed as part of relieving double taxation on such income.
- v. The preamble further states that the statutory language of § 965(g) contemplates that the disallowance for the applicable percentage will apply to distributions of PTEP. Section 965(g)(1) provides, “[n]o credit shall be allowed under § 901 for the applicable percentage of any foreign income taxes paid or accrued (or treated as paid or accrued). . . .” In addition, § 965(g)(3) provides that no deduction is allowed for any tax for which credit is not allowable under § 901 by reason of § 965(g)(1).

- vi. A deduction is allowed only for taxes directly paid or accrued by the taxpayer, not taxes deemed paid by the taxpayer. Because a U.S. taxpayer would ordinarily be subject to foreign tax only on a distribution from a foreign corporation, not on an income inclusion under U.S. tax law, “taxes paid or accrued” can only be understood to refer to foreign income taxes directly paid or accrued under § 901 regarding a distribution to the taxpayer of PTEP. Allowing a full credit for all of those foreign income taxes would render § 965(g)(3) meaningless.
- vii. Accordingly, in order to give effect to the language of § 965(g)(3), foreign taxes paid or accrued on distributions of § 965(a) PTEP and § 965(b) PTEP are subject to the credit disallowance rules of § 965(g)(1).
- viii. The preamble also states that there is no policy reason to differentiate between foreign income taxes attributable to a distribution of PTEP that are paid or accrued directly by the U.S. shareholder and are creditable under § 901 and those foreign income taxes that are paid or accrued by other CFCs as part of the distribution of the earnings to the U.S. shareholder and are creditable under § 960(a)(3).
- ix. Thus, because § 965(g)(3) contemplates the disallowance of foreign tax credits attributable to distributions of PTEP when the foreign income taxes are directly paid or accrued by the U.S. shareholder, the final regulations continue to provide that the foreign tax credit is disallowed regarding the applicable percentage of foreign income taxes deemed paid under § 960(a)(3) with respect to a distribution of PTEP in the same manner as credits are disallowed for foreign taxes deemed paid under § 960(a)(1) regarding a § 965(a) inclusion.
- x. Additionally, some commenters raised specific objections about the application of these rules to foreign income taxes paid and deemed paid with respect to distributions of § 965(b) PTEP, stating that the disallowance is inappropriate because these earnings do not represent an amount for which a § 965(c) deduction is allowed. One commenter also stated that it was inappropriate to disallow the applicable percentage of foreign income taxes paid and deemed paid with respect to distributions of § 965(b) PTEP because a distribution of § 965(b) PTEP results in a dollar-for-dollar reduction to basis (to the extent thereof),

followed by gain recognition, because there is no automatic basis increase in the amount of such earnings under § 961.

- xi. Additionally, the commenter pointed out that the proposed regulations could create inequities between taxpayers because the proposed regulations could be read to imply that a taxpayer that had no § 965(a) inclusion amount because of the operation of § 965(b) had no applicable percentage, and thus no reduction in creditable foreign income taxes paid or deemed paid on distributions of the § 965(b) PTEP.
- xii. Treasury and the IRS have determined that § 965(b) PTEP is treated as included in income under § 951(a) for purposes of § 960, and thus is treated similarly to § 965(a) PTEP for purposes of applying § 965(g). Additionally, regarding the reduction in basis associated with a distribution of § 965(b) PTEP, the final regulations provide that a § 958(a) U.S. shareholder may elect to make certain basis adjustments to increase the basis of DFICs with § 965(b) PTEP. *See* Treas. Reg. § 1.965-2(f)(2).

(b) Compatibility of Applicable Percentage Credit Disallowance with U.S. Bilateral Income Tax Treaties.

- i. One commenter stated that Prop. Treas. Reg. § 1.965-5 is incompatible with the provisions of U.S. bilateral income tax treaties that provide for relief from double taxation. However, the credit against U.S. income tax provided for in these treaties is generally allowed “[i]n accordance with the provisions and subject to the limitations of the law of the U.S. (as it may be amended from time to time without changing the general principle hereof).”
- ii. The disallowance of the applicable percentage of foreign income taxes under § 965(g)(1) and Treas. Reg. § 1.965-5 is similar to the application of § 904 and other provisions in the Code that limit the allowable foreign tax credit. The disallowance takes into account the § 965(c) deduction and reflects the fact that, because of the § 965(c) deduction, the income included under § 965 is subject to an effective rate of U.S. tax that is significantly lower than the U.S. tax rates ordinarily imposed on corporations or individuals.
- iii. Absent this disallowance, foreign income tax incurred with respect to the income included under § 965 could inappropriately be used to offset U.S. tax on unrelated

foreign source income, rather than to mitigate double taxation incurred regarding the taxable amount of the § 965(a) inclusion.

- iv. Accordingly, the preamble states that the application of § 965(g)(1) and Treas. Reg. § 1.965-5 is consistent with the provisions of U.S. bilateral income tax treaties that provide for relief from double taxation.

(c) Applicable Percentage with Respect to Foreign Income Taxes that are Not Net Basis Taxes.

- i. The proposed regulations provided that no deduction or credit is allowed for the applicable percentage of net basis taxes imposed on a U.S. citizen by the citizen's jurisdiction of residence upon receipt of a distribution of § 965(a) PTEP or § 965(b) PTEP. Prop. Treas. Reg. § 1.965-5(b). A comment recommended that the final regulations define "net basis taxes" and clarify that Prop. Treas. Reg. § 1.965-5(b) does not apply to creditable gross basis income taxes.
- ii. Section 965(g) and Prop. Treas. Reg. § 1.965-5(b) apply to all creditable foreign income taxes. The reference to "net basis taxes" was included in the proposed regulations for illustrative purposes only, and the taxes listed in Prop. Treas. Reg. § 1.965-5(b) are not an exhaustive list of the taxes subject to Prop. Treas. Reg. § 1.965-5(b). The final regulations clarified this accordingly. *See* Treas. Reg. § 1.965-5(b).

(d) Applicable Percentage Regarding Distributions of § 965(b) PTEP.

- i. The definition of applicable percentage in § 965(g) and Prop. Treas. Reg. § 1.965-5(d) is computed based on a taxpayer's § 965(a) inclusion for a § 958(a) U.S. shareholder inclusion year. Commenters stated that it was not clear under the proposed regulations how the applicable percentage with respect to § 965(b) PTEP should be determined when a DFIC has section 965(b) PTEP but the § 958(a) U.S. shareholder does not have an aggregate § 965(a) inclusion amount, because its pro rata shares of accumulated post-1986 deferred foreign income are entirely offset by its pro rata shares of specified E&P deficits.
- ii. The final regulations provide that if there is no aggregate § 965(a) inclusion amount, the applicable percentage is 55.7% (that is, the applicable percentage that would apply

if the § 965(b) PTEP had been included in income and were an amount to which § 965(c)(1)(B) applied). *See* Treas. Reg. § 1.965-5(d)(2).

- iii. The final regulations also clarify how the applicable percentage applies with respect to domestic pass-through owners and with respect to distributions of PTEP. Regarding domestic pass-through owners, the final regulations provide that the applicable percentage determined under Treas. Reg. § 1.965-5(d)(1) or (2) with respect to a domestic pass-through entity applies with respect to taxes deemed paid by a domestic pass-through owner even if the domestic pass-through entity does not have a § 965(a) inclusion amount. Treas. Reg. § 1.965-5(d)(3).
- iv. Regarding foreign income taxes imposed on distributions of PTEP, the final regulations provide that the applicable percentage that is applied is the applicable percentage with respect to the § 958(a) U.S. shareholder and the § 958(a) U.S. inclusion year in which the § 958(a) U.S. shareholder had the § 965(a) inclusion as a result of which the § 965(a) PTEP or the § 965(b) PTEP first arose. Treas. Reg. § 1.965-5(d)(4).

(e) Applicable Percentage Regarding Tax on Gain from Sale of Stock.

- i. The proposed regulations provided that the disallowance of foreign tax credits under § 965(g)(1) applies with respect to the applicable percentage of foreign income taxes attributable to distributions of § 965(a) PTEP and § 965(b) PTEP. Prop. Treas. Reg. § 1.965- 5(b).
- ii. A commenter requested guidance on whether the applicable percentage also applies to foreign income taxes imposed on an amount of a shareholder's gain from the sale of the specified foreign corporation's stock taken into account for foreign, but not U.S., income tax purposes, equal to its tax basis increase under § 961(a) or Treas. Reg. § 1.965-2(f)(2) by reason of § 965.
- iii. Treasury and the IRS have determined that under Treas. Reg. § 1.904-6, foreign tax imposed on a disposition of stock is associated with the gain (or other income) that is (or would be) recognized for U.S. tax purposes upon a taxable disposition, without regard to whether the taxpayer's basis in the stock (and, accordingly, the amount

of gain recognized) is a different amount for U.S. and foreign tax purposes.

- iv. Because no portion of a foreign tax imposed on the sale of a specified foreign corporation's stock is considered imposed with respect to its PTEP, the final regulations did not expand the scope of the rule in the proposed regulations.

3. Operation of § 960(a)(3).

(a) Disallowance of Credits for Foreign Taxes Treated as Deemed Paid Under § 960(a)(1) Regarding § 965(b) PTEP.

- i. The proposed regulations provided that no credit would be allowed under § 960(a)(3) or any other section for foreign income taxes that would have been deemed paid under § 960(a)(1) regarding the § 965(a) earnings amount that is reduced under Prop. Treas. Reg. § 1.965-1(b)(2) or Prop. Treas. Reg. § 1.965-8(b). Prop. Treas. Reg. § 1.965-5(c)(1)(ii). Treasury and the IRS received comments asserting that this rule should not be included in the final regulations. The final regulations retain the rule that was in the proposed regulations.
- ii. Commenters stated that allowing a deemed paid credit under § 960(a)(3) is necessary to avoid double taxation; however, there is no double taxation associated with § 965(b) PTEP. The § 965(a) earnings amount offset by an aggregate foreign E&P deficit is excluded from U.S. taxable income and thereby effectively exempted from U.S. tax under § 965(b)(4)(A) and Prop. Treas. Reg. § 1.965-1(b)(2) or Prop. Treas. Reg. § 1.965-8(b).
- iii. The preamble states that, as a policy matter, this exclusion eliminates the need for a foreign tax credit. The purpose of the foreign tax credit is to mitigate double taxation by allowing foreign income taxes to reduce the U.S. tax that would otherwise be imposed on foreign source income. Allowing foreign income taxes imposed on income that is not subject to U.S. tax by reason of § 965(b) to be credited against U.S. tax on unrelated income would confer a windfall double benefit for taxpayers with § 965(b) PTEP.
- iv. As a technical matter, § 965(b)(4)(A) treats § 965(a) earnings amounts offset by an aggregate foreign E&P deficit as previously included in income under § 951(a)

“for purposes of applying § 959.” Accordingly, § 965(b) PTEP are treated as PTEP resulting from a § 951(a) inclusion, despite never actually having been included in U.S. taxable income. Under § 960(a)(1), a domestic corporate shareholder that includes an amount in income under § 951(a) is deemed to have paid a ratable portion of the foreign corporation’s foreign income taxes at the time of the income inclusion. According to Treasury and the IRS, amounts treated as PTEP resulting from an income inclusion under § 951(a) should similarly be treated as having resulted in foreign taxes deemed paid under § 960(a)(1).

- v. Section 960(a)(3) generally allows a credit for foreign income taxes paid by CFCs upon a subsequent distribution of the § 965(b) PTEP through a chain of CFCs to the domestic corporate shareholder, but does not allow a credit for foreign income taxes that were previously deemed paid (or treated as deemed paid) under § 960(a)(1) when the amounts were included (or treated as included) in income under § 951(a). Because foreign income taxes attributable to a § 965(a) earnings amount that were offset by an aggregate foreign E&P deficit were treated as deemed paid under § 960(a)(1) when those earnings were treated as included in income under § 951(a), those taxes are not available to be deemed paid again under § 960(a)(3) upon a subsequent distribution of the § 965(b) PTEP.
- vi. The preamble states that, consistent with that treatment and with § 960(a)(2), the regulations under § 902 remove from the foreign corporation’s pool of post-1986 foreign income taxes the foreign income taxes that are attributable to earnings included in income under § 951(a) or otherwise removed from its post-1986 undistributed earnings. *See* Treas. Reg. § 1.902-1(a)(8)(i).
- vii. Commenters stated that the plain language of § 965(b)(4)(A) means that § 965(a) earnings amounts offset by an aggregate foreign E&P deficit are treated as income previously included under § 951(a) solely for purposes of applying § 959, and not for purposes of applying § 960(a). However, the application of § 959 is a precondition to the application of § 960(a)(3). Treasury and the IRS believe that § 960(a)(3) cannot be applied independently of § 959 and that the TCJA did not change the relationship between these sections.

- viii. Indeed, stated Treasury and the IRS, the commenters recognize the interaction between §§ 959 and 960(a)(3) by recommending that a credit be allowed under § 960(a)(3) upon a distribution of § 965(b) PTEP, which requires treating such amounts as PTEP for purposes of § 960(a)(3) as well as for purposes of § 959. If the § 965(b) PTEP were treated as PTEP excluded from gross income on distribution under § 959(a) in applying § 960(a)(3), it necessarily would follow that in applying that same section those amounts must be treated as having been included in income under § 951(a) and resulted in foreign taxes deemed paid under § 960(a)(1) as well.
- ix. Some commenters raised the concern that U.S. companies would face a higher U.S. tax burden by not being able to claim foreign tax credits under § 960(a)(3) for foreign income tax imposed on E&P that is not subject to tax in the U.S. by reason of § 965(b). The commenters said that this would reduce the competitive advantage Congress sought to confer through the enactment of the foreign tax credit regime and discourage repatriation of PTEP.
- x. The preamble states that the purpose of the foreign tax credit regime is to relieve double taxation of foreign source income by reducing U.S. tax on that income, not to guarantee that U.S. taxpayers will be able to use all foreign income taxes paid to reduce their U.S. tax burden. *See* § 904. The foreign tax credit regime was never intended to subsidize foreign income taxes that are paid in excess of the U.S. tax burden on the foreign source income. Because these earnings are not subject to U.S. tax, any foreign tax credits related to these earnings would only be used to offset other unrelated foreign source income.
- xi. Thus, Treasury and the IRS believe that the rule in the final regulations is based upon both the technical analysis of the relevant sections of the Code and the underlying policy. As a result, no credit is allowed under § 960(a)(3) or any other provision of the Code for taxes attributable to § 965(a) earnings amounts offset by an aggregate foreign E&P deficit that would have been deemed paid under § 960(a)(1) had the amounts actually been included in income under § 951(a).

(b) Definition of Upper-Tier Foreign Corporation.

- i. The proposed regulations provide that the credit allowed under § 960(a)(3) is only with respect to foreign income taxes imposed on an upper-tier foreign corporation on distributions of § 965(a) PTEP or § 965(b) PTEP from a lower-tier foreign corporation. Prop. Treas. Reg. § 1.965-5(c)(1)(ii). A commenter requested that the final regulations clarify that references to “upper-tier foreign corporation” includes a disregarded entity or partnership that is legally an owner of the specified foreign corporation in question, and that references to distributions similarly refer to legal distributions not to U.S. tax characterizations.
- ii. The final regulations did not broaden the definition of “upper-tier foreign corporation.” To the extent that there is a distribution of PTEP from a foreign corporation to a disregarded entity or partnership that is owned by a foreign corporation, the foreign corporate owner would be considered an “upper-tier foreign corporation.” Therefore, a credit would be allowed under § 960(a)(3) upon ultimate distribution of the PTEP to an eligible U.S. shareholder for creditable foreign income taxes imposed on the disregarded entity or partnership that are considered paid by the foreign corporate owner for U.S. tax purposes regarding the distribution of PTEP from the lower-tier foreign corporation.
- iii. To the extent that there is a distribution of PTEP from a foreign corporation to a disregarded entity or partnership that is owned by a domestic corporation, the domestic corporate owner should be entitled to a credit under § 901 for the creditable foreign income taxes imposed on the disregarded entity or partnership that are considered paid by the domestic corporation for U.S. tax purposes. Therefore, there is no need to broaden the definition of “upper-tier foreign corporation” to include disregarded entities and partnerships.
- iv. Finally, clarification was requested on whether the requirement that the PTEP be distributed by a lower-tier foreign corporation in order for taxes to be deemed paid with respect to the PTEP under § 960(a)(3) applies to both § 965(a) PTEP and § 965(b) PTEP, or just to the latter. Treasury and the IRS believe that regulations are clear that the requirement applies to both § 965(a) PTEP and § 965(b) PTEP. *See* Treas. Reg. § 1.965-5(c)(1)(ii).

4. Deemed Paid Credit Computation.

(a) Treatment of Adjustment Under § 965(b)(4)(B).

- i. The proposed regulations provided that, for purposes of § 902(c)(1), the post-1986 undistributed earnings of an E&P deficit foreign corporation are increased under § 965(b)(4)(B) and Treas. Reg. § 1.965-2(d)(2)(i)(A) as of the first day of the foreign corporation's first taxable year following the E&P deficit foreign corporation's last taxable year that begins before January 1, 2018. Prop. Treas. Reg. § 1.965-6(c)(3). Commenters recommended that the final regulations conform to the language of § 965(b)(4)(B) to provide that these adjustments happen in the last taxable year that begins before January 1, 2018.
- ii. Section 965(b)(4)(B) provides that a U.S. shareholder's pro rata share of the E&P of any E&P deficit foreign corporation is increased by the amount of the specified E&P deficit of such corporation taken into account by the shareholder by reason of allocation of the deficit to a DFIC. Under § 902(c)(1), post-1986 undistributed earnings are based on the E&P of the foreign corporation, computed in accordance with §§ 964(a) and 986, without diminution for dividends distributed during the taxable year.
- iii. Treasury regulations modify the computation of E&P included in post-1986 undistributed earnings as necessary to carry out the provisions of § 902. For example, under Treas. Reg. § 1.902-1(a)(9)(i), PTEP arising in prior post-1986 taxable years are not included in post-1986 undistributed earnings.
- iv. Given this background, Treasury and the IRS determined that post-1986 undistributed earnings should not be increased during the last taxable year of an E&P deficit foreign corporation beginning before January 1, 2018, as a result of § 965(b)(4)(B). An immediate increase could allow shareholders to claim deemed paid credits with respect to amounts earned after November 2, 2017, by E&P deficit foreign corporations even though such earnings were not in excess of accumulated deficits.
- v. That would result in a windfall to § 958(a) U.S. shareholders of DFICs and E&P deficit foreign corporations because such shareholders are not taxable on accumulated post-1986 deferred foreign income of a DFIC

to the extent of the DFIC's allocable share of an aggregate foreign E&P deficit and, with respect to the E&P deficit corporation, they would be entitled to deemed paid taxes that they would not otherwise be eligible to claim because of the accumulated deficit, a result inconsistent with general operation of § 902.

- vi. Additionally, the preamble states that deemed paid taxes would not be subject to the disallowance for the applicable percentage provided for in § 965(g), even though the foreign income taxes were able to be deemed paid only as a result of the operation of § 965. Accordingly, this rule was not changed in the final regulations. *See* Treas. Reg. § 1.965-6(b)(3).

(b) Deemed Paid Credits for E&P Deficit Foreign Corporations.

- i. The proposed regulations provided that when the denominator of the § 902 fraction is zero or less than zero, the § 902 fraction is zero, and no foreign taxes are deemed paid. Prop. Treas. Reg. § 1.965-6(c)(2). A commenter requested that the foreign taxes of an E&P deficit foreign corporation could be deemed paid with respect to a § 965(a) inclusion, for example, by allocation of such taxes pro rata to DFICs.
- ii. Treasury and the IRS did not adopt the suggestion to treat the post-1986 foreign income taxes of an E&P deficit foreign corporation as taxes paid or accrued by a DFIC. They state there is no basis in the statute for modifying the computation of deemed paid credits in this manner. In addition, neither § 902 nor 960 nor the regulations issued under those sections provide for the allocation of taxes from one foreign corporation to another as suggested by the comment.

(c) Application of § 902 as if § 965(a) Inclusion Were a Dividend.

- i. The proposed regulations provided, in relevant part, that for purposes of determining foreign taxes deemed paid under § 960(a)(1) with respect to a § 965(a) inclusion with respect to a DFIC, § 902 applies as if the § 965(a) inclusion were a dividend paid by the DFIC. Prop. Treas. Reg. § 1.965-6(b). Questions arose as to the effect of treating a § 965(a) inclusion as a dividend for this purpose. This language merely incorporates the language of § 960(a)(1) into the regulations, as § 960(a)(1) also provides in relevant part

that “§ 902 shall be applied as if the amount so included were a dividend paid by such foreign corporation.” The language in Prop. Treas. Reg. § 1.965-6(b) did not mean that any of the requirements of §§ 902 and 960 should be considered inapplicable for purposes of determining deemed paid taxes with respect to § 965(a) inclusions.

- ii. Further, the language in Prop. Treas. Reg. § 1.965-6(b) did not mean that § 965(a) inclusions should be treated as dividends for purposes of the ordering rule under Treas. Reg. § 1.960-1(i)(2). The final regulations clarify that the ordering rules of Treas. Reg. § 1.960-1(i)(2) continue to apply. *See* Treas. Reg. § 1.965-2(b).

(d) Section 902 Fraction.

- i. The proposed regulations provided that the term “§ 902 fraction” means, regarding either a DFIC or an E&P deficit foreign corporation, the fraction that is (i) the dividend paid by, or the inclusion under § 951(a)(1) (including a § 965(a) inclusion) regarding, the foreign corporation, as applicable, divided by (ii) the foreign corporation’s post-1986 undistributed earnings. Prop. Treas. Reg. § 1.965-6(c). A question was raised as to whether dividends and inclusions under § 951(a)(1) are combined for purposes of the § 902 fraction. Another comment concerned whether the definition of “§ 902 fraction” implied that the ordering rule in Treas. Reg. § 1.960-1(i)(2) was no longer effective.
- ii. The final regulations include a defined term, “§ 902 fraction,” that is consistent with § 902(a), while tying it to the computation of deemed paid taxes in § 902(a). *See* Treas. Reg. § 1.965-6(b)(2) and (4). The final regulations also confirm that the ordering rule in Treas. Reg. § 1.960-1(i)(2), as modified by Treas. Reg. § 1.965-2(b), applies in years in which a taxpayer may have a § 965(a) inclusion. Accordingly, the § 902 fraction must be computed separately with respect to dividends and inclusions under § 951(a)(1). The examples in Treas. Reg. § 1.965-2(j)(1) and (4) illustrate the determination of deemed paid taxes (including the computation of § 902 fractions) under §§ 902 and 960 in fact patterns involving § 965(a) inclusions.

(e) Ownership Requirements for Deemed Paid Taxes.

- i. The proposed regulations provide that the rule treating members of a consolidated group as a single corporation did not apply for purposes of computing the foreign taxes deemed paid with respect to a § 965(a) inclusion, and that the foreign taxes deemed paid must be computed on a separate member basis. *See* Prop. Treas. Reg. § 1.965-8(e)(2).
- ii. A commenter requested that the final regulations treat all the members of a consolidated group as a single taxpayer for all purposes of § 965, such that members owning less than 10% of a DFIC would be able to claim deemed paid credits with respect to the DFIC.
- iii. Another commenter requested relief in the case in which a domestic corporation satisfied the ownership requirements under § 902 regarding a DFIC when it received a distribution from the DFIC, but did not satisfy the ownership requirements under § 960 on the date of the § 965(a) inclusion.
- iv. The final regulations continue to follow the statute under § 960 regarding the ownership requirements for eligibility for a foreign tax credit and, therefore, did not adopt either of these comments. *See* Treas. Reg. § 1.965-8(e)(2).

(f) Hovering Deficits.

- i. The preamble to the proposed regulations stated that the regulations would not provide a rule that, to the extent that a hovering deficit is treated as reducing the post-1986 earnings and profits of a DFIC, related taxes would be added to the DFIC's post-1986 foreign income taxes in the inclusion year with respect to the DFIC. After the issuance of the proposed regulations, Treasury and the IRS received additional comments requesting reconsideration of this issue. Comments highlighted the following language in the legislative history to § 965:

“[T]he conferees expect the Secretary may issue guidance to provide that, solely for purposes of calculating the amount of foreign income taxes deemed paid by the U.S. shareholder with respect to an inclusion under § 965, a hovering deficit may be absorbed by current year earnings and profits and the foreign income taxes related to the hovering deficit may be added to the specified foreign corporation's post-1986

foreign income taxes in that separate category on a pro rata basis in the year of inclusion.”

- ii. To effectuate the legislative history, the final regulations provide that to the extent the hovering deficit would have been absorbed by E&P accrued during the taxable year but for a § 965(a) inclusion, taxes that relate to the hovering deficit are taken into account for purposes of determining post-1986 foreign income taxes.
- iii. Therefore, Treas. Reg. § 1.965-6(d) provides that in the last taxable year that begins before January 1, 2018 of a DFIC that is also a foreign surviving corporation, for purposes of determining the related taxes that are included in post-1986 foreign income taxes, the post-transaction earnings that can be offset by a hovering deficit include any current year earnings which were included under § 965 by a § 958(a) U.S. shareholder; and the hovering deficit offset is treated as occurring as of the last day of the DFIC’s inclusion year.

F. Treas. Reg. § 1.965-7 – Elections and Payment Rules.

1. Treas. Reg. § 1.965-7 provided rules regarding the timing and manner of certain elections that may be available to taxpayers under § 965, and payments to be made pursuant to those elections.
2. Election Statements.
 - (a) The proposed regulations provided that, in order to make elections regarding § 965, the person making the election must attach an election statement, signed under penalties of perjury, to its return for the relevant taxable year. Prop. Treas. Reg. §§ 1.965-2(f)(2)(iii)(B)(2), 1.965-7(b)(2)(iii), 1.965-7(c)(2)(iii), 1.965-7(d)(3)(iii), 1.965-7(e)(2)(iii), and 1.965-7(f)(5)(iii). The proposed regulations did not address whether the election statement attached to or included with the return must be signed or whether the person making the election can attach an unsigned statement and retain the signed copy in its records.
 - (b) The final regulations provide that the signature requirement is satisfied if the unsigned copy is attached to a timely-filed return of the person making the election, provided that the person retains the signed original in the manner specified in § 1.6001-1(e). See Treas. Reg. §§ 1.965-2(f)(2)(iii)(B)(2), 1.965-7(b)(2)(iii), 1.965-7(c)(2)(iii), 1.965-7(d)(3)(iii), 1.965-7(e)(2)(iii), and 1.965-7(f)(5)(iii).

- (c) In addition, commenters requested clarification regarding whether the election statement could be signed by a return preparer and who must sign the statement in the case of a married filing jointly income tax return. The final regulations do not specifically address who must sign a statement but indicate that general rules concerning who is authorized to sign tax returns apply.

3. Acceleration Events and Triggering Events.

- (a) Section 965(h)(3) provides that an acceleration event occurs when there is an addition to tax for failure to timely pay an installment required under § 965(h), a liquidation or sale of substantially all of the assets of the person who made the § 965(h) election (including in a title 11 or similar case), a cessation of business by the person who made the § 965(h) election, or any similar circumstance. Prop. Treas. Reg. § 1.965-7(b)(3)(ii) clarified what events are acceleration events and what is considered a similar circumstance. Prop. Treas. Reg. § 1.965-7(b)(3)(ii)(B) provided that a liquidation, sale, exchange, or other disposition of substantially all of the assets of the person making the election (including in a title 11 or similar case or, in the case of an individual, death) would be an acceleration event.
- (b) Similarly, § 965(i)(2) lists triggering events that end the payment deferral for purposes of the § 965(i) election, including a liquidation or sale of substantially all of the assets of the S corporation (including in a title 11 or similar case), a cessation of business by the S corporation, the S corporation ceasing to exist, or any similar circumstance. Prop. Treas. Reg. § 1.965-7(c)(3)(ii) clarified the similar circumstances treated as triggering events. Specifically, Prop. Treas. Reg. § 1.965-7(c)(3)(ii)(B) provided that a liquidation, sale, exchange, or other disposition of substantially all of the assets of the S corporation (including in a title 11 or similar case) would be a triggering event.
- (c) In addition, § 965(m)(2)(B)(ii) provides that, with respect to a real estate investment trust (“REIT”) that made a § 965(m) election, a liquidation or sale of substantially all of the assets of the REIT (including in a title 11 or similar case), a cessation of business by the REIT, or any similar circumstance will cause any amount not yet included in gross income (due to the § 965(m) election) to be included in gross income as of the day before the date of the event. Prop. Treas. Reg. § 1.965-7(d)(5) clarified what a similar circumstance means by providing that a liquidation, sale, exchange, or other disposition of substantially all of the assets of the REIT will cause the acceleration of the remaining inclusion.

- (d) Disposition or Exchange of Substantially All of the Assets.
- i. Commenters questioned whether a disposition of substantially all of the assets resulting from a downstream tax-free reorganization or an exchange described in § 351 or 721 should constitute an acceleration event or triggering event, particularly when the assets remain under the control of the taxpayer, and whether a reorganization described in § 368(a)(1)(F) should be treated as an acceleration event or triggering event. One commenter, relating only to triggering events under § 965(i), proposed multiple alternatives, including removing the “exchange or other disposition” language from Prop. Treas. Reg. § 1.965-7(c)(3)(ii)(B) and providing that any nonrecognition transaction is not an exchange.
 - ii. Treasury and the IRS believe that any disposition of substantially all of the assets of the person making the § 965(h) election, the S corporation, or the REIT, including in a tax-free reorganization or an exchange described in § 351 or 721, poses a risk to the IRS’s ability to collect the full amount of the § 965(h) net tax liability, § 965(i) net tax liability, or total net tax liability under § 965, as the case may be.
 - iii. They believe that it is essential for tax administration purposes for the IRS to be apprised of these dispositions. Providing an exclusion to the general rule that an exchange or other disposition of substantially all of the assets of the person making the § 965(h) election, the S corporation regarding which a § 965(i) election is in effect, or the REIT with a § 965(m) election in effect for nonrecognition transactions could hamper the IRS’s ability to collect the outstanding tax liabilities and could enable certain taxpayers to inappropriately dilute their interests in their assets or change their businesses in a way that is inconsistent with the purposes behind the elections and related triggering and acceleration events.
 - iv. The final regulations also do not include a special exception for reorganizations under § 368(a)(1)(F) because requiring a transfer agreement, if applicable, in those situations is necessary for tax administration purposes.
 - v. A commenter also requested clarification of the meaning of “substantially all” for purposes of the acceleration event and triggering event rules. The phrase “substantially all” is

used in various Code provisions and in regulations, and often is determined based on all of the facts and circumstances. Consistent with this general approach, Treasury and the IRS declined to provide a bright-line definition of “substantially all” in the final regulations.

(e) Death of Transferor.

- i. Prop. Treas. Reg. § 1.965-7(b)(3)(ii)(B) provided that for a person who made a § 965(h) election, the liquidation, sale, exchange, or other disposition of substantially all of the assets of the person, including, for an individual, by reason of death, is an acceleration event. Prop. Treas. Reg. § 1.965-7(b)(3)(iii)(A)(1)(ii) specifically excluded death of an individual from the covered acceleration events that allow for a transfer agreement.
- ii. A commenter requested that, because death is specifically mentioned as a triggering event in § 965(i)(2)(A)(iii) but not § 965(h)(3), death not be treated as an acceleration event for purposes of the § 965(h) election. In addition, the commenter requested that, if death is treated as an acceleration event for purposes of the § 965(h) election, it be treated as a covered acceleration event (as described in Prop. Treas. Reg. § 1.965-7(b)(3)(iii)(A)(1)) and thus be eligible for a transfer agreement. Under § 965(h)(3), an acceleration event includes a liquidation or sale of substantially all of the assets of the taxpayer or any similar circumstance, and Prop. Treas. Reg. § 1.965-7(b)(3)(ii)(B) provided that an exchange or other disposition of substantially all of the assets of the taxpayer (outside of the context of the death of an individual) is an acceleration event. The death of an individual taxpayer is similar to any transfer or other disposition of substantially all of the assets of a taxpayer, and, accordingly, is a similar circumstance that should be an acceleration event.
- iii. Treasury and the IRS have determined that there are administrative difficulties with transferring liabilities and executing transfer agreements in the event of death. Moreover, in many cases, there would be multiple beneficiaries in the case of death, and multiple transferees are not permitted for purposes of § 965(h). For those reasons, and because the § 965(i) rules more clearly contemplate allowing transfers on death (and allowing transfers to multiple transferees or beneficiaries), Treasury and the IRS have determined that it is appropriate not to

treat the death of an individual shareholder as a covered acceleration event for purposes of § 965(h), and the comment is not adopted.

4. Transfer Agreements.

(a) Inclusion of Form 965-A or 965-B. The proposed regulations provided that transfer agreements for purposes of § 965(h) and § 965(i) are required to include the eligible § 965(h) transferor's or eligible § 965(i) transferor's most recent Form 965-A or 965-B, as applicable, among other information. Prop. Treas. Reg. §§ 1.965-7(b)(3)(iii)(B)(4)(v) and (c)(3)(iv)(B)(4)(v). In some cases, no Form 965-A or 965-B will have been required to be filed before the transfer agreement. Accordingly, the final regulations clarify that the Form 965-A or 965-B is only required to be filed with a transfer agreement if the eligible § 965(h) transferor or eligible § 965(i) transferor was required to file the form. Treas. Reg. §§ 1.965-7(b)(3)(iii)(B)(4)(v) and (c)(3)(iv)(B)(4)(v).

(b) Due Date for Transfer Agreements.

i. Prop. Treas. Reg. §§ 1.965-7(b)(3)(iii)(B)(2)(ii) and § 1.965-7(c)(3)(iv)(B)(2)(ii) provided that, if an acceleration event or a triggering event occurred before September 10, 2018, a transfer agreement had to be filed by October 9, 2018, in order to be considered timely filed. In addition, Prop. Treas. Reg. §§ 1.965-7(b)(3)(iii)(B)(2)(i) and § 1.965-7(c)(3)(iv)(B)(2)(i) provided that, if an acceleration event or a triggering event occurred on or after September 10, 2018, a transfer agreement had to be filed within thirty days of the acceleration or triggering event in order to be considered timely filed. Prop. Treas. Reg. §§ 1.965-7(b)(3)(iii)(B)(2)(i) and 1.965-7(c)(3)(iv)(B)(2)(i) provided that transfer agreements had to be filed in accordance with the rules provided in publications, forms, instructions, or other guidance.

ii. Because additional guidance, including where to file the agreements, was not issued before certain transfer agreements would have been due, the transition rules in Treas. Reg. §§ 1.965-7(b)(3)(iii)(B)(2)(ii) and 1.965-7(c)(3)(iv)(B)(2)(ii) have been updated to provide that if a triggering event or acceleration event occurred on or before Feb. 5, 2019, the transfer agreement must be filed by March 7, 2019, in order to be considered timely filed. *See also* Treas. Reg. § 1.965-7(c)(3)(v)(D)(2)(ii) (similarly

extending the deadline for filing agreements to make a § 965(h) election after a triggering event).

(c) Multiple Transferees.

- i. Regarding a § 965(h) acceleration event, Prop. Treas. Reg. § 1.965-7(b)(3)(iii)(B)(1) defines an eligible § 965(h) transferee as a “single U.S. person that is not a domestic pass-through entity” that meets additional requirements. Regarding a § 965(i) triggering event, Prop. Treas. Reg. § 1.965-7(c)(3)(iv)(B)(1) defined an eligible § 965(i) transferee as a “single U.S. person that is not a domestic pass-through entity.”
- ii. A commenter requested that multiple transferees be allowed to be eligible transferees for purposes of both § 965(h) and § 965(i). Section 965(h) and Prop. Treas. Reg. § 1.965-7(b) do not allow for a partial transfer of the § 965(h) net tax liability. Allowing multiple transferees would be similar to allowing for partial transfers. Furthermore, the existence of multiple transferees poses significant administrative challenges for the IRS.
- iii. Accordingly, Treasury and the IRS did not adopt the recommendation. However, § 965(i)(2)(B) specifically contemplates partial transfers of the § 965(i) net tax liability. As a result, the final regulations clarify in Treas. Reg. § 1.965-7(c)(3)(iv)(B)(1) that if a transfer (including as a result of the death of an eligible § 965(i) transferor) consists of multiple partial transfers (as described in Treas. Reg. § 1.965-7(c)(3)(iii)), then the eligible § 965(i) transferor can enter into multiple transfer agreements, one for each partial transfer, with different eligible § 965(i) transferees.

(d) Consolidated Groups.

- i. Prop. Treas. Reg. § 1.965-7(b)(3)(ii)(F) provided that an acceleration event includes, in the case of a consolidated group, the consolidated group ceasing to exist. Prop. Treas. Reg. § 1.965-7(b)(3)(iii)(A)(1)(iv) provided that, for purposes of the eligible § 965(h) transferee exception (as defined in Prop. Treas. Reg. § 1.965-7(b)(3)(iii)), a covered acceleration event includes, regarding an acceleration event under Prop. Treas. Reg. § 1.965-7(b)(3)(ii)(F), an event resulting from the acquisition of a consolidated group within the meaning of Treas. Reg. § 1.1502-13(j)(6) if the

acquired consolidated group members join a different consolidated group as of the day following the acquisition. The proposed regulations did not provide for covered acceleration events related to other fact patterns in which a consolidated group ceases to exist.

- ii. Commenters requested that there be an additional covered acceleration event to account for a situation in which the consolidated group ceases to exist by reason of one or more members of the consolidated group transferring all of their assets to other members, with only one member remaining (for example, a consolidated group consisting only of a parent and a subsidiary ceasing to exist by reason of the subsidiary liquidating into the parent).
- iii. Treasury and the IRS believe that it is appropriate to permit the remaining member to enter into a transfer agreement in these circumstances. Accordingly, Treas. Reg. § 1.965-7(b)(3)(iii)(A)(1)(v) includes this scenario as a covered acceleration event. In addition, Treas. Reg. § 1.965-7(b)(3)(iii)(B)(1)(v) provides that, regarding the acceleration event in Treas. Reg. § 1.965-7(b)(3)(iii)(A)(1)(v), the remaining member of the consolidated group to which all of the other members' assets are transferred is an eligible § 965(h) transferee (provided that it meets the remaining requirements of Treas. Reg. § 1.965-7(b)(3)(iii)(B)(1)).
- iv. Another commenter requested that there be an additional covered acceleration event to account for a situation in which a consolidated group is wholly owned by a corporation that is not an includible corporation (within the meaning of § 1504(b)) when a § 965(h) election was made but subsequently becomes an includible corporation even though the situation does not involve the acquisition of stock of the common parent. For example, this situation could arise when the corporation that owns the consolidated group is an S corporation and subsequently revokes its S corporation election.
- v. Treasury and the IRS believe that it is appropriate to permit transfer agreements in these circumstances. Accordingly, Treas. Reg. § 1.965-(b)(3)(iii)(A)(1)(vi) provides that a covered acceleration event occurs when the group ceases to exist as a result of the termination of the subchapter S election pursuant to § 1362(d) of a shareholder of the common parent of the consolidated group and, for the

shareholder's taxable year immediately following the termination, the shareholder joins in the filing a consolidated return as of a consolidated group that includes all of the former members of the former consolidated group.

- vi. In addition, Treas. Reg. § 1.965-7(b)(3)(iii)(B)(1)(vi) provides that, with respect to the acceleration event in Treas. Reg. § 1.965-7(b)(3)(iii)(A)(1)(vi), the agent (within the meaning of Treas. Reg. § 1.1502-77) of the new consolidated group that includes the shareholder whose subchapter S election was terminated and all of the former members of the former consolidated group is an eligible § 965(h) transferee (provided that it meets the remaining requirements of Treas. Reg. § 1.965-7(b)(3)(iii)(B)(1)).

(e) Joint and Several Liability.

- i. Prop. Treas. Reg. § 1.965-7(b)(3)(iii)(D)(2) provided that an eligible § 965(h) transferor remains jointly and severally liable for any unpaid installments assumed by the eligible § 965(h) transferee, as well as any penalties, additions to tax, or other additional amounts attributable to the § 965(h) net tax liability that was transferred. A representation to this effect is required in the transfer agreement if the § 965(h) transferor remains in existence after the transfer. Prop. Treas. Reg. § 1.965-7(b)(3)(iii)(B)(4)(viii).
- ii. A commenter questioned whether the joint and several liability requirement was necessary, given that the eligible § 965(h) transferee has agreed to assume the liability and has the assets from which the liability would be satisfied, and whether there should be differing treatment between eligible § 965(h) transferors that liquidate immediately after the transfer and those that do not. The commenter also noted that in many cases, the § 965(h) net tax liability would be taken into account in the purchase price of a sale of substantially all of the assets of the eligible § 965(h) transferor.
- iii. The final regulations did not adopt this comment. Requiring the eligible § 965(h) transferor to be jointly and severally liable for the unpaid § 965(h) net tax liability, as well as any penalties, additions to tax, or other additional amounts attributable to the § 965(h) net tax liability, protects the IRS's ability to collect the full amount of the § 965(h) net tax liability and helps guard against abusive

transactions. In addition, as the comment noted, taxpayers are able to account for the joint and several liability in their transactions.

(f) Death of an S Corporation Shareholder.

- i. Under § 965(i)(2)(A)(iii) and (i)(2)(C) and Prop. Treas. Reg. § 1.965-7(c)(3)(ii)(C) and (c)(3)(iv)(A)(1), the death of an S corporation shareholder who made a § 965(i) election is a triggering event, and the deferred liability can be transferred if a transfer agreement is entered into with an eligible § 965(i) transferee (as defined in Prop. Treas. Reg. § 1.965-7(c)(3)(iv)(B)(1)). Any transfer agreement with respect to a § 965(i) election be filed within 30 days of the date that the transfer occurred.
- ii. Treasury and the IRS have determined that when the triggering event is the death of the eligible § 965(i) transferor, filing a transfer agreement within 30 days may be impractical. Accordingly, the final regulations provide, in Treas. Reg. § 1.965-7(c)(3)(iv)(B)(2)(iii), that in the case of the death of an eligible § 965(i) transferor, the transfer agreement is required to be filed by the later of the unextended due date for the eligible § 965(i) transferor's final income tax return and January 31, 2019.
- iii. In addition, the final regulations clarify in Treas. Reg. § 1.965-7(c)(3)(iv)(B)(5) what transfer agreements are required following the death of an eligible § 965(i) transferor. In order to make the transfer agreements more administrable for both taxpayers and the IRS, the final regulations provide that, except in the case of transfers to trusts, in the event of the death of an eligible § 965(i) transferor, if the beneficiary or beneficiaries are known and determined as of the due date for the transfer agreement (that is, generally, the unextended due date for the eligible § 965(i) transferor's final income tax return), then the transfer will be treated as a transfer directly between the eligible § 965(i) transferor and the eligible § 965(i) transferee beneficiary or beneficiaries, and only one transfer agreement for each eligible § 965(i) transferee is required.
- iv. If, however, the beneficiary or beneficiaries are not known and determined by the due date for the transfer agreement, then the transfer will be treated as two transfers: first, the transfer on death between the eligible § 965(i) transferor

and his or her estate, and, second, a transfer (not on death) between the estate and the eligible § 965(i) transferee beneficiary or beneficiaries, and separate transfer agreements are required for each transfer.

(g) Terms of Transfer Agreements.

i. Transfer Agreements After Acceleration Events.

(a) The proposed regulations provided specific information and representations that a transfer agreement must contain, including a statement that the transferee agrees to assume the transferor's liability for any unpaid installment payments. The final regulations include modifications to certain requirements for the terms of a transfer agreement.

(b) First, the final regulations clarify that an eligible § 965(h) transferee must consent to an assessment with respect to the liability that it assumes. Specifically, when an eligible § 965(h) transferor and an eligible § 965(h) transferee enter into a transfer agreement, the amount of the § 965(h) net tax liability will already be assessed against the transferor. For the transfer agreements to be administrable, the final regulations add the requirement that an eligible § 965(h) transferee waive the right to a notice of liability and consent to the immediate assessment of the portion of the eligible § 965(h) transferor's § 965(h) net tax liability remaining unpaid as a term of the transfer agreement. Treas. Reg. § 1.965-7(b)(3)(iii)(B)(4)(ix).

(c) Second, the final regulations retain the proposed regulations' requirement that an eligible § 965(h) transferee represent that it is able to make the remaining payments with respect to the § 965(h) net tax liability being assumed. Because the transfer of substantially all of the assets of the eligible § 965(h) transferor presents a risk to the IRS's ability to collect the outstanding § 965(h) net tax liability, the final regulations require a transfer agreement to include a statement as to whether the leverage ratio of the eligible § 965(h) transferee exceeds three to one, subject to modification by future guidance.

See Treas. Reg. §§ 1.965-7(b)(3)(iii)(B)(4)(ix) and (b)(3)(iii)(B)(6).

- (d) A taxpayer with a leverage ratio in excess of three to one may be an eligible § 965(h) transferee and may file a valid transfer agreement, provided the requirements of Treas. Reg. § 1.965-7(b)(3)(iii)(B) are met. The IRS may, however, use the information provided regarding an eligible § 965(h) transferee's leverage ratio in connection with a subsequent evaluation of the accuracy of an eligible § 965(h) transferee's representation that it has the ability to pay the outstanding § 965(h) net tax liability.
- (e) The ability of an eligible § 965(h) transferee to pay the outstanding § 965(h) net tax liability depends on all of the relevant facts and circumstances, including its leverage ratio and also including the eligible § 965(h) transferee's revenue, the value of its assets, its access to capital, the volatility of its business, the size of the § 965(h) net tax liability assumed, and other factors. The IRS may request further information when evaluating a transfer agreement in order to assess these aspects of the transferee. Treas. Reg. §§ 1.965-7(b)(3)(iii)(C)(1) and (c)(3)(iv)(C)(1).
- (f) If the IRS determines that this representation (or any of the other information contained in the transfer agreement) is incorrect, then the transfer agreement may be rejected as of the date of the acceleration event or the Service may determine that an acceleration event has occurred with respect to the eligible § 965(h) transferee as of the date of the determination. *See* Treas. Reg. § 1.965-7(b)(3)(iii)(C)(2).
- (g) Third, Treas. Reg. § 1.965-7(b)(3)(iii)(B)(4)(xi) clarifies, consistent with the requirement in Prop. Treas. Reg. § 1.965-7(b)(3)(iii)(B)(2)(i) that a transfer agreement be filed consistent with other guidance, that additional terms for transfer agreements may be prescribed pursuant to publications, forms, instructions, or other guidance.

ii. Transfer Agreements and Consent Agreements After Triggering Events.

- (a) The final regulations also include changes to the terms of the transfer agreements to be entered into by eligible § 965(i) transferees and the consent agreements to be entered into by certain shareholders after certain triggering events consistent with the changes to the terms of the transfer agreements to be entered into in connection with the relevant acceleration events.
- (b) The final regulations require a transfer agreement or consent agreement to include a statement as to whether the leverage ratio of the eligible § 965(i) transferee or the taxpayer making the § 965(h) election after a triggering events exceeds three to one. *See* Treas. Reg. §§ 1.965-7(c)(3)(iv)(B)(4)(ix), (c)(3)(iv)(B)(6), (c)(3)(v)(D)(4)(v), and (c)(3)(v)(D)(6). The final regulations also clarify that additional terms for transfer agreements and consent agreements in connection with triggering events may be prescribed pursuant to publications, forms, instructions, or other guidance. Treas. Reg. §§ 1.965-7(c)(3)(iv)(B)(4)(x) and (c)(3)(v)(D)(4)(vi).

G. Section 965(h) Elections.

1. Deficiencies or Additional Liabilities.

- (a) Section 965(h)(4) provides that if a deficiency is assessed regarding a person's § 965(h) net tax liability, other than in cases of negligence, intentional disregard of rules and regulations, or fraud with intent to evade tax, the amount of the deficiency will be prorated among the installments, and for any installment the due date of which has already passed, the part of the deficiency prorated to that installment will be due on notice and demand.
- (b) Prop. Treas. Reg. § 1.965-7(b)(1)(ii) extended this rule to apply in the case of a person that increases the amount of its § 965(h) net tax liability when it files a return after payment of the first installment or files an amended return. Requiring notice and demand before payment of the additional amount when it is not due to a deficiency that has been assessed is administratively difficult and inconsistent with the rule provided in Prop. Treas. Reg. § 1.965-7(b)(1)(ii)(C), applicable in the case of negligence,

intentional disregard of rules and regulations, or fraud with intent to evade tax.

- (c) Therefore, the final regulations have been modified to provide that in the case of an additional liability reported on a return or amended return, any amount that is prorated to an installment, the due date of which has already passed, will be due with the return reporting the additional amount. Treas. Reg. § 1.965-7(b)(1)(ii)(B). The rule with respect to deficiencies remains the same, and payment for a deficiency prorated to an installment, the due date of which has already passed, is due on notice and demand.

- 2. Elections in Multiple Years. A comment requested clarification regarding whether a person who has § 965(h) net tax liabilities in multiple taxable years due to ownership of DFICs with different inclusion years can make the § 965(h) election for each year individually. Because the § 965(h) election is made with respect to the § 965(h) net tax liability for a taxable year and is made with the person's tax return, it must be made separately for each year that the person has a § 965(h) net tax liability. Treasury and the IRS have determined that no additional clarification is necessary. Treas. Reg. § 1.965-7(b)(2) and (g)(4).

H. Certain Elections.

1. Section 965(i) Elections.

- (a) Trusts and Estates. Comments requested clarification of the application of the rules regarding elections in the case of trusts and estates. The preamble divided these comments into two categories: (a) requests for guidance concerning which persons are treated as S corporation shareholders for purposes of the § 965(i) election and entering into transfer agreements after a triggering event, and (b) requests for guidance concerning what events constitute triggering events. We will not discuss them here.

(b) Section 962 Elections.

- i. A commenter requested guidance concerning the interaction of a § 962 election and a § 965(i) election. Treasury and the IRS believe that it is clear that an eligible taxpayer may make a § 962 election that applies with respect to a § 965(a) inclusion that results in a § 965(i) net tax liability that the taxpayer defers payment of pursuant to a § 965(i) election, because there are no limitations in the § 962 regulations or the § 965 regulations that would preclude the elections. Accordingly, no change was made to the final regulations.

- ii. The commenter also requested guidance concerning whether making both the § 962 election and the § 965(i) election would result in the treatment of distributions from a DFIC owned by the S corporation to which the § 965(i) election relates occurring before a triggering event as dividends not excluded from gross income.
 - iii. Treasury and the IRS believe that it is clear that amounts attributable to a § 965(a) inclusion with respect to which a § 962 election applies that would otherwise be excluded from gross income under § 959 are prevented from being excluded before a triggering event due to the application of § 962(d), because no tax will have been paid with respect to the § 965(a) inclusion.
 - iv. However, in the case of a domestic pass-through owner that has made a § 962 election applicable to its distributive share of a domestic pass-through entity's § 965(a) inclusion amount, the issue raised by the comment is a longstanding issue of general applicability within Subpart F that is outside of the scope of regulations concerning § 965. Accordingly, Treasury and the IRS declined to adopt the comment.
2. Section 965(m) Elections. Section 965(m) allows a real estate investment trust (REIT) to make an election to include its § 965(a) inclusions (and correspondingly deduct its § 965(c) deductions) over an eight-year period, rather than all in one taxable year. We will not discuss these provisions here.
3. Section 965(n) Elections.
- (a) Prop. Treas. Reg. § 1.965-7(e) provided that if a taxpayer makes a § 965(n) election for a taxable year, certain § 965-related amounts are not taken into account in determining the taxpayer's net operating loss under § 172 for the year or in determining the taxpayer's taxable income for such taxable year (computed without regard to the deduction allowable under § 172) that may be reduced by net operating loss carryovers or carrybacks to such taxable year under § 172.
 - (b) A commenter requested clarification that the § 965(n) election applies for purposes of the alternative minimum tax ("AMT") and § 1411. Treasury and the IRS believe that because the § 965(n) election affects the net operating loss deduction and taxable income, which are starting points for determining alternative minimum tax net operating loss deduction and alternative

minimum taxable income under §§ 56(d) and 55(b)(2), respectively, it is clear that the § 965(n) election applies for purposes of the AMT. Similarly, it is clear that the § 965(n) election affects the computations under Treas. Reg. § 1.1411-4(h) if an election under Treas. Reg. § 1.1411-10(g) has been made, and no clarification is needed.

- (c) A commenter also requested clarification that a § 965(n) election can be made for every year in which a REIT has a § 965(a) inclusion by reason of a § 965(m) election. Given that Treas. Reg. § 1.965-7(e), like Prop. Treas. Reg. § 1.965-7(e), provides that a § 965(n) election can be made for a taxable year in which a person has a § 965(a) inclusion, Treasury and the IRS believe that no additional clarification is necessary.

4. Election to Use Alternative Method of Calculating Post-1986 Earnings and Profits.

- (a) Prop. Treas. Reg. § 1.965-7(f)(5)(i) provided for an election to use an alternative method for calculating post-1986 earnings and profits and provides that the election is made for each specified foreign corporation by its controlling domestic shareholder (as defined in Treas. Reg. § 1.964-1(c)(5)) pursuant to the rules of Treas. Reg. § 1.964-1(c)(3). A commenter requested modifications regarding multiple aspects of this election.
- (b) First, the commenter requested that references to the rules in Treas. Reg. § 1.964-1(c)(3) be deleted because the requirements, particularly with respect to the statement required by Treas. Reg. § 1.964-1(c)(3)(ii) and the notice to minority shareholders required by Treas. Reg. § 1.964-1(c)(3)(iii), are too onerous for this purpose. Second, the commenter requested that U.S. shareholders be allowed to make a blanket election for all of their specified foreign corporations or be allowed to make a single election and specifically provide a schedule of those specified foreign corporations for which they do not want to make the election. Third, the commenter requested that the penalties of perjury statement requirement be eliminated.
- (c) Treasury and the IRS believe that requiring a controlling domestic shareholder to file the statement required by Treas. Reg. § 1.964-1(c)(ii) in order to make the election described in Prop. Treas. Reg. § 1.965-7(f) is duplicative in light of the requirement to provide an election statement described in Prop. Treas. Reg. § 1.965-7(f)(5)(iii). However, the requirement to give notice to minority shareholders is not a duplicative requirement, and it helps ensure

that all taxpayers are using the same amounts for post-1986 earnings and profits to calculate their § 965(a) inclusions.

- (d) Accordingly, Treas. Reg. § 1.965-7(f)(5)(i) retains the reference to Treas. Reg. § 1.964-1(c)(3) but provides that the statement described in Treas. Reg. § 1.964-1(c)(3)(ii) is not required.
- (e) In addition, Prop. Treas. Reg. § 1.965-7(f) provides that the election is made on a specified foreign corporation by specified foreign corporation basis, in part because the ability to use the November 2, 2017, measurement date might differ among specified foreign corporations. While it is important for the IRS to know what method is being used for each specified foreign corporation in order to properly determine the amount of post-1986 earnings and profits, it is not necessary for a separate statement to be filed with respect to each specified foreign corporation.
- (f) Therefore, the final regulations permit a single election statement to be filed that provides the necessary information with respect to each specified foreign corporation. Finally, the election statement required by Prop. Treas. Reg. § 1.965-7(f)(5)(iii) contains additional information beyond the making of the election, including the name and taxpayer identification number (if any) of both the person making the election and the specified foreign corporation, so the request that the penalties of perjury statement be eliminated is not adopted.

- 5. Total Net Tax Liability Under § 965. Section 965(h) elections and § 965(i) elections allow the deferral of payment of amounts based on a taxpayer's total net tax liability under § 965. *See* Treas. Reg. §§ 1.965-7(b)(1), (c)(1), (g)(4), and (g)(6). Total net tax liability is calculated on the basis of a taxpayer's net income tax "with" and "without" the application of § 965, which is intended to isolate the portion of a taxpayer's net income tax attributable to § 965. We will not discuss this further here.

I. Treas. Reg. § 1.965-8 – Affiliated Groups (Including Consolidated Groups).

- 1. Treas. Reg. § 1.965-8 sets forth rules governing the application of § 965 and the § 965 regulations to members of an affiliated group (as defined in § 1504(a)), including members of a consolidated group (as defined in Treas. Reg. § 1.1502-1(h)).

2. Treatment of Consolidated Groups.

(a) Treatment for Purposes of Determining Aggregate Foreign Cash Position.

- i. The proposed regulations provided rules allowing a § 958(a) U.S. shareholder to disregard certain assets for purposes of determining its aggregate foreign cash position. *See* Prop. Treas. Reg. § 1.965-3(b). The proposed regulations further provided that all members of a consolidated group that are § 958(a) U.S. shareholders of a specified foreign corporation are treated as a single § 958(a) U.S. shareholder for certain enumerated purposes that do not include Prop. Treas. Reg. § 1.965-3(b). Prop. Treas. Reg. § 1.965-8(e).
- ii. Notice 2018-78 explained that, to prevent the overstatement of the aggregate foreign cash position, the final regulations would provide that all members of a consolidated group that are § 958(a) U.S. shareholders of a specified foreign corporation would also be treated as a single § 958(a) U.S. shareholder for purposes of Treas. Reg. § 1.965-3(b).
- iii. However, comments have noted that treating all members of a consolidated group that are § 958(a) U.S. shareholders of a specified foreign corporation as a single § 958(a) U.S. shareholder for purposes of Treas. Reg. § 1.965-3(b) but not for all purposes of determining the aggregate foreign cash position could still result in overstatement of the aggregate foreign cash position, if, for example, stock of a specified foreign corporation was transferred between such shareholders between cash measurement dates.
- iv. Accordingly, the final regulations provide that the consolidated group aggregate foreign cash position is determined as if all members of a consolidated group that are § 958(a) U.S. shareholders of a specified foreign corporation were a single § 958(a) U.S. shareholder. *See* Treas. Reg. § 1.965-8(e)(1), (e)(3), and (f)(4).
- v. A “correcting amendment” to the final regulations provides that all members of a consolidated group that are U.S. shareholders of a DFIC or E&P deficit foreign corporation are treated as a single U.S. shareholder for purposes of the basis election. *See* 84 Fed. Reg. 14260 (Apr. 10, 2019).

(b) Treatment for Other Purposes.

- i. Commenters also requested that the final regulations treat all members of a consolidated group as a single U.S. shareholder for all purposes of § 965. One commenter highlighted a fact pattern in which it argues that the anti-abuse rule in Treas. Reg. § 1.965-4(b) applies and causes double taxation if the members are treated as separate but would not apply if the members were treated as a single U.S. shareholder.
- ii. Treasury and the IRS believe that treatment of members of a consolidated group as a single U.S. shareholder would not alter the application of the anti-abuse rule in the fact pattern raised. Even if it did, however, broadly changing the consequences of well-established principles concerning the determination of inclusions under § 951 in a consolidated group would not be justified by the application of an anti-abuse rule to a transaction that falls within its parameters.

3. Treatment of Affiliated Groups Other than Consolidated Groups.

- (a) A commenter also suggested that § 958(a) U.S. shareholders that are members of an affiliated group that do not file a consolidated U.S. federal income tax return also be treated as a single U.S. shareholder for purposes of determining the aggregate foreign cash position of each member. It suggested that the statute evidences Congressional intent for such treatment.
- (b) Treasury and the IRS have determined that the rules in § 965(b)(5) concerning the allocation of an affiliated group member's aggregate unused E&P deficit to certain members of its affiliated group do not evidence an intent to treat all members of an affiliated, but not consolidated, group as a single U.S. shareholder and declined to adopt the recommendation.

4. Other Comments.

- (a) Application to Individuals. Numerous comments recommended that guidance exempt individuals from the application of § 965. A comment also recommended that § 965(c)(3)(E), which provides that the cash position of certain noncorporate entities must be taken into account in determining a U.S. shareholder's aggregate foreign cash position, not apply with respect to individuals but did not supply any reasoning for the recommendation. The statute applies to increase the subpart F income of all DFICs, with no exception to

the extent that a DFIC has one or more U.S. shareholders that are individuals. See § 965(a).

J. § 965 Overpayments.¹

1. On August 2, 2018, in PMTA 2018-016, the IRS discussed § 965(h) overpayments and reiterated that any 2017 payments or estimated tax payments under § 965(h) that exceeded the net income tax liability described under § 965(h)(6)(A)(ii), are not eligible for a refund unless and until the amount of payments exceeds the entire unpaid 2017 income tax liability, including all amounts to be paid in installments under § 965(h) in subsequent years.
1. This issue was also discussed in the IRS questions and answers (“Q&As”) relating to I.R.C. § 965 answer number 14. Answer 14 provides that any excess amount paid is applied to the “next successive annual installment (due in 2019), and to the extent such excess exceeds the amount of that installment due, then to the next such successive annual installment (due in 2020), etc.” Taxpayers expressed concerns with the legal basis for this answer.
2. The Service states that its legal authority to make a credit or refund is in § 6402. By its terms, the IRS states § 6402(a) does not grant the Service the legal authority to credit or refund any amount except to the extent that an overpayment exists with respect to a liability, citing *Minihan v. Commissioner*, 138 T.C. 1 (2012). The Associate Chief Counsel also states in the memorandum that § 6402(b) does not authorize the Service to apply any amount as a credit to the succeeding year’s estimated income tax except to the extent that such amount constitutes an overpayment. I.R.C. § 6402(a) and (b).
3. Accordingly, the memorandum states that an overpayment under § 6402(a) does not exist with respect to a 2017 income tax liability unless and until the entire liability is fully paid, including any amount of that liability that is subject to an election to pay that income tax liability in installments under § 965(h). Absent an overpayment of the entire tax liability for the 2017 tax period, the Service cannot issue a credit or refund under § 6402(a) with respect to the 2017 tax period.
4. A number of commentators including the U.S. Chamber of Commerce have asked Treasury and the IRS to revise the guidance on § 965 and overpayments. The Chamber of Commerce stated that requiring taxes (including estimated taxes) to be applied in full against the transition tax liability rather than as a refund or a credit against the 2018 tax liability is contrary to the § 965 statutory language and the legislative intent.

¹ A Technical Correction would fix this problem. See Section XI below.

5. On March 13, 2018, the IRS posted § 965 guidance including a question and answer section (Q&A) on its website. The Q&A stated that the first § 965 installment would be paid separately indicating that the § 965 liability payment would be separate from regular tax liabilities and that the estimated taxes would not be applied against the transition tax. Then one month later, the IRS issued additional guidance on the § 965 Q&A website with two new questions and answers in 13 and 14 that abandoned that approach. The abandonment of the separate approach for § 965 was announced only a few days before tax payments were due.
6. The Chamber pointed out that taxpayers often overpay their tax liability and that as a result taxpayers will consistently have overpayments that are allocated to the § 965 installment payments resulting in a significantly shortened installment period and an acceleration of millions of dollars of tax payments. The Chamber stated this is not consistent with the clear reading of § 965(h) and (i) or with the policy Congress intended by including an election to make installment payments over the prescribed eight-year period. Treating overpayments as satisfying the transition tax liability is inconsistent with the policy to allow the payments over eight years.
7. The IRS recently released a Chief Counsel Memorandum (“CCM”) on August 2, 2018 reiterating that taxes (including estimated taxes) will be applied in full against the transition tax liability rather than as a refund or a credit and stated that the IRS position was based on §§ 6402 and 6403.
8. The Chamber challenges the IRS’s position in the CCM and stated that the tax overpayment is not a payment of the installment under § 6403. Taxpayers who overpaid their 2017 taxes did not overpay the § 965 installment tax; they overpaid their 2017 net income tax liability – which by definition excludes the § 965 liability for the year. Thus, there is no overpayment of the tax payable as an installment under § 6403. Furthermore, when a timely deferral election is made, only the first installment is technically due with the 2017 return.
9. Under IRC § 6402(a), the IRS can either refund overpayments or credit them against 2018 estimated taxes.
10. The Chamber also stated that it is very concerned that the IRS guidance is functionally a new tax regulation that was issued with immediate effect and without following the applicable rules of the Administrative Procedure Act. The Chamber believes the guidance is a legislative rule subject to notice and comment and that it should have been incorporated into the proposed regulations.
11. Since TCJA was enacted at the very end of the year, the Chamber notes that, taxpayers preparing their 2017 extension payments had to minimize

potential underpayment penalties by being overly cautious. The IRS issued the guidance regarding the application of overpayments to the transition tax when most taxpayers had already scheduled their electronic fund transfers punishing taxpayers for acting responsibly. The Chamber stated that taxpayers who are in an overpayment position are placed at a competitive disadvantage to taxpayers who are in an underpayment position as a result of the new guidance on § 965 and overpayments.

K. Other Proposed Regulations and Comment's Provided with § 965 Proposed Regulations.

1. Application of § 986(c).

- (a) The proposed regulations provide that, for purposes of § 986(c), foreign currency gain or loss with respect to distributions of § 965(a) previously taxed earnings and profits is determined based on movements in the exchange rate between December 31, 2017, and the date on which the E&P is actually distributed. Prop. Treas. Reg. § 1.986(c)-1(a), *see also* Notice 2018-13.
- (b) Consistent with § 3.05 of Notice 2018-07, the proposed regulations also provide that any gain or loss recognized under § 986(c) with respect to distributions of § 965(a) previously taxed earnings and profits is reduced in the same proportion as the reduction by a § 965(c) deduction amount of the § 965(a) inclusion amount that gave rise to such § 965(a) previously taxed earnings and profits, consistent with the statute and other indicia of Congressional intent. Prop. Treas. Reg. § 1.986(c)-1(b).
- (c) Because § 965(b) previously taxed earnings and profits are not included in gross income under § 951(a)(1), Treasury and the IRS determined it would not be appropriate to apply § 986(c) with respect to distributions of that E&P. Therefore, Prop. Treas. Reg. § 1.986(c)-1(c) provides that § 986(c) does not apply with respect to distributions of § 965(b) previously taxed earnings and profits.

2. Repeal of § 958(b)(4).

- (a) Effective for the last taxable year of foreign corporations beginning before January 1, 2018, and each subsequent year, and for the taxable years of United States shareholders in which or with which such taxable years of the foreign corporations and the Tax Act repealed § 958(b)(4). Before repeal, § 958(b)(4) provided that subparagraphs (A), (B), and (C) of § 318(a)(3) were not to be applied to consider a United States person to own stock which is owned by a person who is not a United States person. The subparagraphs of § 318(a)(3) generally attribute stock owned by a

person to a partnership, estate, trust, or corporation in which such person has an interest (so-called “downward” attribution).

- (b) Multiple comments requested guidance be issued addressing the repeal of § 958(b)(4). Treasury and the IRS said that this issue is beyond the scope of the § 965 proposed regulations.
- (c) However, consistent with § 5.02 of Notice 2018-13, the instructions to Form 5471 will be amended to provide an exception from certain filing requirements for a United States person that is a United States shareholder with respect to a CFC or other specified foreign corporation if no United States shareholder (including the United States person) owns, within the meaning of § 958(a), stock of the CFC or other specified foreign corporation, and the foreign corporation is a CFC or specified foreign corporation solely because a United States person is considered to own the stock of the CFC or other specified foreign corporation owned by a foreign person under § 318(a)(3). Consistent with § 6 of Notice 2018-13 and § 7 of Notice 2018-26, taxpayers may rely on this exception with respect to the last taxable year of a foreign corporation beginning before January 1, 2018, and each subsequent year of the foreign corporation, and for the taxable years of a United States shareholder in which or with which these taxable years of the foreign corporation end.
- (d) A Technical Correction would restore § 958(b) retroactively, but with a new § 951B. *See* Section XI, below.

II. GILTI.

A. GILTI Final Regulations. Treasury and the IRS finalized the proposed GILTI regulations and made a number changes, as discussed below.

1. Treas. Reg. § 1.951-1 – Amounts Included in Gross Income of U.S. Shareholders.

(a) Pro Rata Share Rules.

- i. A United States shareholder (“U.S. shareholder”) who owns stock of a foreign corporation on the last day of the foreign corporation’s taxable year on which the foreign corporation is a controlled foreign corporation (“CFC”) includes in gross income its “pro rata share” of the CFC’s Subpart F income (as defined in § 952) for the taxable year. § 951(a)(1) and Treas. Reg. § 1.951-1(a). In general, a U.S. shareholder’s pro rata share of Subpart F income is determined based on its proportionate share of a hypothetical distribution of all the current earnings and

profits (“E&P” and “current E&P”) of the CFC.
§ 951(a)(2)(A) and Treas. Reg. § 1.951-1(b)(1)(i) and (e)(1).

- ii. A U.S. shareholder’s pro rata share of tested income (as defined in § 951A(c)(2)(A) and Treas. Reg. § 1.951A-2(b)(1)), tested loss (as defined in § 951A(c)(2)(B)(i) and Treas. Reg. § 1.951A-2(b)(2)), qualified business asset investment (“QBAI”) (as defined in § 951A(d)(1) and Treas. Reg. § 1.951A-3(b)), tested interest expense (as defined in Treas. Reg. § 1.951A-4(b)(1)), and tested interest income (as defined in Treas. Reg. § 1.951A-4(b)(2)) (each a “tested item”) generally are also determined based on a hypothetical distribution of current E&P, with certain modifications to account for the differences between each tested item and Subpart F income. § 951A(e)(1) and Treas. Reg. § 1.951A-1(d).
- iii. For purposes of the hypothetical distribution, the proposed regulations defined “current E&P” for a taxable year as the greater of (i) the E&P of the corporation for the taxable year determined under § 964, or (ii) the sum of the Subpart F income (as determined under § 952, as increased under § 951A(c)(2)(B)(ii) and Prop. Treas. Reg. § 1.951A-6(d)) and the tested income of the corporation for the taxable year. Prop. Treas. Reg. § 1.951-1(e)(1)(ii). A commenter said that using the term “current earnings and profits” for this purpose is confusing because the definition differs significantly from the definition of “earnings and profits” provided in § 964(a), and therefore suggested using a different term for this purpose. In response to this comment, the final regulations replaced the term “current earnings and profits” with “allocable earnings and profits” (“allocable E&P”).

(b) Pro rata share anti-abuse rule.

- i. The proposed regulations provided that any transaction or arrangement that is part of a plan a principal purpose of which is the avoidance of Federal income taxation, including, but not limited to, a transaction or arrangement to reduce a U.S. shareholder’s pro rata share of the Subpart F income of a CFC, which transaction or arrangement would otherwise avoid Federal income taxation, is disregarded in determining such U.S. shareholder’s pro rata share of the Subpart F income of the corporation (the “pro rata share anti-abuse rule”). *See*

Treas. Reg. § 1.951-1(e)(6). The pro rata share anti-abuse rule also applies in determining the pro rata share of each tested item of a CFC for purposes of determining a U.S. shareholder's global intangible low-taxed income ("GILTI") inclusion amount under § 951A(a) and Treas. Reg. § 1.951A-1(b).

- ii. Comments suggested that the pro rata share anti-abuse rule is overbroad and could be interpreted to apply to nearly all transactions, arrangements, or tax elections that reduce the pro rata share amounts of a U.S. shareholder. In particular, comments noted that, under one interpretation of the rule, a U.S. shareholder that disposes of CFC stock could be required indefinitely to include its "pro rata share" of the CFC's Subpart F income or tested items regarding such stock.
- iii. Treasury and the IRS agreed that the scope of the pro rata share anti-abuse rule should be clarified. Accordingly, the final regulations provide that the rule applies only to require appropriate adjustments to the allocation of allocable E&P that would be distributed in a hypothetical distribution regarding any share outstanding as of the hypothetical distribution date. Treas. Reg. § 1.951-1(e)(6). Thus, under the rule, if applicable, adjustments will be made solely to the allocation of allocable E&P in the hypothetical distribution between shareholders that own, directly or indirectly, stock of the CFC as of the relevant hypothetical distribution date. As clarified, the rule will not apply to adjust the allocable E&P allocated to a shareholder by reason of a transfer of CFC stock, except by reason of a change to the distribution rights regarding stock in connection with such transfer (for example, an issuance of a new class of stock, including by recapitalization).
- iv. Other comments suggested that the final regulations limit the pro rata share anti-abuse rule to transactions or arrangements that lack economic substance or are artificial, or only to transactions or arrangements that result in non-economic allocations that shift Subpart F income or tested items away from a U.S. shareholder. One comment suggested that the rule should apply only to enumerated transactions identified by Treasury and the IRS as being abusive, and another comment suggested that the regulations should include examples illustrating transactions to which the pro rata share anti-abuse rule would or would not apply.

- v. These recommendations were not adopted. Transactions that lack economic substance or are artificial would typically be disregarded under general tax principles, and non-economic allocations would generally be addressed through the facts and circumstances approach of Treas. Reg. § 1.951-1(e)(3), such that limiting the pro rata share anti-abuse rule in the manner recommended could render it superfluous. Moreover, the concerns underlying the rule may arise in non-artificial transactions, or transactions with substance, that would be respected under general tax principles. In addition, attempting to specifically identify all the transactions covered by the rule or to specify such transactions by example would be impractical and inconsistent with one of the purposes underlying any anti-avoidance rule – that is, to deter the development and implementation of new transactions or arrangements intended to avoid the operative rule.
- vi. Another comment recommended an exception to the pro rata share anti-abuse rule for transactions entered into with unrelated parties and for transactions entered into with related parties located in the same country of tax residence as the relevant CFC. The comment also recommended a “small business” exception for U.S. shareholders with worldwide gross receipts under \$25 million.
- vii. Treasury and the IRS believe that the policy concerns underlying the rule can be implicated by transactions that involve unrelated parties, such as accommodation parties (for instance, a financial institution) that hold stock with certain distribution rights in order to reduce an unrelated U.S. shareholder’s pro rata share of Subpart F income or tested items. Further, these concerns can arise regardless of whether the parties involved are located in the same country of tax residence as the CFC.
- viii. Finally, they have concluded that the level of gross receipts of the shareholders is not relevant to, and therefore does not justify, an exception to the rule. Any administrative burden on small businesses would not stem from the rule itself but rather from engaging in a transaction a principal purpose of which is to avoid Federal income taxation.
- ix. Accordingly, these recommendations were not adopted.

(c) Facts and circumstances approach.

- i. Treas. Reg. § 1.951-1(e)(3)(ii) of the existing regulations provides special rules applicable to CFCs with two or more classes of stock with discretionary distribution rights. Under these rules, the allocation of current E&P is primarily based on the relative fair market value of the stock with discretionary distribution rights. The preamble to the proposed regulations noted that this fair market value allocation method had been the basis of certain attempted avoidance structures. Accordingly, the proposed regulations adopted a facts and circumstances approach in allocating current E&P in a hypothetical distribution between multiple classes of stock, including stock with discretionary distribution rights. Prop. Treas. Reg. § 1.951-1(e)(3). The proposed regulations provided that, where appropriate, the relative fair market value of the stock may still be taken into account, but as one of several factors, none of which is dispositive.
- ii. A comment stated that the facts and circumstances approach set forth in the proposed regulations was a vague and subjective standard that would create uncertainty, while the fair market value approach in the existing regulations for stock with discretionary distribution rights is a long-standing and objective standard. The comment further noted that the preamble to the 2005 Treasury decision that adopted the fair market value approach specifically rejected the facts and circumstances approach, stating that “the interests of sound tax policy and administration are served by requiring the value-based allocation.” The comment recommended that the fair market value approach be retained in the final regulations, in lieu of the proposed facts and circumstances approach, for purposes of determining the pro rata share of Subpart F income and tested items.
- iii. Treasury and the IRS believe, based on experience administering the fair market value approach, that a facts and circumstances approach, in which the fair market value of stock is relevant but not determinative, would be a more reliable method for determining a U.S. shareholder’s pro rata share of Subpart F income (and tested items) than the fair market value approach. While fair market value is easily determinable for publicly traded stock, determining the fair market value of privately-held stock is more difficult and typically requires a determination of the

stock's rights to distributions of current and accumulated E&P and capital, as well as the voting rights regarding such stock.

- iv. In contrast, under § 951(a)(2) and Treas. Reg. § 1.951-1(b)(1), a shareholder's pro rata share of Subpart F income is determined based solely on a hypothetical distribution of Subpart F income for the taxable year. Furthermore, the amount of Subpart F income treated as distributed in the hypothetical distribution is determined under Treas. Reg. § 1.951-1(e) based on a distribution of allocable E&P. Thus, the most relevant attribute of any share of CFC stock for purposes of the hypothetical distribution is its economic rights regarding the allocable E&P of the CFC, which is generally determined by reference to its current E&P.
- v. Generally, a share's voting rights, rights to distributions of E&P accumulated before the current year, and rights to capital, all of which are also taken into account in determining fair market value, are not relevant to the hypothetical distribution of allocable E&P, and therefore a fair market value approach can distort the determination required under § 951(a)(2) and Treas. Reg. § 1.951-1(b)(1). A more flexible facts and circumstances approach that considers fair market value as a factor can also take into account other factors related to the expected distributions of allocable E&P regarding such stock, without taking into account capital liquidation rights and other factors that are not relevant to the distribution of allocable E&P.
- vi. Accordingly, the final regulations did not adopt this recommendation.

(d) Modifications to Example 4.

- i. The proposed regulations provided that no amount of current E&P is treated as distributed in the hypothetical distribution regarding a particular class of stock to the extent that a distribution of such amount would constitute a redemption of stock (even if the redemption would be treated as a dividend under §§ 301 and 302(d)), a distribution in liquidation, or a return of capital. Prop. Treas. Reg. § 1.951-1(e)(4)(i). The proposed regulations included an example to illustrate the application of this rule. Prop. Treas. Reg. § 1.951-1(e)(7)(v) Example 4. A comment said that Prop. Treas. Reg. § 1.951-1(e)(4)(i) and the example illustrating the rule were confusing because,

given the definition of current E&P in the proposed regulations, the hypothetical distribution would typically not give rise to a return of capital (other than through a redemption).

- ii. This rule was not intended to refer to the consequences of the hypothetical distribution itself (for example, the extent to which it could give rise to a return of capital), but rather was intended to provide that terms of the stock or related agreements and arrangements that could give rise to redemptions, liquidations, or returns of capital if actually exercised (or otherwise taken into account) are not taken into account for purposes of the hypothetical distribution.
- iii. The final regulations and the related example are clarified to reflect this intent. Treas. Reg. § 1.951-1(e)(4)(i) and Treas. Reg. § 1.951-1(e)(7)(v) Example 4.
- iv. Similarly, the final regulations clarify that the facts and circumstances taken into account in determining the distribution rights of a class of stock do not include actual distributions (or any amount treated as a dividend) made during the taxable year that includes the hypothetical distribution date. Treas. Reg. § 1.951-1(e)(3). These distributions (or dividends) are not relevant in determining a class of stock's economic rights and interest in the allocable E&P (which are not reduced by actual distributions during the taxable year) as of the hypothetical distribution date.

(e) Application of § 951(a)(2)(B) to Subpart F income and tested income in the same taxable year.

- i. Under § 951(a)(2)(B), a U.S. shareholder's pro rata share of Subpart F income regarding stock for a taxable year (as determined under § 951(a)(2)(A)) is reduced by the amount of distributions received by any other person during the year as a dividend regarding the stock, subject to a limitation based on the period of the taxable year in which the shareholder owned the stock within the meaning of § 958(a). Section 951A(e)(1) provides that the pro rata share of tested income, tested loss, and QBAI is determined under the rules of § 951(a)(2) in the same manner as such section applies to Subpart F income.
- ii. Accordingly, the proposed regulations provided that a U.S. shareholder's pro rata share of tested income is determined

under § 951(a)(2) and Treas. Reg. § 1.951-1(b) and (e), generally substituting “tested income” for “Subpart F income” each place it appears. Prop. Treas. Reg. § 1.951A-1(d)(2).

- iii. Because § 951(a)(2)(B) applies for purposes of determining the pro rata share of both Subpart F income and tested income, the proposed regulations could be interpreted as permitting a dollar-for-dollar reduction under § 951(a)(2)(B) in both a U.S. shareholder’s pro rata share of Subpart F income and its pro rata share of tested income. Treasury and the IRS believe that this would be an inappropriate double benefit that is not contemplated under § 951(a)(2)(B) and § 951A(e)(1).
- iv. Accordingly, the regulations under § 951(a)(2)(B) were revised to clarify that a dividend received during the taxable year by a person other than the U.S. shareholder reduces the U.S. shareholder’s pro rata share of Subpart F income and its pro rata share of tested income in the same proportion as its pro rata share of each amount bears to its aggregate pro rata share of both amounts. Treas. Reg. § 1.951-1(b)(1)(ii).
- v. The examples in Treas. Reg. § 1.951-1(b)(2) were modified solely to illustrate the application of the revised rule in Treas. Reg. § 1.951-1(b)(1) and to conform to the terminology in the final regulations. Treasury and the IRS state they are studying the application of § 951(a)(2)(A) and (B) in certain cases that may lead to inappropriate results, for example, due to the concurrent application of the provisions. In addition, they are studying the application of § 951(a)(2)(B) regarding dividends paid to foreign persons, dividends that give rise to a deduction under § 245A(a), and dividends paid on stock after the disposition of such stock by a U.S. shareholder.

(f) Revisions to cumulative preferred stock rule.

- i. The proposed regulations provided a special rule applicable to preferred shares with accrued but unpaid dividends that do not compound annually at or above the applicable Federal rate (“AFR”) under § 1274(d)(1) (“cumulative preferred stock rule”). Prop. Treas. Reg. § 1.951-1(e)(4)(ii). If the cumulative preferred stock rule applies regarding stock, the current E&P allocable to the stock may not exceed the amount of dividends actually paid during the

taxable year regarding the stock plus the present value of the unpaid current dividends regarding the stock determined by using the AFR that applies on the date the stock is issued for the term from the issue date to the mandatory redemption date and assuming the dividends will be paid at the mandatory redemption date.

- ii. A comment stated that it is unclear whether the applicability of the cumulative preferred stock rule is determined based on the AFR as of the issuance date or, alternatively, the AFR for the current year. The comment suggested that, because the amount of the preferred dividend determined under the cumulative preferred stock rule is based on the AFR as of the issue date, for consistency, the applicability of the rule should be determined by reference to the AFR as of the issue date as well. Treasury and the IRS agreed with this comment, and the final regulations were revised accordingly. Treas. Reg. § 1.951-1(e)(4)(ii).
- iii. The proposed regulations provided that the amount of any arrearage on cumulative preferred stock is determined taking into account the time value of money principles in the cumulative preferred stock rule. Prop. Treas. Reg. § 1.951-1(e)(4)(iii). A comment recommended that the rule be clarified to reference the calculation of the present value of the unpaid current dividends described in the cumulative preferred stock rule. Treasury and the IRS agreed with this comment, and the final regulations were revised accordingly. Treas. Reg. § 1.951-1(e)(4)(iii).
- iv. The proposed regulations contained a special rule for purposes of §§ 951 through 964 to treat a controlled domestic partnership as a foreign partnership to determine stock ownership in a CFC by a U.S. person for purposes of § 958(a) if certain conditions are met. Prop. Treas. Reg. § 1.951-1(h). A comment suggested that because the proposed regulations defined a “controlled domestic partnership” by reference to a specific U.S. shareholder, the rule could be read to apply only regarding that shareholder but not regarding other partners of the controlled domestic partnership, for which the partnership would therefore still be treated as domestic.
- v. The comment requested that the final regulations clarify that the treatment as a foreign partnership is regarding all partners of the partnership. The rule, if applicable, is

intended to treat a domestic partnership as a foreign partnership regarding all its partners.

- vi. The final regulations revised the definition of controlled domestic partnership to clarify the scope of the rule. Treas. Reg. § 1.951-1(h)(2); Treas. Reg. § 1.965-1(e)(2). A change was also made to Treas. Reg. § 1.951-1(h) to conform to the change in the final regulations to the treatment of domestic partnerships for purposes of § 951A.

2. Treas. Reg. § 1.951A-1 – General Provisions.

(a) CFC inclusion date.

- i. The proposed regulations provided that, for purposes of determining the GILTI inclusion amount of a U.S. shareholder for a U.S. shareholder inclusion year, the U.S. shareholder takes into account its pro rata share of a tested item regarding a CFC for the U.S. shareholder inclusion year that includes a CFC inclusion date regarding the CFC. Prop. Treas. Reg. § 1.951A-1(d)(1). Under the proposed regulations, the term “U.S. shareholder inclusion year” meant a taxable year of a U.S. shareholder that includes a CFC inclusion date of a CFC of the U.S. shareholder, the term “CFC inclusion date” meant the last day of a CFC inclusion year on which a foreign corporation is a CFC, and the term “CFC inclusion year” meant any taxable year of a foreign corporation beginning after December 31, 2017, at any time during which the corporation is a CFC. Prop. Treas. Reg. § 1.951A-1(e)(1), (2) and (4).
- ii. Comments said that, under certain circumstances, the requirement that a U.S. shareholder take into account its pro rata share of a CFC’s tested items for a U.S. shareholder inclusion year that includes a CFC inclusion date could have the effect of requiring a U.S. shareholder to take into account its pro rata share of the CFC’s tested items for a U.S. shareholder inclusion year that does not include the last day of the CFC inclusion year. This could happen, for instance, if a U.S. person with a taxable year ending December 31, 2019, sells a wholly-owned foreign corporation with a taxable year ending November 30, 2020, to a foreign person on December 1, 2019 and, as a result of the sale, the foreign corporation ceases to be a CFC; in that case, under the proposed regulations, the CFC inclusion date regarding the foreign corporation would be December 1, 2019, whereas the CFC inclusion year of the

foreign corporation would not end until November 30, 2020.

- iii. The comments raised several concerns, in particular, that the U.S. person in this example would be unable to determine its pro rata share of any tested item of the foreign corporation as of December 31, 2019, since the foreign corporation's tested items could not be determined until November 30, 2020. They also noted that the proposed regulations' definition of CFC inclusion date was inconsistent with § 951A(e)(1), which provides that the pro rata share of certain amounts 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. The comments recommended that the relevant definitions be revised to accord with § 951A(e)(1).
- iv. Treasury and the IRS agreed with these comments. Accordingly, the final regulations provide that a U.S. shareholder takes into account its pro rata share of a tested item of a CFC in the U.S. shareholder inclusion year that includes the last day of the CFC inclusion year. Treas. Reg. § 1.951A-1(d)(1). However, consistent with §§ 951(a)(2) and 951A(e)(1), a U.S. shareholder's pro rata share of each tested item of a CFC is still determined based on the § 958(a) stock owned by the shareholder on the last day of the CFC's taxable year on which it is a CFC (the "hypothetical distribution date"). Treas. Reg. §§ 1.951-1(e)(1)(i) and 1.951A-1(f)(3). The term "hypothetical distribution date" in the final regulations has the same meaning as the term "CFC inclusion date" in the proposed regulations.

(b) Pro rata share of certain tested items.

i. Pro Rata Share of QBAI.

- (a) The proposed regulations provided that, in general, a U.S. shareholder's pro rata share of the QBAI of a tested income CFC is proportionate to the U.S. shareholder's pro rata share of the tested income of the tested income CFC for the CFC inclusion year. Prop. Treas. Reg. § 1.951A-1(d)(3)(i). However, they also provided that, to the extent the amount of a tested income CFC's QBAI is greater than ten times its tested income for the year (that is, the point at which the shareholder's deemed tangible

income return (“DTIR”) attributable to the QBAI would fully offset its pro rata share of the tested income CFC’s tested income), the excess QBAI was allocated solely to common shares (and not to preferred shares) (the “excess QBAI rule”). Prop. Treas. Reg. § 1.951A-1(d)(3)(ii).

- (b) The excess QBAI rule was intended to ensure that a shareholder could not obtain an increase in its DTIR by reason of preferred stock that exceeds the increase in its aggregate pro rata share of tested income from the ownership of the stock. Without the excess QBAI rule, U.S. persons would be incentivized to acquire debt-like preferred stock of CFCs that have significant amounts of QBAI and minimal tested income in order to effectively exempt some or all of the U.S. person’s pro rata shares of tested income from other CFCs from taxation under § 951A. The preamble to the proposed regulations requested comments on the approach in the proposed regulations, including the excess QBAI rule, for determining a U.S. shareholder’s pro rata share of a CFC’s QBAI.
- (c) The only comment received regarding the QBAI allocation approach in the proposed regulations agreed that it was appropriate to limit the allocation of QBAI to a preferred shareholder, because the debt-like claim that a preferred shareholder has on a CFC should not entitle it to an amount of QBAI that could be used to effectively exempt tested income of the shareholder’s other CFCs. The comment noted that, in cases where a CFC has minimal tested income and substantial QBAI, the approach in the proposed regulations could result in a common shareholder receiving a pro rata share of QBAI that is disproportionate to its pro rata share of tested income, but acknowledged that this effect would be reversed in future years when the CFC generates more tested income.
- (d) Treasury and the IRS agreed with the comment that the approach in the proposed regulations achieved the correct result over a multi-year period. Accordingly, the final regulations generally adopted the QBAI allocation rule of the proposed regulations, with certain modifications to the excess

QBAI rule to better effectuate the purposes of the rule. Specifically, the final regulations provide that, in the case of a tested income CFC with tested income that is less than ten percent of its QBAI (the tested income CFC’s “hypothetical tangible return”), a shareholder’s pro rata share of QBAI is determined based on the shareholder’s pro rata share of this hypothetical tangible return. Treas. Reg. § 1.951A-1(d)(3)(ii)(A) and (C).

- (e) A U.S. shareholder’s pro rata share of the hypothetical tangible return is determined under the rules for determining the shareholder’s pro rata share of tested income, for this purpose treating the hypothetical tangible return as tested income. Treas. Reg. § 1.951A-1(d)(3)(ii)(B). In most cases, the excess QBAI rule in the final regulations will produce the same results as the excess QBAI rule in the proposed regulations. However, unlike the excess QBAI rule in the proposed regulations, the application of the excess QBAI rule in the final regulations is not limited to preferred stock.² Further, regarding common stock, by separating the allocation of excess QBAI from the allocation of tested income, and instead applying a hypothetical distribution model to the excess QBAI, the rule ensures that the reduction under § 951(a)(2)(B) and Treas. Reg. § 1.951A-1(b)(1)(ii) to a U.S. shareholder’s pro rata share of tested income does not result in an excessive reduction to the U.S. shareholder’s pro rata share of QBAI. Treas. Reg. § 1.951A-1(d)(3)(iii)(C) Example 3.
- (f) Finally, the final regulations clarify that the aggregate amount of any tested item (including QBAI) of a CFC for a CFC inclusion year allocated to the CFC’s stock cannot exceed the amount of such tested item of the CFC for the CFC inclusion year. Treas. Reg. § 1.951A-1(d)(1).

² When the excess QBAI rule in the final regulations applies to a CFC with preferred stock, the increase to the preferred shareholder’s DTIR by reason of the preferred stock generally will be limited to an amount equal to its pro rata share of tested income, consistent with the purpose of the rule in the proposed regulations. This is because the formula for determining the preferred shareholder’s pro rata share of QBAI (that is, multiplying the CFC’s QBAI by the ratio that such shareholder’s pro rata share of the hypothetical tangible return bears to the CFC’s total hypothetical tangible return) will yield a product that equals 10 times that shareholder’s pro rata share of tested income. For an illustration, *see* Treas. Reg. § 1.951A-1(d)(3)(iii)(B) Example 2.

ii. Pro Rata Share of Tested Loss.

- (a) The proposed regulations provided that a CFC's tested loss is allocated based on a hypothetical distribution of an amount of current E&P equal to the amount of tested loss, except that, in general, tested loss is allocated only to common stock. Prop. Treas. Reg. § 1.951A-1(d)(4)(i)(C). The general rule that tested loss is allocated only to common stock was subject to two exceptions.
- (b) First, the proposed regulations allocated tested loss to preferred shares to the extent the tested loss reduces the E&P accumulated since the issuance of those preferred shares to an amount below the amount necessary to satisfy any accrued but unpaid dividends regarding such preferred shares. Prop. Treas. Reg. § 1.951A-1(d)(4)(ii).
- (c) Second, when the common stock has no liquidation value, the proposed regulations allocated tested loss to classes of preferred stock with liquidation value in reverse order of priority. Prop. Treas. Reg. § 1.951A-1(d)(4)(iii).
- (d) These two exceptions resulted in tested loss allocations corresponding to changes in the economic value of the CFC stock. The preamble to the proposed regulations requested comments on the proposed approach for determining a U.S. shareholder's pro rata share of a CFC's tested loss, including how (or whether) to allocate tested loss of a CFC when no class of CFC stock has positive liquidation value.
- (e) Comments were supportive of the approach taken in the proposed regulations to determine pro rata shares of tested loss because the approach avoids complexity, minimizes the potential for abusive allocations of tested loss, and is consistent with the economic reality that common stock generally bears the risk of loss before preferred stock.
- (f) One comment recommended that if no class of stock has liquidation value, the tested loss should be allocated first to any shareholders that hold guaranteed debt of the CFC, and then to the most

senior class of common stock, unless another class of stock will in fact bear the economic loss. Treasury and the IRS believe, based on experience with pro rata share rules in the Subpart F context, that the facts and circumstances approach provides a flexible and appropriate allocation of tested loss, including in cases where no class of stock has liquidation value. Therefore, this comment was not adopted.

3. Prop. Treas. Reg. § 1.951A-2 – Tested Income and Tested Loss.

(a) Determination of gross income and allowable deductions.

- i. For purposes of determining tested income or tested loss, gross tested income is reduced by deductions (including taxes) properly allocable to the gross tested income (or which would be properly allocable to gross tested income if there were such gross income) under rules similar to the rules of § 954(b)(5). § 951A(c)(2)(A)(ii). The proposed regulations provided that, for purposes of determining tested income and tested loss, the gross income and allowable deductions of a CFC for a CFC inclusion year are determined under the rules of Treas. Reg. § 1.952-2 for determining the Subpart F income of a CFC. Prop. Treas. Reg. § 1.951A-2(c)(2). Treas. Reg. § 1.952-2 provides rules for determining gross income and taxable income of a foreign corporation. For this purpose, and subject to certain exceptions, these rules generally treat foreign corporations as domestic corporations. Treas. Reg. § 1.952-2(a)(1) and (b)(1).
- ii. The preamble to the proposed regulations requested comments on the application of Treas. Reg. § 1.952-2 for purposes of determining Subpart F income, tested income, and tested loss, including whether other approaches for determining tested income and tested loss, or whether additional modifications to Treas. Reg. § 1.952-2 for purposes of calculating tested income and tested loss, would be appropriate.
- iii. Several comments were received in response to this request. The comments generally supported applying Treas. Reg. § 1.952-2 for purposes of determining tested income. However, a number of comments requested modifications to, or clarifications regarding, the application of Treas. Reg. § 1.952-2. Some suggested that Treas. Reg.

§ 1.952-2 be revised for purposes of determining tested income and tested loss to allow the use of net operating loss carryforwards under § 172 and net capital losses subject to limits under § 1212. Another comment requested that Treasury and the IRS provide a list of specific deductions allowed to a CFC that would be disallowed to a domestic corporation, such as under § 162(m) or 280G. The same comment requested clarification that carryforwards of a CFC's disallowed interest deduction under § 163(j)(2) are not subject to any limitation or restrictions.

- iv. Some comments suggested that § 245A should apply to determine a CFC's Subpart F income and tested income and tested loss under Treas. Reg. § 1.952-2. There is also a concern that Treas. Reg. § 1.952-2 could be interpreted so expansively as to entitle a CFC to a deduction expressly limited to domestic corporations, such as a deduction under § 250.
- v. Treasury and the IRS intend to address issues related to the application of Treas. Reg. § 1.952-2, taking into account these comments, in a future guidance project. This guidance is expected to clarify that, in general, any provision that is expressly limited in its application to domestic corporations, such as § 250, does not apply to CFCs by reason of Treas. Reg. § 1.952-2. Treasury and the IRS continue to study whether, and to what extent, § 245A should apply to dividends received by a CFC and welcomed comments on this subject.
- vi. Treas. Reg. § 1.952-2(b)(2) provides that the taxable income of a CFC engaged in the business of reinsuring or issuing insurance or annuity contracts and which, if it were a domestic corporation engaged in such business, would be taxable as a life insurance company to which subchapter L applies, is generally determined by treating such corporation as a domestic corporation taxable under subchapter L and by applying the principles of Treas. Reg. §§ 1.953-4 and 1.953-5 for determining taxable income.
- vii. A comment requested that the final regulations confirm that the rules of current §§ 953 and 954(i) apply in determining the tested income or tested loss of a CFC described in Treas. Reg. § 1.952-2(b)(2). Treasury and the IRS agreed that the tested income or tested loss of a CFC described in Treas. Reg. § 1.952-2(b)(2) should be calculated in the same manner as its insurance income under §§ 953 and

954(i), and the rule was revised accordingly. Treas. Reg. § 1.951A-2(c)(2)(i). However, no inference was intended that a CFC may determine reserve amounts based on foreign statement reserves in the absence of a ruling request.

(b) Gross income excluded by reason of § 954(b)(4).

- i. Section 951A(c)(2)(A)(i)(III) provides that gross tested income does not include any item of gross income excluded from foreign base company income (as defined in § 954) (“FBCI”) or insurance income (as defined in § 953) “by reason of § 954(b)(4)” (the “GILTI high tax exclusion”). The proposed regulations provided that the GILTI high tax exclusion applied only to items of gross income that are excluded from FBCI or insurance income solely by reason of an election under § 954(b)(4) and Treas. Reg. § 1.954-1(d)(5). Prop. Treas. Reg. § 1.951A-2(c)(1)(iii). Thus, the exclusion did not apply to any item of gross income excluded from FBCI or insurance income by reason of an exception other than § 954(b)(4), regardless of the effective rate of foreign tax to which such item is subject.
- ii. One comment noted that the so-called clarification was consistent with the language of the GILTI high tax exclusion, which is limited by its terms to income subject to the high tax exception of § 954(b)(4). Several comments, however, requested that the final regulations expand the GILTI high tax exclusion to exclude additional categories of high-taxed income. These comments said, based on the legislative history of the TCJA, that Congress intended that income of a CFC would be subject to tax under the GILTI regime only if it is subject to a low rate of foreign tax.
- iii. Some comments suggested that the exclusion be expanded to apply to high-taxed income that would be FBCI or insurance income but for the application of one or more exceptions in § 954(c), (h), or (i).
- iv. Comments recommending an expansion of the GILTI high tax exclusion to any item of high-taxed income suggested various methods to determine the appropriate foreign tax rate for this purpose. One recommended the same threshold as used for the high tax exception for Subpart F income under § 954(b)(4) – that is, a rate that is 90% of the maximum rate specified in § 11 (21%), or 18.9%. Another

recommended a 13.125% rate, citing the conference report accompanying the TCJA that indicated that, in general, no residual U.S. tax would be owed on GILTI subject to a foreign tax rate greater than or equal to that rate.

- v. Other comments suggested that even if the GILTI high tax exclusion is not expanded to take into account all high-taxed income, taxpayers should be permitted to elect to treat income that would otherwise be gross tested income as Subpart F income in order to qualify for the exception under § 954(b)(4), for example, through a rebuttable presumption that all income (or alternatively, all high-taxed income) of a CFC is Subpart F income.
- vi. The final regulations did not adopt these comments. Treasury and the IRS have declined to exercise regulatory authority under § 951A(f)(1)(B) because that authority relates to the treatment of a GILTI inclusion amount, rather than an item of gross tested income. A GILTI inclusion amount is determined based on a U.S. shareholder's pro rata share of all the tested items of one or more CFCs and, as a result, the determination of the extent to which foreign tax is imposed on any single item of net income for purposes of § 954(b)(4) cannot be made by reference to a GILTI inclusion amount.
- vii. The final regulations also do not permit taxpayers to elect to treat income that would otherwise be gross tested income as Subpart F income in order to qualify for the exception under § 954(b)(4). Unlike § 954(b)(4), nothing in § 954(a) or the legislative history suggests that taxpayers should be permitted to treat income that is not described in § 954(a), such as gross tested income, as FBCI through a rebuttable presumption or otherwise. In addition, this type of rebuttable presumption could give rise to significant administrability concerns.
- viii. However, these concerns were considered further in a notice of proposed rulemaking that is discussed below. It addresses an election under § 954(b)(4) regarding income that would otherwise qualify as tested income.
- ix. Treasury and the IRS continue to believe that the GILTI high tax exclusion, as articulated in the proposed regulations, reflects a reasonable interpretation of § 951A(c)(2)(A)(i)(III) and § 954(b)(4), for the reasons stated in the notice of proposed rulemaking. Accordingly,

the final regulations retain the GILTI high tax exclusion without modification. Treas. Reg. § 1.951A-2(c)(1)(iii). Until the regulations described in the notice of proposed rulemaking are effective, a taxpayer may not exclude any item of income from gross tested income under § 951A(c)(2)(A)(i)(III) unless the income would be FBCI or insurance income but for the application of § 954(b)(4) and Treas. Reg. § 1.954-1(d).

(c) Gross income taken into account in determining Subpart F income.

i. In General.

- (a) Section 951A(c)(2)(A)(i)(II) provides that gross tested income is determined without regard to any gross income taken into account in determining the Subpart F income of the corporation (the “Subpart F exclusion”). Section 952(a) defines “Subpart F income” as the sum of certain categories of income, including FBCI and insurance income.
- (b) Other than for coordinating between the Subpart F exclusion and § 952(c), the proposed regulations did not provide guidance on income that is “taken into account in determining the Subpart F income” of a CFC within the meaning of the Subpart F exclusion. In this regard, the final regulations provide rules for determining gross income included in FBCI and insurance company for purposes of the Subpart F exclusion, including by reason of the application of the de minimis and full inclusion rules in § 954(b). Treas. Reg. § 1.951A-2(c)(4)(ii)(A) and (B) and (iii)(C).
- (c) The final regulations also clarify the circumstances in which the Subpart F exclusion applies to less common items included in Subpart F income under § 952(a)(3) through (5) (Subpart F income resulting from participation in or cooperation with certain international boycotts, payments of illegal bribes, kickbacks, or other payments, or income derived from any country during which § 901(j) applies to that country). Treas. Reg. § 1.951A-2(c)(4)(ii)(C) through (E).

(d) Coordination with § 952(c).

i. In General.

- (a) The amount of Subpart F income for a taxable year is subject to the E&P limitation and recapture provisions in § 952(c). Section 952(c)(1)(A) provides that a CFC's Subpart F income for any taxable year cannot exceed its E&P for that year. Treas. Reg. § 1.952-1(c)(1). However, § 952(c)(2) provides that, to the extent Subpart F income is reduced by reason of the E&P limitation in any taxable year, any excess of the E&P of the corporation for any subsequent taxable year over the Subpart F income for that year is recharacterized as Subpart F income. Treas. Reg. § 1.952-1(f)(1). An amount recaptured under § 952(c)(2) is treated as Subpart F income in the same separate category (as defined in Treas. Reg. § 1.904-5(a)) as the Subpart F income that was subject to the E&P limitation in a prior taxable year. Treas. Reg. § 1.952-1(f)(2)(ii).
- (b) The Code does not provide a rule that explicitly coordinates the Subpart F exclusion with § 952(c). In order to resolve this ambiguity, the proposed regulations set forth such a coordination rule by providing that the gross tested income and allowable deductions properly allocable to gross tested income are determined without regard to the application of § 952(c) (the “§ 952(c) coordination rule”). Prop. Treas. Reg. § 1.951A-2(c)(4)(i).
- (c) Thus, income that would be Subpart F income but for the application of the E&P limitation in § 952(c)(1)(A) was excluded from gross tested income by reason of the Subpart F exclusion. In addition, income that gave rise to E&P that resulted in Subpart F recapture under § 952(c)(2) was not excluded from gross tested income by reason of the Subpart F exclusion. In effect, the § 952(c) coordination rule treats an item of gross income as “taken into account” in determining Subpart F income to the extent, and only to the extent, that the item would be included in Subpart F income absent the application of § 952(c).

- (d) The proposed regulations included an example that illustrated this rule. Prop. Treas. Reg. § 1.951A-2(c)(4)(ii)(A). In the example, in Year 1, FS, a CFC wholly owned by a U.S. shareholder, has \$100x of foreign base company sales income, a \$100x loss in foreign oil and gas extraction income, and no E&P. In Year 2, FS has gross income of \$100x that is not otherwise excluded from the definition of gross tested income in Prop. Treas. Reg. § 1.951A-2(c)(1)(i) through (v), and no allowable deductions, and \$100x of E&P. The example held that in Year 1 FS had no Subpart F income because of the E&P limitation in § 952(c)(1)(A) and no gross tested income because gross tested income is determined without regard to § 952(c). In Year 2, the example concluded that, because FS's E&P (\$100x) exceed its Year 2 Subpart F income (\$0), the Subpart F income of Year 1 is recaptured in Year 2 under § 952(c)(2), and FS also has \$100x of gross tested income in Year 2 because gross tested income is determined without regard to § 952(c).
- (e) One comment agreed that the § 952(c) coordination rule was an appropriate interpretation of the statute, noting that the rule preserves the ability for § 952(c)(2) to recapture Subpart F income generated in prior years, while preventing recapture under § 952(c)(2) from permanently exempting gross tested income generated in subsequent years. However, several comments suggested that the § 952(c) coordination rule be withdrawn. These comments said that the § 952(c) coordination rule can lead to double taxation because the rule can result in the taxation of an aggregate amount of CFC income in excess of the net economic CFC income over a multi-year period.
- (f) Treasury and the IRS believe that the § 952(c) coordination rule is consistent with the relevant statutory provisions and results in the appropriate amount of income that is subject to tax under §§ 951 and 951A. Gross income that would be Subpart F income during the current year but for the application § 952(c)(1)(A) is literally “taken into account” in determining Subpart F income in that it potentially gives rise to future Subpart F income by reason of § 952(c)(2).

- (g) Furthermore, gross tested income is not subject to an E&P limitation analogous to the E&P limitation on Subpart F income under § 952(c)(1)(A). In this regard, the determination of tested income under the GILTI regime is based on a taxable income concept, similar to the determination of income earned directly by a U.S. taxpayer, whereas the Subpart F regime is rooted in a distributable dividend model, and thus predicated on the existence of E&P.
- (h) Therefore, for example, a CFC could have \$100x of gross tested income but no E&P in a taxable year (due, for instance, to a loss in foreign oil and gas extraction income), and the U.S. shareholder of the CFC (assuming no QBAI or other CFCs) will nonetheless have a \$100x GILTI inclusion amount for the taxable year. This is the result under § 951A notwithstanding that the CFC in this case has no net economic income and no E&P for the year.
- (i) If the same CFC for the same taxable year also has \$100x of foreign base company sales income and \$100x of E&P related to such income, in addition to the \$100x GILTI inclusion amount, the CFC's U.S. shareholder would have a \$100x Subpart F inclusion. Under these facts, the U.S. shareholder is taxed on an aggregate amount of taxable income of the CFC (\$200x) that exceeds the CFC's net economic income and E&P (\$100x). In this example, the U.S. shareholder is not subject to tax twice regarding a single item of income, but rather is subject to tax once regarding each of two items – the CFC's Subpart F income of \$100x and the CFC's gross tested income of \$100x.
- (j) The § 952(c) coordination rule merely ensures that the same result obtains whether all items of income and loss arise in a single year (as in this example) or arise in different taxable years (as in the example in Prop. Treas. Reg. § 1.951A-2(c)(4)(ii)(A)).
- (k) Treasury and the IRS also believe that it is not appropriate to exclude the E&P recapture rule from the scope of the § 952(c) coordination rule. Because § 951A contains no analog to the E&P limitation in § 952(c)(1)(A), it also contains no analog to the E&P recapture rule in § 952(c)(2).

Without a GILTI recapture rule, the approach recommended by comments would effectively allow prior year losses in categories of income excluded from gross tested income (for example, Subpart F income or foreign oil and gas extraction income) to permanently exempt gross tested income in subsequent years.

- (l) For instance, if, in a taxable year, a CFC has \$100x of foreign base company sales income, a \$100x loss in foreign base company services income, and thus no Subpart F income by reason of the E&P limitation of § 952(c)(1)(A), any gross tested income earned by the CFC in a subsequent year would recapture the foreign base company sales income from the previous year, and thus such gross income would never be subject to § 951A.
- (m) In excluding certain categories of income from gross tested income (namely, Subpart F income, foreign oil and gas extraction income, and effectively connected income), Congress not only ensured that the income would not be subject to the GILTI regime, but also that losses regarding that income would not be permitted to reduce income subject to the GILTI regime. Similarly, § 951A(c)(2)(B)(ii) provides that a loss in a category of income subject to the GILTI regime (that is, tested loss) cannot reduce the income subject to the Subpart F regime by reason of the E&P limitation rule of § 952(c)(1)(A). Treas. Reg. § 1.951A-6(b).
- (n) A comment recommended as another alternative that the § 952(c)(2) coordination rule not be applied regarding recapture accounts that existed before the TCJA. The comment said that it would be inappropriate for income that triggers recapture under § 952(c)(2) based on pre-TCJA recapture account balances to also be treated as gross tested income because § 951A did not exist before 2018 and therefore no tested losses could have reduced Subpart F income.
- (o) The final regulations did not adopt this recommendation. Nothing in the statute or legislative history suggests that pre-TCJA recapture

account balances should be treated differently than post-TCJA account balances. Further, there appears to be no stronger policy rationale for permitting losses that arose before the TCJA to permanently exempt gross tested income from taxation than for permitting GILTI-exempt losses that arise after the TCJA to do the same.

- (p) While the comments regarding the § 952(c) coordination rule generally pertained to the application of the E&P limitation in § 952(c)(1)(A), the same issues as discussed regarding § 952(c)(1)(A) arise regarding application of the qualified deficit rule in § 952(c)(1)(B) and the chain deficit rule in § 952(c)(1)(C). Accordingly, the final regulations revised the § 952(c) coordination rule to apply also to disregard the effect of a qualified deficit or a chain deficit in determining gross tested income. Treas. Reg. § 1.951A-2(c)(4)(ii).
- (q) One comment requested clarification that income subject to the high tax exception of § 954(b)(4) is not included in gross tested income even if the income would also be excluded from Subpart F income by reason of § 952(c)(1)(A). The comment provided an example in which a CFC has \$100x of foreign base company services income, a \$100x loss in another category of Subpart F income, no E&P, and thus no Subpart F income by reason of the E&P limitation of § 952(c)(1)(A).
- (r) The comment said that if the election under § 954(b)(4) is made regarding the foreign base company services income, one interpretation of the proposed regulations is that the \$100x of foreign base company services income is not excluded from gross tested income by either the Subpart F exclusion under § 951A(c)(2)(A)(i)(II) (because such income is not included in Subpart F by reason of the high tax exception of § 954(b)(4)) or the GILTI high tax exclusion under § 951A(c)(2)(A)(i)(II) (because such income is not excluded from Subpart F income “solely” by reason of the high tax exception of § 954(b)(4)).

- (s) Treasury and the IRS believe that the clarification is unnecessary because an election under § 954(b)(4) cannot be made regarding a net item eliminated by reason of § 952(c)(1)(A). Treas. Reg. § 1.954-1(d)(4)(ii) provides that the net item of income to which the high tax exception of § 954(b)(4) applies is the Subpart F income of a CFC determined after taking into account the earnings and profits limitation of § 952(c)(1)(A).
 - (t) Therefore, the net item of income that can be excluded under the high tax exception is determined after the application of § 952(c)(1)(A). Indeed, in the example presented by the comment, because the Subpart F income of the CFC after application of the E&P limitation is zero, there is no net item of income for which an election under § 954(b)(4) and Treas. Reg. § 1.954-1(d)(5) can be made. Accordingly, the \$100x of foreign base company services income is excluded from gross tested income solely by reason of the Subpart F exclusion under § 951A(c)(2)(A)(i)(II).
- ii. Coordination with qualified deficit rule in § 952(c)(1)(B).
- (a) The qualified deficit rule in § 952(c)(1)(B) reduces a U.S. shareholder's Subpart F inclusion attributable to a qualified activity (defined in § 952(c)(1)(B)(iii)) to the extent of that shareholder's pro rata share of any qualified deficit (defined in § 952(c)(1)(B)(ii)). A comment suggested that a tested loss could, in some cases, also give rise to a qualified deficit that could reduce Subpart F income in a subsequent taxable year. The comment stated that this could occur, for example, if certain deductions and losses that make up a qualified deficit are also properly allocable to gross tested income. Accordingly, the comment recommended that the final regulations deny a U.S. shareholder the ability to both reduce its net CFC tested income and increase a qualified deficit by reason of the same economic loss.
 - (b) Treasury and the IRS agreed that the same deduction or loss should not result in a double benefit under § 951A and the qualified deficit rule, but have not identified a situation in which a single

deduction or loss can both reduce tested income (or increase tested loss) and also give rise to or increase a qualified deficit. A deduction or loss that is properly allocable to gross tested income cannot also be attributable to a qualified activity that gives rise to Subpart F income, and the same deduction cannot be taken into account more than once under §§ 954(b)(5) and 951A(c)(2)(A)(ii).

- (c) Nevertheless, for the avoidance of doubt, the final regulations provide that deductions that are allocated and apportioned to gross tested income are not attributable to a qualified activity and thus do not also increase or give rise to a qualified deficit. Treas. Reg. § 1.951A-2(c)(3).

iii. Coordination with § 952(c)(1)(B)(vii). Section 952(c)(1)(B)(vii)(I) contains an election to apply § 953(a) without regard to the same country exception in § 953(a)(1)(A). Comments requested that the § 952(c) coordination rule be modified to clarify that gross tested income is determined after giving effect to the election in § 952(c)(1)(B)(vii)(I). The rule in Prop. Treas. Reg. § 1.951A-2(c)(4) was not intended to address the election in § 952(c)(1)(B)(vii)(I). Accordingly, the final regulations modified the § 952(c) coordination rule to apply only regarding the E&P limitation rules of § 952(c)(1) (including the qualified deficit and chain deficit rules) and the E&P recapture rule of § 952(c)(2).

iv. Coordination with De Minimis Rule, Full Inclusion Rule, and High Tax Exception.

- (a) Section 954(a) provides that FBCI for a taxable year is equal to the sum of foreign personal holding company income (as determined under § 954(c)) (“FPHCI”), foreign base company sales income (as determined under § 954(d)) and foreign base company services income (as determined under § 954(e)). However, § 954(b)(3)(A) provides that if the sum of FBCI (determined without regard to allocable deductions) (“gross FBCI”) and gross insurance income for the taxable year is less than the lesser of five percent of gross income or \$1,000,000, then no part of the gross income for the taxable year is treated as FBCI or insurance income (the “de minimis rule”). Conversely,

§ 954(b)(3)(B) provides that if the sum of gross FBCI and gross insurance income for the taxable year exceeds 70% of gross income, the entire gross income for the taxable year is treated as gross FBCI or gross insurance income, as appropriate (the “full inclusion rule”).

- (b) One comment requested that the de minimis and full inclusion rules be taken into account for purposes of determining “gross income taken into account” in determining Subpart F income within the meaning of the Subpart F exclusion. The comment said that such a rule would prevent double taxation because full inclusion Subpart F income would be taxed solely under § 951 (and not § 951A), whereas de minimis Subpart F income would be taxed solely under § 951A (and not § 951).
- (c) Treasury and the IRS agreed with this comment. Accordingly, subject to the application of the § 952(c) coordination rule, the final regulations provide that the Subpart F exclusion applies to gross income included in FBCI (adjusted net FBCI as defined in Treas. Reg. § 1.954-1(a)(5)) or insurance income (adjusted net insurance income as defined in § 1.954-1(a)(6)). Treas. Reg. § 1.951A-2(c)(4)(i).
- (d) Thus, for purposes of the Subpart F exclusion, gross income taken into account in determining Subpart F income does not include any item of gross income excluded from FBCI or insurance income under the de minimis rule or the high tax exception of § 954(b)(4), but generally does include any item of gross income included in FBCI or insurance income under the full inclusion rule. In addition, for purposes of the Subpart F exclusion, gross income taken into account in determining Subpart F income does not include gross income that qualifies for an exception to a category of FBCI described in § 954(a), including amounts excepted from the definition of FPHCI, such as rents and royalties derived from an active business under § 954(c)(2)(A) and Treas. Reg. § 1.954-2(b)(5) and (6) or active financing income under § 954(h).
- (e) Treas. Reg. § 1.954-1(d)(6) provides that an item of gross income that is included in FBCI or insurance

income under the full inclusion rule (“full inclusion FBCI”) is excluded from Subpart F income if more than 90% of the gross FBCI and gross insurance income for the taxable year (determined without regard to the full inclusion rule) is attributable to net amounts excluded from Subpart F income under the high tax exception of § 954(b)(4).

(f) Treasury and the IRS believe that it would be inappropriate for an item of gross income that would be included in gross tested income but for the full inclusion rule to be excluded from both gross tested income (by reason of the Subpart F exclusion) and Subpart F income (by reason of Treas. Reg. § 1.954-1(d)(6)). Accordingly, the final regulations provide that full inclusion FBCI excluded from Subpart F income by reason of Treas. Reg. § 1.954-1(d)(6) is not excluded from gross tested income by reason of the Subpart F exclusion. Treas. Reg. § 1.951A-2(c)(4)(iii)(C).

(g) The final regulations further clarify that income excluded from Subpart F income under Treas. Reg. § 1.954-1(d)(6) is also not excluded from gross tested income by reason of the GILTI high tax exclusion. Accordingly, income excluded from Subpart F income by reason of Treas. Reg. § 1.954-1(d)(6) is included in gross tested income.

(e) Effect of basis adjustments under § 961(c).

i. Section 961(c) provides that, under regulations prescribed by the Secretary, if a U.S. shareholder is treated under § 958(a)(2) as owning stock of a CFC which is owned by another CFC, then adjustments similar to those provided under § 961(a) and (b) are made to the basis in the stock, and the basis in stock of any other CFC by reason of which the U.S. shareholder is considered under § 958(a)(2) as owning the stock. The provision further provides, however, that these adjustments are made only for the purposes of determining the amount included under § 951 in the gross income of such U.S. shareholder (or any successor U.S. shareholder). There are no regulations in effect under § 961(c).

ii. Comments questioned whether basis adjustments under § 961(c) should be taken into account for purposes of

determining gross tested income of a CFC upon the CFC's disposition of stock of another CFC. One comment noted that, while § 951A(f)(1)(A) treats a GILTI inclusion in the same manner as a Subpart F inclusion for purposes of basis adjustments under § 961, the resulting basis under § 961(c) only applies for purposes of determining amounts included in gross income under § 951. The comment recommended nonetheless that regulations provide that § 961(c) basis adjustments apply both for purposes of determining Subpart F income and gross tested income to prevent certain items of income from being inappropriately taxed twice; the comment further noted, however, that unintentional non-taxation should also be avoided.

- iii. The interaction of basis adjustments under § 961(c) and § 951A will be further considered in a guidance project addressing previously taxed E&P ("PTEP") under §§ 959 and 961. *See* Notice 2019-1 (which announced an intention to address PTEP in forthcoming proposed regulations). Treasury and the IRS recognize the concern expressed in the comment but are also aware that taking into account § 961(c) basis adjustments for purposes of determining gross tested income could inappropriately reduce the amount of stock gain subject to tax.
- iv. This may occur because, as was the case before the TCJA, § 961(c) adjustments are not taken into account for purposes of determining E&P, and thus a disposition of lower-tier CFC stock may generate E&P for the upper-tier CFC to the extent of the amount of the gain in the stock determined without regard to § 961(c).
- v. If the resulting E&P give rise to a dividend (including by reason of a disposition under § 1248) to a corporate U.S. shareholder, the dividend may result in an offsetting dividends received deduction. §§ 245A(a) and 1248(j). If § 245A(a) applies to the dividend, the taxable portion of any unrealized appreciation in the upper-tier CFC stock, to the extent attributable to unrealized appreciation in assets of the upper-tier CFC, would effectively be reduced in an amount equal to the dividend, either because of a dividend distribution that reduces the value in the upper-tier CFC stock without a corresponding basis reduction (§ 961(d) applies only to the extent loss would otherwise be recognized) or by reason of a disposition to the extent the gain is recharacterized under § 1248(j) as a dividend for purposes of applying § 245A.

vi. Comments were requested on this issue, including the extent to which adjustments should be made to minimize the potential for the same item of income being subject to tax more than once and to minimize the inappropriate reduction of gain in CFC stock held by corporate U.S. shareholders.

(f) Deduction or loss attributable to disqualified basis.

i. In General.

- (a) The proposed regulations included a rule that would generally disallow, for purposes of calculating tested income or tested loss, any deduction or loss attributable to disqualified basis in depreciable or amortizable property (including, for example, intangible property) resulting from a disqualified transfer of the property. Prop. Treas. Reg. § 1.951A-2(c)(5). The relevant terms for purposes of applying the rule in Prop. Treas. Reg. § 1.951A-2(c)(5) were defined by reference to certain provisions and terms in Prop. Treas. Reg. § 1.951A-3(h)(2) (disregarding disqualified basis for purposes of determining QBAI), with certain modifications. Prop. Treas. Reg. § 1.951A-2(c)(5)(iii).
- (b) In general, the term “disqualified basis” was defined as the excess of a property’s adjusted basis immediately after a disqualified transfer, over the sum of the property’s adjusted basis immediately before the disqualified transfer and the amount of gain recognized by the transferor in the disqualified transfer that is subject to tax as Subpart F income or effectively connected income. Prop. Treas. Reg. § 1.951A-3(h)(2)(ii)(A) and (B).
- (c) The term “disqualified transfer” was defined as a transfer of property by a transferor CFC during the transferor CFC’s disqualified period to a related person in which gain was recognized, in whole or in part. Prop. Treas. Reg. § 1.951A-3(h)(2)(ii)(C). Finally, the term “disqualified period” is defined regarding a transferor CFC as the period that begins on January 1, 2018, and ends as of the close of the transferor CFC’s last taxable year that is not a CFC inclusion year. Prop. Treas. Reg. § 1.951A-3(h)(2)(ii)(D). Income generated by fiscal-year

CFCs during the disqualified period is subject to neither the transition tax under § 965 nor the tax on GILTI under § 951A.

- (d) In response to comments, Treasury and the IRS revised these rules in a manner consistent with the purpose of the rule in the proposed regulations. Certain comments and revisions related to the determination of disqualified basis for purposes of both Prop. Treas. Reg. §§ 1.951A-2(c)(5) and 1.951A-3(h)(2).

ii. Authority.

- (a) Several comments recommended that the rule in Prop. Treas. Reg. § 1.951A-2(c)(5) be withdrawn or substantially narrowed and re-proposed. Some of these comments recommended that the rule be revised to apply only to “non-economic” transactions or transactions engaged in with a tax-avoidance purpose, or that avoidance-type transactions be addressed through existing statutory or judicial doctrines. One comment recommended that the rule continue to be limited to transfers between related persons because third-party sales are fundamentally different from the “non-economic transactions” described in the legislative history. However, one comment opposed any additional limitations or weakening of the anti-abuse rules in the proposed regulations.
- (b) Several comments questioned Treasury and the IRS’s authority for issuing the rule. Many of these comments asserted that § 951A(d)(4), which provides authority to issue regulations that are “appropriate to prevent the avoidance of the purposes of this subsection,” does not authorize Treasury and the IRS to promulgate rules that apply for any purpose other than for purposes of determining QBAI under § 951A(d). Also, two comments stated that the disallowance of deductions under Prop. Treas. Reg. § 1.951A-2(c)(5) was contrary to, and therefore not authorized by, § 951A(c)(2)(A)(ii), which requires that the deductions of the CFC be allocated to gross tested income under rules similar to the rules of

§ 954(b)(5) for purposes of calculating tested income or tested loss.

- (c) In response to these comments, Treasury and the IRS revised the proposed rule in a manner that better reflects the source of its authority. Section 7805(a) provides that “the Secretary shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.”
- (d) Section 951A(c)(2)(A) defines “tested income” by reference to certain items of gross income, reduced by “the deductions (including taxes) properly allocable to such gross income under rules similar to the rules of § 954(b)(5) (or to which such deductions would be allocable if there were such gross income).” Section 954(b)(5) provides that FPHCI, foreign base company sales income, and foreign base company services income are reduced, “under regulations prescribed by the Secretary,” by deductions “properly allocable” to such income. Similarly, § 882(c)(1)(A) provides that, for purposes of determining a foreign corporation’s income which is effectively connected with the conduct of a trade or business within the U.S. (“effectively connected income”), “proper apportionment and allocation” of deductions of the foreign corporation “shall be determined as provided in regulations prescribed by the Secretary.”
- (e) The rule, as revised in the final regulations, provides guidance for determining whether certain deductions or losses are “properly allocable” to gross tested income, Subpart F income, or effectively connected income within the meaning of § 951A(c)(2)(A), § 954(b)(5), or § 882(c)(1)(A), respectively.
- (f) The preamble states that the legislative history of the TCJA indicates that § 965 was intended as a transition measure to the new territorial tax system in which § 951A applies, and that Congress intended that all earnings of a CFC would be

potentially subject to tax under either § 965 or § 951A.

- (g) Because the final date for measuring the E&P of a CFC for purposes of § 965 is December 31, 2017 (the “final E&P measurement date”), and the effective date of § 951A is the first taxable year of a CFC beginning after December 31, 2017, all the earnings of a calendar year CFC are potentially subject to taxation under either § 965 or § 951A. However, a fiscal year CFC (for example, a CFC with a taxable year ending November 30) may have a gap between its final E&P measurement date under § 965 (December 31, 2017) and the date on which § 951A first applies regarding its income (December 1, 2018, for a CFC with a taxable year ending November 30).
- (h) Treasury and the IRS believe that a deduction or loss attributable to basis (disqualified basis) created by reason of a transfer from a CFC to a related CFC (a disqualified transfer) during the period between the final E&P measurement date and the effective date of § 951A (the disqualified period), to the extent no taxpayer included an amount in gross income by reason of such disqualified transfer, should not be permitted to reduce a taxpayer’s U.S. income tax liability in subsequent years. Accordingly, the final regulations treat any deduction or loss attributable to disqualified basis as not “properly allocable” to gross tested income, Subpart F income, or effectively connected income of the CFC (“residual CFC gross income”). Treas. Reg. § 1.951A-2(c)(5)(i).
- (i) While the rules that allocate and apportion expenses generally depend on the factual relationship between the item of expense and the associated gross income, the relevant statutory language in §§ 882(c)(1)(A), 951A(c)(2)(A)(ii), and 954(b)(5) does not constrain the IRS from taking into account other considerations in determining whether it is “proper” for a certain item of expense to be allocated to, and therefore reduce, a particular item of gross income.

- (j) The preamble says Treasury and the IRS are not required to issue rules that mechanically allocate an item of expense to gross income to which such expense factually relates if taxable income would be distorted by reason of such allocation. They have determined that the rule in Treas. Reg. § 1.951A-2(c)(5) is necessary to ensure that transactions during the disqualified period, the income or earnings from which are not subject to tax, are not permitted to improperly reduce or eliminate a taxpayer's income that would be subject to tax after the disqualified period.
- (k) This rule creates symmetry between the category of income generated by reason of a transfer during the disqualified period and the category of income to which any deduction or loss attributable to the resulting basis is allocated. That is, a disqualified transfer, by definition, generates residual CFC gross income (income that is not Subpart F income, tested income, or effectively connected income), and the rule in Treas. Reg. § 1.951A-2(c)(5) allocates the deduction or loss attributable to the disqualified basis to the same category of income. In the case of a depreciable or amortizable asset with disqualified basis that is held until the end of its useful life, the aggregate amount of deduction or loss attributable to the disqualified basis allocated to residual CFC gross income under the rule will equal the amount of residual CFC gross income generated in the disqualified transfer.
- (l) The rule in Prop. Treas. Reg. § 1.951A-2(c)(5) provided that any deduction or loss attributable to disqualified basis would be disregarded for purposes of determining tested income or tested loss. In contrast, the rule in the final regulations allocates and apportions any such deduction or loss to gross income other than gross tested income, Subpart F income, or effectively connected income. Regarding the determination of tested income or tested loss, whether an item of deduction or loss is disregarded (under the proposed regulations) or allocated to income other than gross tested income (under the final regulations) does not provide a different result. In either case, the preamble states

that the deduction or loss is not permitted to reduce tested income or increase tested loss.

- (m) However, by allocating an item of deduction or loss to residual CFC gross income, the rule in the final regulations ensures that any deduction or loss attributable to disqualified basis is also not taken into account for purposes of determining the CFC's Subpart F income or effectively connected income. The broadening of the rule to allocate any deduction or loss attributable to disqualified basis away from Subpart F income and effectively connected income is intended to ensure that taxpayers cannot simply circumvent the rule by converting their gross tested income into either Subpart F income or effectively connected income, and thus be permitted to use the deduction or loss attributable to the disqualified basis against such income.
- (n) The preamble to the proposed regulations evidenced an intention that taxpayers not be permitted to claim tax benefits regarding cost-free disqualified basis, and the preamble to the final regulations states these regulations effectuate this intent by closing the loophole. Furthermore, the rule ensures that the words "properly allocable" are interpreted consistently across provisions – §§ 882(c)(1)(A), 951A(c)(2)(A)(ii), and 954(b)(5) – regarding any deduction or loss attributable to disqualified basis.
- (o) The rule in Prop. Treas. Reg. § 1.951A-2(c)(5) applied only to deductions or losses attributable to disqualified basis in "specified property," which is defined as property that is of a type regarding which a deduction is allowable under § 167 or 197. Prop. Treas. Reg. § 1.951A-2(c)(5)(ii). Treasury and the IRS believe, however, that the rule should not be limited to specified property because deductions or losses attributable to disqualified basis in other property may also be used to inappropriately reduce a taxpayer's U.S. income tax liability. On the other hand, Treasury and the IRS also believe that it would be unduly burdensome to require CFCs to determine the disqualified basis in each item of inventory and that it is reasonable to expect that most inventory acquired during the disqualified period will be sold at a gain such that the

disqualified basis in an item of inventory would rarely be relevant.

- (p) Accordingly, the rule in the final regulations applies to deductions or losses attributable to disqualified basis in any property, other than property described in § 1221(a)(1), regardless of whether the property is of a type regarding which a deduction is allowable under § 167 or 197. Treas. Reg. §§ 1.951A-2(c)(5)(iii)(A) and 1.951A-3(h)(2)(ii).
- (q) One comment said that the use of the phrase “non-economic transactions” in the Conference Report means that the authority to draft anti-abuse rules pursuant to §§ 7805 and 951A(d)(4) is limited to non-economic transactions, which necessitates a facts and circumstances test. The rule in Treas. Reg. § 1.951A-2(c)(5) is not premised upon facts and circumstances, such as a taxpayer’s intent; rather, the rule is based on an interpretation of the term “properly allocable” in the context of a deduction or loss attributable to disqualified basis.
- (r) Thus, Treasury and the IRS believe that the rule in Treas. Reg. § 1.951A-2(c)(5), with the modifications, represents an appropriate exercise of their authority under §§ 951A and 7805.

iii. Effect of Disqualified Basis for Purposes of Determining Income or Gain.

- (a) Some comments noted that the rule in Prop. Treas. Reg. § 1.951A-2(c)(5) addressed only deductions or losses attributable to disqualified basis and did not address the effect of disqualified basis in determining a CFC’s income or gain upon the disposition of property. For example, assume USP, a domestic corporation, wholly owns CFC1, which holds property with a fair market value of \$100x and an adjusted basis of \$80x, \$70x of which is disqualified basis. CFC1 sells the property to an unrelated party in exchange for \$100x of cash and, without regard to Prop. Treas. Reg. § 1.951A-2(c)(5), recognizes \$20x of gain. The comments asked whether, under the rule, the disqualified basis of \$70x in the property is disregarded such that the

sale results in \$90x (rather than \$20x) of gross tested income to CFC1.

- (b) Treasury and the IRS believe that the rule in Treas. Reg. § 1.951A-2(c)(5) should apply only for purposes of determining whether a deduction or loss is properly allocable to gross tested income, Subpart F income, or effectively connected income. Thus, disqualified basis is not disregarded for purposes of determining income or gain recognized on the disposition of the property.
- (c) However, because many taxpayers capitalize depreciation or amortization expense to other property, including inventory, and recover those costs through cost of goods sold or depreciation of the other property, the final regulations also provide that any depreciation, amortization, or cost recovery allowances attributable to disqualified basis is not properly allocable to property produced or acquired for resale under §§ 263, 263A, or 471. Treas. Reg. § 1.951A-2(c)(5)(i). This rule is to ensure that depreciation or amortization expenses attributable to disqualified basis are not permitted to indirectly reduce taxable income through the depreciation expense of other property or from the disposition of inventory.
- (d) Disqualified basis is generally reduced or eliminated to the extent that such basis reduces taxable income. Therefore, a sale of property with disqualified basis generally results in the elimination of the disqualified basis, because the basis is taken into account in determining the CFC's taxable income. As a result, absent a special provision, a CFC could "cleanse" the disqualified basis in property by selling the property to a related person after the disqualified period; the related person would have no disqualified basis in the property, and the selling CFC would recognize income only to the extent the amount realized exceeded its adjusted basis in the property (for this purpose, including its disqualified basis).
- (e) Thus, the final regulations provide that, except to the extent that any loss recognized on the transfer of such property is treated as attributable to

disqualified basis under Treas. Reg. § 1.951A-2(c)(5), or the basis is reduced or eliminated in a nonrecognition transaction within the meaning of § 7701(a)(45), a transfer of property with disqualified basis in the hands of a CFC to a related person does not reduce the disqualified basis in the hands of the transferee. Treas. Reg. § 1.951A-3(h)(2)(ii)(B)(1)(ii).

- (f) If, for example, a CFC sells property with an adjusted basis of \$80x and disqualified basis of \$70x to a related person for \$100x in a fully taxable exchange, the selling CFC would recognize \$20x of gross income on the sale, which income may be included in gross tested income, and the disqualified basis in the property immediately after the transfer would remain \$70x in the hands of the related person.

iv. Concurrent Application of the Rule with Other Provisions.

- (a) One comment stated that if Treasury and the IRS retain the rule in Prop. Treas. Reg. § 1.951A-2(c)(5), then the disqualified transfer should be disregarded for all U.S. tax purposes, including for purposes of determining the gain or loss recognized by the transferor CFC by reason of the transfer and the tax attributes of the transferor CFC created by reason of the transfer. The comment expressed concern with potentially adverse consequences to the transferor CFC from the concurrent application of the rule and certain other provisions, such as incremental subpart F income generated by reason of the transfer, additional E&P that could dilute foreign tax credits regarding a Subpart F inclusion, and immediate U.S. taxation on any effectively connected income under § 882 from the transfer.
- (b) The rule in Treas. Reg. § 1.951A-2(c)(5) is intended to provide guidance on determining whether deductions of a CFC attributable to disqualified basis are properly allocable to gross tested income, Subpart F income, and effectively connected income. The rule is not intended to disregard the transfer that created the disqualified basis in its entirety. Moreover, Treasury and the IRS believe that disregarding the transfer for all U.S. tax

purposes is not appropriate because the property has in fact been transferred. In addition, disqualified basis in property does not include basis resulting from “qualified gain,” which is gain from the transfer included by the transferor CFC as effectively connected income or by a U.S. shareholder as its pro rata share of Subpart F income. Treas. Reg. § 1.951A-3(h)(2)(ii)(C)(3). Thus, the rule in Treas. Reg. § 1.951A-2(c)(5) does not apply to basis created in connection with amounts that are taxed under §§ 882 and 951. Accordingly, this recommendation was not adopted.

- (c) Section 901(m) disallows certain foreign tax credits on foreign income not taken into account for U.S. tax purposes as a result of a “covered asset acquisition,” which includes an acquisition of assets for U.S. tax purposes that is treated as the acquisition of stock of a corporation (or is disregarded) for foreign tax purposes and an acquisition of an interest in a partnership which has an election in effect under § 754. §§ 901(m)(2)(B) and (C).
- (d) One comment noted that a disqualified transfer subject to the rule in Prop. Treas. Reg. § 1.951A-2(c)(5) could also constitute a covered asset acquisition under § 901(m), such as the sale of an interest in a disregarded entity during the disqualified period. In such a case, according to the comment, a deduction or loss that is not taken into account for purposes of determining tested income or tested loss under the rule may nevertheless be taken into account for purposes of § 901(m) such that foreign tax credits under § 960 might be disallowed. The comment said that the concurrent application of the rule and § 901(m) could be unduly punitive to taxpayers that engaged in disqualified transfers that were also covered asset acquisitions and therefore recommended that a deduction or loss attributable to disqualified basis also be disregarded for purposes of § 901(m).
- (e) Disqualified basis could give rise to policy concerns under § 901(m) even when a deduction attributable to the disqualified basis is not taken into account in determining tested income or tested loss (or

Subpart F income or effectively connected income). For example, a deduction or loss attributable to the disqualified basis can reduce E&P for a taxable year, with the result that Subpart F income for the taxable year may be limited under § 952(c)(1)(A). Indeed, Prop. Treas. Reg. § 1.901(m)-5(b)(1) provided that basis differences must be taken into account under § 901(m) regardless of whether the deduction is deferred or disallowed for U.S. income tax purposes.

- (f) Treasury and the IRS believe that it is not appropriate to disregard disqualified basis for purposes of § 901(m). However, in response to this comment, the final regulations permit taxpayers to make an election pursuant to which the adjusted basis in each property with disqualified basis held by a CFC or a partnership is reduced by the amount of the disqualified basis and the disqualified basis is eliminated. Treas. Reg. § 1.951A-3(h)(2)(ii)(B)(3). This reduction in adjusted basis is for all purposes of the Code, including § 901(m).
- (g) Thus, if an election is made, a disqualified transfer of property that is also a covered asset acquisition of a relevant foreign asset will result in neither disqualified basis in the property within the meaning of Treas. Reg. § 1.951A-3(h)(2)(ii) nor a basis difference regarding the relevant foreign asset within the meaning of § 901(m)(3)(C). As a result, in the case of an election, the rule in Treas. Reg. § 1.951A-2(c)(5) and § 901(m) will not apply concurrently regarding a disqualified transfer that is also a covered asset acquisition.

(g) Other comments and revisions.

i. Tested Loss Carryforward.

- (a) In determining a U.S. shareholder's net CFC tested income for a taxable year, the U.S. shareholder's aggregate pro rata share of tested losses for the taxable year reduces the shareholder's aggregate pro rata share of tested income for the taxable year. § 951A(c)(1). Comments recommended that the final regulations include a provision allowing a U.S. shareholder's aggregate pro rata share of tested

losses in excess of the shareholder's aggregate pro rata share of tested income for the taxable year to be carried forward to offset the shareholder's net CFC tested income in subsequent years.

- (b) Treasury and the IRS stated that a GILTI inclusion amount is an annual calculation, and that nothing in the statute or legislative history suggests that unused items, such as a U.S. shareholder's aggregate pro rata share of tested losses in excess of the shareholder's aggregate pro rata share of tested income for the taxable year, can or should be carried to another taxable year. Accordingly, this recommendation was not adopted.

ii. Deemed Payments under § 367(d).

- (a) In general, § 367(d) provides that if a U.S. person transfers intangible property to a foreign corporation in an exchange described in § 351 or 361, the person is treated as having sold the property in exchange for payments contingent upon the productivity, use, or disposition of the property. The regulations under § 367(d) provide that the deemed payment may be treated as an expense (whether or not that amount is actually paid) of the transferee foreign corporation that is properly allocated and apportioned to gross income subject to Subpart F under the provisions of Treas. Reg. §§ 1.954-1(c) and 1.861-8. Treas. Reg. § 1.367(d)-1T(c)(2)(ii) and (e)(2)(ii).
- (b) In response to comments, the final regulations clarified that a deemed payment under § 367(d) is treated as an allowable deduction for purposes of determining tested income and tested loss. Treas. Reg. § 1.951A-2(c)(2)(ii). Accordingly, consistent with the regulations under § 367(d), these deemed payments may be allocated and apportioned to gross tested income to the extent provided under Treas. Reg. § 1.951A-2(c)(3).

iii. Compute Tested Income in the Same Manner as E&P A comment requested that the final regulations provide that tested income and tested loss be determined under the principles of § 964, which provides rules for the calculation of E&P of foreign corporations. Another comment

requested that the final regulations permit small CFCs to make an annual election to treat their tested income or tested loss for a CFC inclusion year to be equal to their E&P for the CFC inclusion year. Treasury and the IRS stated that § 951A(c)(2) is clear that tested income or tested loss for a CFC inclusion year is computed by subtracting properly allocable deductions from gross tested income, and that there is nothing in the statute or legislative history to indicate that tested income or tested loss should be limited by, or otherwise determined by reference to, E&P for such year. Accordingly, these recommendations were not adopted.

- iv. Effect of Losses in Other Categories of Income. The proposed regulations provided that allowable deductions are allocated and apportioned to gross tested income under the principles of § 954(b)(5) and Treas. Reg. § 1.954-1(c), by treating gross tested income within a single category (as defined in Treas. Reg. § 1.904-5(a)) as a single item of gross income, in addition to the items in Treas. Reg. § 1.954-1(c)(1)(iii). Prop. Treas. Reg. § 1.951A-2(c)(3). The final regulations clarified that losses in other categories of income (such as FBCI) cannot reduce gross tested income, and that tested losses cannot reduce other categories of income. Treas. Reg. § 1.951A-2(c)(3).

4. Treas. Reg. § 1.951A-3 – Qualified Business Asset Investment.

(a) Inability of tested loss CFCs to have QBAI.

- i. A U.S. shareholder's GILTI inclusion amount is equal to the excess of its net CFC tested income over its net DTIR for the taxable year. § 951A(b)(1) and Treas. Reg. § 1.951A-1(c)(1). A U.S. shareholder's net DTIR is equal to 10% of its aggregate pro rata share of the QBAI of its CFCs. § 951A(b)(2) and Treas. Reg. § 1.951A-1(c)(3). A CFC's QBAI is equal to its aggregate average adjusted basis in specified tangible property. § 951A(1) and Prop. Treas. Reg. § 1.951A-3(b). Specified tangible property is defined as tangible property used in the production of tested income. § 951A(d)(2)(A) and Prop. Treas. Reg. § 1.951A-3(c)(1).
- ii. The proposed regulations provided that tangible property of a tested loss CFC is not used in the production of tested income within the meaning of § 951A(d)(2)(A). In this regard, the proposed regulations provided that tangible

property of a tested loss CFC is not specified tangible property and thus a tested loss CFC's QBAI is zero (the "tested loss QBAI exclusion"). Prop. Treas. Reg. § 1.951A-3(b), (c)(1), and (g)(1).

- iii. Comments recommended that the final regulations eliminate the tested loss QBAI exclusion, so that a tested loss CFC could have specified tangible property and therefore QBAI. One noted that the version of § 951A in the House bill defined specified tangible property as any tangible property to the extent such property is used in the production of tested income or tested loss. The comment said that the text of the statute is ambiguous, the tested loss QBAI exclusion is otherwise inconsistent with § 951A, and the exclusion is not compelled by the statute. The comment also said that this rule may be easily avoided by combining a tested loss CFC with a tested income CFC because there is no corollary to the tested loss QBAI exclusion for partnerships or disregarded entities.
- iv. Treasury and the IRS rejected this recommendation. The Senate amendment to the House bill struck the reference to "tested loss" from the definition of specified tangible property, and the Conference Report explained that the term "used in the production of tested income" means 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."
- v. Thus, the statute, taking into account the relevant footnote in the Conference Report, unambiguously provides that tested loss CFCs cannot have QBAI. Accordingly, the final regulations retain the tested loss QBAI exclusion.
- vi. One comment requested that, if the tested loss QBAI exclusion is retained, Prop. Treas. Reg. § 1.951A-3(b) and (c) should be revised to clarify that the exclusion applies only for a CFC inclusion year regarding which a CFC is a tested loss CFC. The final regulations do not revise these provisions. Treasury and the IRS believe that it already is sufficiently clear that the tested loss QBAI exclusion rule applies only regarding a CFC inclusion year of a CFC for which it is a tested loss CFC and that a CFC is a tested loss CFC only for a CFC inclusion year in which the CFC does not have tested income. Treas. Reg. § 1.951A-2(b)(2).

(b) Determination of depreciable property.

- i. Section 951A(d)(1)(B) provides that specified tangible property is taken into account in determining QBAI only if the property is of a type regarding which a depreciation deduction is allowable under § 167. Similarly, the proposed regulations defined “specified tangible property” as tangible property used in the production of tested income, and defined “tangible property” as property for which the depreciation deduction provided by § 167(a) is eligible to be determined under § 168 (even if the CFC has elected not to apply § 168). Prop. Treas. Reg. § 1.951A-3(c)(1) and (2).
- ii. A comment recommended that, for purposes of determining QBAI, the final regulations take into account the entire adjusted basis in precious metals and other similar tangible property that are used in the production of tested income, even if only a portion of the adjusted basis in such property is depreciable in calculating regular taxable income. The comment suggested that if property is depreciable in part, then the entire asset is “of a type” regarding which a deduction is allowable under § 167 within the meaning of § 951A(d)(1)(B).
- iii. In defining QBAI, § 951A(d) distinguishes between depreciable tangible property and non-depreciable tangible property, such as land. Section 951A(d) defines QBAI as specified tangible property “of a type” for which a deduction is allowable under § 167. The proposed and final regulations interpret the phrase “of a type” consistent with the interpretation of the phrase “of a character” regarding § 168. Treasury and the IRS believe that for consistency, the same standard for determining whether property is depreciable should apply for determining whether property qualifies as QBAI.
- iv. Although unrecoverable commodities used in a business are depreciable, recoverable commodities used in a business are not depreciable because they do not suffer from exhaustion, wear and tear, or obsolescence over a determinable useful life. The recoverable quantity of a commodity used in the business suffers no change in its physical characteristics or value as a result of its use in the business. The comment seemed to imply that precious metals were a single unit of property that was partially depreciable and partially non-depreciable, rather than

quantities of metal in separate categories of property, one of which is depreciable.

- v. Treasury and the IRS believe that it would not be appropriate for purposes of determining a CFC's QBAI to take into account the CFC's entire adjusted basis in an asset that is only partially depreciable. Taking into account basis that is not subject to a depreciation allowance would overstate a CFC's QBAI. For example, in the case of precious metals that are partially depreciable, such as platinum used as a catalyst, a portion of the metal may be subject to exhaustion, wear and tear, or obsolescence during its useful life. The remainder of the metal is recoverable for reuse or sale.
- vi. When initially purchased, the value and tax basis of the recoverable portion generally should reflect the forward price of such metal. The value and tax basis of the depreciable portion of the metal generally should reflect the net present value of the expected returns generated by the metal. QBAI is a proxy for the base upon which non-extraordinary, tangible returns should be calculated. Therefore, only the depreciable portion of the precious metal, which is associated with the tangible returns, should be taken into account in this measurement. Given that liquid commodity markets exist for these precious metals, taxpayers could sell the future rights to the recoverable portion of the asset (thereby reducing their economic outlay and exposure regarding the property). Thus, the depreciable portion of the asset represents the taxpayer's economic investment in generating tangible returns. Accordingly, the comment was not adopted.
- vii. One comment requested that all expenditures paid or incurred regarding the acquisition, exploration, and development of a mine or other natural deposit should be taken into account in determining QBAI. The comment stated that these exploration and development costs for mining operations are "of a type" for which depreciation is allowed, even though the costs are recovered through depletion rather than depreciation. The comment also recommended that the adjusted basis in a mine or other natural deposit included as QBAI should be determined using cost depletion, rather than percentage depletion.
- viii. Section 951A(d)(1)(B) limits property taken into account in determining QBAI to tangible property of a type regarding

which a deduction is allowable under § 167. Congress did not extend the definition of QBAI to property of a type regarding which a deduction is allowed under § 611 (the allowance of deduction for depletion). Although the comment focused on the similarities between cost depletion and depreciation, there are also similarities between cost depletion of mineral properties and the acquisition cost of inventory. The inventory cost of a severed mineral includes the cost depletion attributable to the severed mineral. § 263A and Treas. Reg. § 1.263A-1(e)(3)(ii)(J). In essence, stated Treasury and the IRS, the acquisition cost of the mineral property recovered through cost depletion is the inventory cost of the severed mineral, and QBAI does not include inventory. Accordingly, the recommendation was not adopted.

- ix. The proposed regulations defined “tangible property” as property for which the depreciation deduction provided by § 167(a) is eligible to be determined under § 168 without regard to § 168(f)(1), (2), or (5) and the date placed in service. Prop. Treas. Reg. § 1.951A-3(c)(2). Section 168(k) increases the depreciation deduction allowed under § 167(a) regarding qualified property, which includes tangible and certain intangible property. The final regulations revised the definition of tangible property in Treas. Reg. § 1.951A-3(c)(2) to exclude certain intangible property to which § 168(k) applies, namely, computer software, qualified film or television productions, and qualified live theatrical productions described in § 168(k)(2)(A).

(c) Determination of basis under alternative depreciation system.

- i. For purposes of determining QBAI, the adjusted basis in specified tangible property is determined by using ADS under § 168(g), and by allocating the depreciation deduction regarding the property for the CFC inclusion year ratably to each day during the period in the taxable year to which such depreciation relates. § 951A(d)(3) and Treas. Reg. § 1.951A-3(e)(1). ADS applies to determine the adjusted basis in property for purposes of determining QBAI regardless of whether the property was placed in service before the enactment of § 951A, or whether the basis in the property is determined under another depreciation method for other purposes of the Code. § 951A(d)(3) and Treas. Reg. § 1.951A-3(e)(2).

- ii. In addition, for purposes of determining income and E&P, a CFC is generally required to use ADS for depreciable property used predominantly outside the U.S. § 168(g) and Treas. Reg. §§ 1.952-2(c)(2)(ii) and (iv) and 1.964-1(a)(2). However, a CFC may instead use for this purpose a depreciation method used for its books of account regularly maintained for accounting to shareholders or a method conforming to United States generally accepted accounting principles (a “non-ADS depreciation method”) if the differences between ADS and the non-ADS depreciation method are immaterial. Treas. Reg. §§ 1.952-2(c)(2)(ii) and (iv) and 1.964-1(a)(2).
- iii. A comment recommended that ADS not be required under § 951A(d) for specified tangible property placed in service before the enactment of § 951A. This comment said that § 951A(d)(3) does not compel the conclusion that ADS must be used for assets placed in service before the enactment of § 951A, and cited compliance concerns as a justification for not requiring the use of ADS regarding these assets. Another comment recommended that the final regulations permit taxpayers to elect to compute the adjusted basis in all specified tangible property of a CFC – not just specified tangible property placed in service before the enactment of § 951A – under the method that the CFC uses to compute its tested income and tested loss, even if such method is not ADS.
- iv. Treasury and the IRS stated that § 951A(d)(3) is clear that the adjusted basis in specified tangible property is determined using ADS under § 168(g), and therefore the final regulations did not adopt the recommendation to permit taxpayers an election to compute the adjusted basis in all specified tangible property under the CFC’s non-ADS depreciation method. However, recognizing the potential burden of re-determining the basis under ADS of all specified tangible property held by a CFC placed in service before the enactment of § 951A, and given that a non-ADS depreciation method is permissible only when there are immaterial differences between ADS and these other method, Treasury and the IRS believe that a transition rule is warranted for CFCs that are not required to use ADS for purposes of computing income and E&P.
- v. Accordingly, the final regulations provide that a CFC that is not required to use ADS for purposes of computing income and E&P may elect, for purposes of calculating

QBAI, to use its non-ADS depreciation method to determine the adjusted basis in specified tangible property placed in service before the first taxable year beginning after December 22, 2017, subject to a special rule related to salvage value. Treas. Reg. § 1.951A-3(e)(3)(ii).

- vi. The election also applies to the determination of a CFC's partner adjusted basis under Treas. Reg. § 1.951A-3(g)(3) in partnership specified tangible property placed in service before the CFC's first taxable year beginning after December 22, 2017. This transition rule does not apply for purposes of determining the foreign-derived intangible income ("FDII") of a domestic corporation. § 250(b)(2)(B) (in calculating deemed tangible income return for purposes of FDII, QBAI is generally determined under § 951A(d)).
- vii. A comment requested that the final regulations confirm that the use of ADS in determining the basis in specified tangible property, whether placed in service before or after the enactment of § 951A, for purposes of determining QBAI is not a change in method of accounting or, if it is a change in method, that global approval under § 446(e) be given for such a change. Another comment recommended that a CFC switching to ADS for property placed in service before the enactment of § 951A should not be required to file Form 3115 to request an accounting method change for depreciation, and that the cumulative adjustment should be taken into account for the adjusted basis in the specified tangible property as of the CFC's first day of the first year to which § 951A applies.
- viii. The preamble says that determination of the adjusted basis in property under § 951A(d) is not a method of accounting subject to the consent requirement of § 446(e). As a result, a CFC does not need the IRS's consent to use ADS for purposes of determining its adjusted basis in specified tangible property in determining its QBAI. A CFC that uses ADS for purposes of determining QBAI should determine the correct basis in the property under ADS as of the CFC's first day of the first taxable year to which § 951A applies and apply § 951A(d)(3) accordingly. The final regulations also clarified that the adjusted basis in property is determined based on the cost capitalization methods of accounting used by the CFC for purposes of determining its tested income and tested loss. Treas. Reg. § 1.951A-3(e)(1).

- ix. A change to ADS from another depreciation method for purposes of computing tested income or tested loss, however, is a change in method of accounting subject to § 446(e). Treasury and the IRS expect that many CFCs that are not already using ADS for purposes of computing income and E&P will change their method of accounting for depreciation to the straight-line method, the applicable recovery period, or the applicable convention under ADS to comply with Treas. Reg. § 1.952-2(c)(2)(iv) and Treas. Reg. § 1.964-1(c)(1)(iii)(c) and that most of such changes are already eligible for automatic consent under Rev. Proc. 2015-13, 2015-5 I.R.B. 419.
- x. Treasury and the IRS will publish another revenue procedure further expanding the availability of automatic consent for depreciation changes and updating the terms and conditions in §§ 7.07 and 7.09 of Rev. Proc. 2015-13 (related to the source, separate limitation classification, and character of § 481(a) adjustments) to take into account § 951A. After the change in accounting method, the basis in specified tangible property will be the correct basis for purposes of determining income, E&P, and QBAI.
- xi. The final regulations clarify the interaction between the daily proration of depreciation rule in § 951A(d)(3) and the applicable convention under ADS. Under § 951A(d)(3), the adjusted basis in property is determined by allocating the depreciation deduction regarding property to each day during the period in the taxable year to which the depreciation relates. The half-year convention, mid-month convention, and mid-quarter convention in § 168(d) treat property as placed in service (or disposed of) for purposes of § 168 at the midpoint of the taxable year, month, or quarter, as applicable, irrespective of when the property was placed in service (or disposed of) during the taxable year.
- xii. The final regulations clarify that the period in the CFC inclusion year to which such depreciation relates is determined without regard to the applicable convention under § 168(d). Treas. Reg. § 1.951A-3(e)(1). Accordingly, in the year property is placed in service, the depreciation deduction allowed for the taxable year is prorated from the day the property is actually placed in service, and, in the year property is disposed of, the depreciation deduction allowed for the taxable year is prorated to the date of disposition. Allocating depreciation

to each day during the period in which the property is used irrespective of the applicable convention ensures that the average of the aggregate adjusted basis as of the close of each quarter is properly adjusted to reflect the depreciation allowed for the taxable year.

- xiii. Treasury and the IRS continue to study issues related to the determination of QBAI for purposes of § 951A. In particular, Treasury and the IRS are aware that a CFC that is a partner in a foreign partnership may have difficulty determining the basis in partnership property under ADS, particularly when the partnership is not controlled by U.S. persons. Comments were requested regarding methodologies for determining the basis in partnership property owned by a foreign partnership that is not controlled directly or indirectly by U.S. persons.

(d) Dual use property.

- i. Section 951A(d)(2)(B) provides that if property is used both in the production of tested income and income that is not tested income, the property is specified tangible property in the same proportion that the gross income described in § 951A(c)(1)(A) produced regarding such property bears to the total gross income produced regarding such property. The proposed regulations provided that if tangible property is used in both the production of gross tested income and other income, the portion of the adjusted basis in the property treated as adjusted basis in specified tangible property is determined by multiplying the average of the adjusted basis in the property by the dual use ratio. Prop. Treas. Reg. § 1.951A-3(d)(1).
- ii. If the property produced directly identifiable income for a CFC inclusion year, the dual use ratio would be the ratio of the gross tested income produced by the property to the total amount of gross income produced by the property. Prop. Treas. Reg. § 1.951A-3(d)(2)(i). In all other cases, the dual use ratio is the ratio of the gross tested income of the tested income CFC to the total amount of gross income of the tested income CFC. Prop. Treas. Reg. § 1.951A-3(d)(2)(ii).
- iii. Under the proposed regulations, the dual use ratio required a determination of whether and how much gross income is “directly identifiable” with particular specified tangible property. Treasury and the IRS recognize that application

of the directly identifiable standard could result in substantial uncertainty and controversy. In addition, they believe that the rules under § 861 for allocating a depreciation or amortization deduction attributable to property owned by a CFC to categories of income of the CFC represent a reliable and well-understood proxy for determining the type of income produced by the property, even in circumstances where there is no income that is “directly identifiable” with the property.

- iv. Accordingly, the final regulations provide that the dual use ratio, regarding tangible property for a CFC inclusion year, is the ratio calculated as the sum of the amount of the depreciation deductions regarding the property for the CFC inclusion year that is allocated and apportioned to gross tested income for the CFC inclusion year under Treas. Reg. § 1.951A-2(c)(3) and the depreciation regarding the property capitalized to inventory or other property held for sale, the gross income or loss from the sale of which is taken into account in determining tested income for the CFC inclusion year.
- v. This is divided by the sum of the total amount of the depreciation deduction regarding the property for the CFC inclusion year and the total amount of depreciation regarding the property capitalized to inventory or other property held for sale, the gross income or loss from the sale of which is taken into account for the CFC inclusion year. Treas. Reg. § 1.951A-3(d)(3). The dual use ratio also applies regarding partnership specified tangible property, except, for this purpose, determined by reference to a tested income CFC’s distributive share of the amounts described in the preceding sentence. Treas. Reg. § 1.951A-3(g)(3)(iii).
- vi. The rules in Treas. Reg. § 1.951A-3 do not apply in determining QBAI for purposes of computing the deduction of a domestic corporation under § 250 for its FDII. Prop. Treas. Reg. § 1.250(b)-2 for the QBAI rules related to the FDII deduction. The preamble states that, except as indicated regarding the election to use a non-ADS depreciation method for assets placed in service before the enactment of § 951A, revisions similar to the revisions to Prop. Treas. Reg. § 1.951A-3 will be made to Prop. Treas. Reg. § 1.250(b)-2.

(e) Partnership QBAI.

- i. Section 951A(d)(3) provides that, for purposes of calculating QBAI, if a CFC holds an interest in a partnership at the close of the CFC's taxable year, the CFC takes into account its distributive share of the aggregate of the partnership's adjusted basis in depreciable tangible property used in its trade or business that is used in the production of tested income (determined regarding the CFC's distributive share of income regarding such property). For this purpose, a CFC's distributive share of the adjusted basis in any property is the CFC's distributive share of income regarding such property. § 951A(d)(3) (flush language).
- ii. The proposed regulations implemented the rule in § 951A(d)(3) by providing that, if a tested income CFC holds an interest in one or more partnerships as of the close of a CFC inclusion year, the QBAI of the tested income CFC for the CFC inclusion year is increased by the sum of the tested income CFC's partnership QBAI regarding each partnership for the CFC inclusion year. Prop. Treas. Reg. § 1.951A-3(g)(1).
- iii. Under the proposed regulations, a tested income CFC's partnership QBAI regarding a partnership was the sum of the tested income CFC's share of the partnership's adjusted basis in partnership specified tangible property as of the close of a partnership taxable year that ends with or within a CFC inclusion year. Prop. Treas. Reg. § 1.951A-3(g)(2)(i).
- iv. A tested income CFC's share of the partnership's adjusted basis in partnership specified tangible property is determined by multiplying the partnership's adjusted basis in the property by the tested income CFC's partnership QBAI ratio regarding the property.
- v. Similar to the rule for dual use property, under the proposed regulations, the tested income CFC's partnership QBAI ratio regarding partnership specified tangible property depended on whether the property produces directly identifiable income. In the case of partnership specified tangible property that produces directly identifiable income for a partnership taxable year, a tested income CFC's partnership QBAI ratio regarding the property was the tested income CFC's distributive share of

the gross income produced by the property for the partnership taxable year that is included in the gross tested income of the tested income CFC for the CFC inclusion year to the total gross income produced by the property for the partnership taxable year. Prop. Treas. Reg. § 1.951A-3(g)(2)(ii)(A).

- vi. In the case of partnership specified tangible property that does not produce directly identifiable income for a partnership taxable year, a tested income CFC's partnership QBAI ratio regarding the property was the tested income CFC's distributive share of the gross income of the partnership for the partnership taxable year that is included in the gross tested income of the tested income CFC for the CFC inclusion year to the total amount of gross income of the partnership for the partnership taxable year. Prop. Treas. Reg. § 1.951A-3(g)(2)(ii)(B).
- vii. The partnership QBAI ratio in the proposed regulations was effectively an amalgamation of two ratios – a ratio that describes the portion of the partnership specified tangible property that is used in the production of gross tested income (that is, the dual use ratio) and a ratio that describes a tested income CFC's proportionate interest in all the income produced by the property.
- viii. The final regulations disaggregate the partnership QBAI ratio into these two ratios – the dual use ratio (as defined in Treas. Reg. § 1.951A-3(d)(3)) and a new proportionate share ratio (as defined in Treas. Reg. § 1.951A-3(g)(4)(ii)). Accordingly, the final regulations provide that a tested income CFC's "partner adjusted basis" regarding partnership specified tangible property – that is, the adjusted basis in partnership specified tangible property taken into account in determining the tested income CFC's partnership QBAI – is generally, in the case of partnership specified tangible property used in the production of only gross tested income ("sole use partnership property"), the tested income CFC's proportionate share of the partnership's adjusted basis in the property for the partnership taxable year. Treas. Reg. § 1.951A-3(g)(3)(ii).
- ix. A tested income CFC's partner adjusted basis regarding partnership specified tangible property used in the production of gross tested income and gross income that is not gross tested income ("dual use partnership property") is generally the tested income CFC's proportionate share of

the partnership's adjusted basis in the property for the partnership taxable year, multiplied by the tested income CFC's dual use ratio regarding the property (determined by reference to the tested income CFC's distributive share of amounts described in Treas. Reg. § 1.951A-3(d)(3)).
Treas. Reg. § 1.951A-3(g)(3)(iii).

- x. In either case, a tested income CFC's proportionate share of the partnership's adjusted basis in partnership specified tangible property is the partnership's adjusted basis in the property for the partnership taxable year multiplied by the tested income CFC's proportionate share ratio regarding the property for the partnership taxable year.
- xi. A rule that determines adjusted basis in specified tangible property taken into account in determining QBAI by reference to the "directly identifiable income" attributable to such property would lead to substantial uncertainty and controversy, whereas the rules under § 861 for allocating and apportioning depreciation attributable to property owned by a CFC to categories of income represent a longstanding proxy for determining the types of income produced by the property.
- xii. For this reason, the final regulations determine the dual use ratio by reference to the amount of depreciation deductions allocated to gross tested income under Treas. Reg. § 1.951A-2(c)(3).
- xiii. Similarly, Treasury and the IRS believe that calculating partnership QBAI by reference to the "directly identifiable income" produced by partnership specified tangible property would lead to substantial uncertainty and controversy, and that a partner's share of a depreciation deduction regarding partnership specified tangible property is a reliable proxy for determining a CFC's distributive share of income regarding this property. Accordingly, the final regulations determine the proportionate share ratio regarding partnership specified tangible property also by reference to the depreciation regarding the property, rather than the directly identifiable income attributable to the property or the gross income of the partner. Treas. Reg. § 1.951A-3(g)(4)(ii).
- xiv. A comment recommended that if the partnership QBAI ratio is determined by reference to a partnership's gross taxable income, that § 704(c) allocations (including items

of income under the remedial method) be taken into account in determining the CFC's distributive share of the gross income produced by the property for the partnership taxable year.

- xv. For purposes of the proportionate share ratio, the final regulations did not adopt this recommendation. Section 704(b) income represents a partner's economic interest in the partnership and therefore more closely aligns with the economic production of income from partnership property that QBAI is intended to measure. Accordingly, the final regulations provide that the proportionate share ratio is determined by reference to the amount of depreciation regarding property (and a tested income CFC's distributive share of such amount) determined under § 704(b). Treas. Reg. § 1.951A-3(g)(4)(i).
- xvi. Therefore, items determined under § 704(c) are not taken into account for purposes of determining a tested income CFC's partner adjusted basis in partnership specified tangible property held by a partnership and thus the tested income CFC's partnership QBAI regarding the partnership. However, because the dual use ratio is determined by reference to the allocation and apportionment of depreciation deductions to gross tested income of a tested income CFC, and thus is based on a taxable income concept, items determined under § 704(c) are taken into account for purposes of determining the dual use ratio.
- xvii. The proposed regulations provided that partnership QBAI was the sum of the tested income CFC's share of the partnership's adjusted basis in partnership specified tangible property. Prop. Treas. Reg. § 1.951A-3(g)(2)(i). A comment recommended that the final regulations clarify that the adjusted basis in partnership specified tangible property includes any basis adjustment under § 743(b). In response to this comment, the final regulations clarified that an adjustment under § 743(b) to the adjusted basis in partnership specified tangible property regarding a tested income CFC is taken into account in determining the tested income CFC's partner adjusted basis in the partnership specified tangible property. Treas. Reg. § 1.951A-3(g)(3) and (7).
- xviii. In addition, to ensure that the adjusted basis in property other than tangible property is not inappropriately shifted to tangible property for purposes of determining QBAI, the

final regulations provide that basis adjustments to partnership specified tangible property under § 734(b) are taken into account only if they are basis adjustments under § 734(b)(1)(B) or 734(b)(2)(B) attributable to distributions of tangible property or basis adjustments under § 734(b)(1)(A) or 734(b)(2)(A) by reason of gain or loss recognized by a distributee partner under § 731(a). Treas. Reg. § 1.951A-3(g)(6).

- xix. A comment also requested that the final regulations clarify that a CFC's QBAI is increased not only for partnership specified tangible property owned by partnerships in which the CFC is a direct partner, but also for lower-tier partnerships in which the CFC indirectly owns an interest through one or more upper-tier partnerships. The final regulations made this clarification. Treas. Reg. § 1.951A-3(g)(1).
- xx. Finally, a comment suggested that, under § 951A(d)(3) and the proposed regulations, a disposition of a partnership interest by a tested income CFC could result in the CFC including its distributive share of partnership income in its gross tested income, but not taking into account any of the partnership's basis in partnership specified tangible property for purposes of calculating the CFC's QBAI.
- xxi. Under § 951A(d)(3) and Prop. Treas. Reg. § 1.951A-3(g)(1), if a CFC held an interest in a partnership at the close of the taxable year of the CFC, the CFC would take into account its share of a partnership's adjusted basis in certain tangible property for QBAI purposes. However, neither § 951A(d)(3) nor the proposed regulations had a rule that would allow a tested income CFC to increase its QBAI for its share of partnership QBAI if the tested income CFC owned the partnership interest for part of the year but not at the close of the CFC taxable year. However, a partner that disposes of its entire partnership interest before the close of the CFC taxable year could have a distributive share of partnership income if the partnership taxable year closes before the close of the CFC taxable year, including by reason of the disposition itself. § 706(c)(2)(A) (taxable year of partnership closes regarding partner whose entire interest terminates, including by reason of a disposition).
- xxii. Treasury and the IRS agreed that a partner that has a distributive share of income from a partnership should also

be permitted partnership QBAI regarding the partnership. Therefore, the final regulations provide that a partner need only hold an interest in a partnership during the CFC inclusion year to have partnership QBAI regarding the partnership. Treas. Reg. § 1.951A-3(g)(1). The final regulations also provide that § 706(d) applies to determine a tested income CFC's partner adjusted basis in partnership specified tangible property owned by a partnership if there is a change in the tested income CFC's interest in the partnership during the CFC inclusion year. Treas. Reg. § 1.951A-3(g)(3)(i).

- (f) Disregard of basis in specified tangible property held temporarily.
- i. Section 951A(d)(4) authorizes the issuance of regulations or other guidance that the Secretary determines are appropriate to prevent the avoidance of the purposes of § 951A(d), including regulations or other guidance which provide for the treatment of property that is transferred, or held, temporarily. The proposed regulations addressed a tested income CFC (“acquiring CFC”) that acquires specified tangible property with a principal purpose of reducing the GILTI inclusion amount of a U.S. shareholder for any U.S. shareholder inclusion year, and the tested income CFC holds the property temporarily but over at least the close of one quarter.
 - ii. In that case, the specified tangible property was disregarded in determining the acquiring CFC's average adjusted basis in specified tangible property for purposes of determining the acquiring CFC's QBAI for any CFC inclusion year during which the tested income CFC held the property (the “temporary ownership rule”). Prop. Treas. Reg. § 1.951A-3(h)(1). If an acquisition of specified tangible property would, but for the temporary ownership rule, reduce the GILTI inclusion amount of a U.S. shareholder, then the property was “per se” treated as temporarily held and acquired with a principal purpose of reducing the GILTI inclusion amount of a U.S. shareholder if the tested income CFC holds the property for less than a 12-month period that includes at least the close of one quarter during its taxable year (the “12-month per se rule”). Therefore, the specified tangible property would be disregarded under the proposed regulations for purposes of determining QBAI.
 - iii. Although some comments supported the temporary ownership rule and, in particular, stated that the principal

purpose standard was a reasonable interpretation of § 951A(d)(4), many comments asserted that it was overbroad. Comments expressed particular concern with the scope of the 12-month per se rule, noting for example that it could (i) apply to transactions not motivated by tax avoidance such as ordinary course transactions, (ii) require burdensome asset-level tracking of CFC property, and (iii) lead to uncertain return filing positions or financial accounting volatility if property acquired by a CFC has not yet been held for 12 months when a U.S. shareholder files its return or publishes a financial statement.

- iv. In response to these comments, Treasury and the IRS believe that it is appropriate to narrow the scope of the temporary ownership rule, and that the following changes strike the appropriate balance between mitigating the compliance burden and identifying transactions that have the potential to avoid the purposes of § 951A(d).
- v. First, the final regulations made certain technical changes that are intended to refine and clarify the application of the temporary ownership rule. For example, the rule applies, in part, based on a principal purpose of increasing the DTIR of a U.S. shareholder (“applicable U.S. shareholder”) and, for this purpose, certain related U.S. persons are treated as a single applicable U.S. shareholder. Treas. Reg. § 1.951A-3(h)(1)(i) and (vi).
- vi. Further, in response to comments, the final regulations provide that property held temporarily over a quarter close is subject to the temporary ownership rule only if the holding of the property over the quarter close would, without regard to the temporary ownership rule, increase the DTIR of an applicable U.S. shareholder for its taxable year. Treas. Reg. § 1.951A-3(h)(1)(i).
- vii. The final regulations also provide that a CFC’s holding period for purposes of this rule does not include the holding period for which the property was held by any other person under § 1223. Treas. Reg. § 1.951A-3(h)(1)(v). The final regulations did not adopt the request to permit a tacking of holding periods for purpose of the temporary ownership rule, because temporary acquisitions of property through nonrecognition transactions, particularly between related parties, can artificially increase a U.S. shareholder’s DTIR by, for instance, causing the property to be taken into

account for an additional quarter close for purposes of calculating QBAI.

- viii. The final regulations also modified the 12-month per se rule to make it a presumption rather than a per se rule. Therefore, under the final regulations the temporary ownership rule is presumed to apply only if property is held for less than 12 months. Treas. Reg. § 1.951A-3(h)(1)(iv)(A). This presumption may be rebutted if the facts and circumstances clearly establish that the subsequent transfer of the property was not contemplated when the property was acquired by the acquiring CFC and that a principal purpose of the acquisition of the property was not to increase the DTIR of the applicable U.S. shareholder.
- ix. As a result of this change, a taxpayer generally will know when it files its return whether the temporary ownership rule will apply. In order to rebut the presumption, a taxpayer must attach a statement to the Form 5471 filed with the taxpayer's return for the taxable year of the CFC in which the subsequent transfer occurs disclosing that it rebuts the presumption.
- x. In response to a comment, the final regulations include a second presumption that generally provides that property is presumed not to be subject to the temporary ownership rule if held for more than 36 months. Treas. Reg. § 1.951A-3(h)(1)(iv)(B).
- xi. The final regulations clarify that the adjusted basis in property may be disregarded under the rule for multiple quarter closes. Treas. Reg. § 1.951A-3(h)(1)(ii). However, in the case that the temporary holding results in the property being taken into account for only one additional quarter close of a tested income CFC in determining the DTIR of a U.S. shareholder inclusion year, the adjusted basis in the property is disregarded under this rule only as of the first tested quarter close that follows the acquisition. Treas. Reg. § 1.951A-3(h)(1)(vii)(C) (Example 2) (disregarding the adjusted basis in specified tangible property for a single quarter due to differences in CFC taxable years). This rule ensures that the adjusted basis in property is not inappropriately disregarded in excess of the amount necessary to eliminate the increase in the DTIR of the applicable U.S. shareholder by reason of the temporary holding.

- xii. Treas. Reg. § 1.951A-3(h)(1)(iii) also includes a safe harbor for certain transfers involving CFCs. Under the safe harbor, the holding of property as of a tested quarter close is not treated as increasing the DTIR if certain conditions are satisfied. In general, the safe harbor applies to transfers between CFCs that are owned in the same proportion by the U.S. shareholder, have the same taxable years, and are all tested income CFCs. The safe harbor is intended to exempt non-tax motivated transfers from the rule when the temporary holding of the property does not have the potential for increasing the DTIR of an applicable U.S. shareholder. The addition of the safe harbor responds to the comment requesting that the rule be tailored depending on whether the transfers involve related or unrelated parties.
- xiii. In response to comments, Treas. Reg. § 1.951A-3(h)(1)(vii) includes four new examples to illustrate the application of the rule. The examples identify a transaction that is not subject to the rule due to the application of the safe harbor, and three transactions that are subject to the rule, including transfers of property between CFCs that have different taxable years, and an acquisition of property by a tested income CFC from a tested loss CFC, which cannot have QBAI pursuant to Treas. Reg. § 1.951A-3(b) and (c)(1).
- xiv. The final regulations did not adopt the comments requesting a de minimis or ordinary course transaction exception. Treasury and the IRS believe that these types of exceptions are unnecessary due to the narrowed and refined scope of the rule in the final regulations, including as a result of converting the 12-month per se rule into a rebuttable presumption, adding the safe harbor, and illustrating certain transactions that are targeted by the rule through new examples. Moreover, because the rule is limited to the temporary holding of depreciable property used in a CFC's trade or business (that is, specified tangible property), they do not anticipate that many such assets will be acquired and disposed of in the "ordinary course" of a CFC's business, however that standard is defined.
- xv. Finally, the final regulations did not adopt the comment requesting an exception for acquisitions of property that result in effectively connected income or Subpart F income to the transferor. Treasury and the IRS believe that, unlike the rule that addresses disqualified basis in Treas. Reg. § 1.951A-2(c)(5) and Treas. Reg. § 1.951A-3(h)(2), the

treatment of gain recognized by the transferor (if any) is not relevant for purposes of determining whether it is appropriate to take into account specified tangible property held temporarily for purposes of determining QBAI. Nothing in § 951A(d)(4) or the legislative history suggests that transfers of property that result in income or gain that is subject to U.S. tax should be exempt from the rule. Indeed, the policy concern underlying this rule – the temporary holding of specified tangible property with a principal purpose of increasing the DTIR of a U.S. shareholder – is present regardless of whether the basis in the specified tangible property reflects gain that is subject to U.S. tax.

(g) Determination of disqualified basis.

- i. The determination of disqualified basis is relevant for purposes of both the rule in Treas. Reg. § 1.951A-2(c)(5) (allocating deductions attributable to disqualified basis to residual CFC gross income) and the rule in Treas. Reg. § 1.951A-3(h)(2) (disregarding disqualified basis for purposes of calculating QBAI).
- ii. The proposed regulations defined “disqualified basis” in property as the excess of the property’s adjusted basis immediately after a disqualified transfer, over the sum of the property’s adjusted basis immediately before the disqualified transfer and the qualified gain amount regarding the disqualified transfer. Prop. Treas. Reg. § 1.951A-3(h)(2)(ii)(A). In addition, the proposed regulations defined “disqualified transfer” as a transfer of property by a transferor CFC during a transferor CFC’s disqualified period to a related person in which gain was recognized, in whole or in part. Prop. Treas. Reg. § 1.951A-3(h)(2)(ii)(C).
- iii. A comment noted that the proposed regulations did not explain whether the computation of disqualified basis in property takes into account basis adjustments under § 743(b) or § 734(b) allocated to that property under § 755 during the disqualified period. The final regulations provide that adjustments under §§ 732(d), 734(b), and 743(b) can create, increase, or reduce disqualified basis in property. Treas. Reg. § 1.951A-3(h)(2)(ii)(A) and (B).
- iv. The proposed regulations provided that disqualified basis may be reduced or eliminated through depreciation,

amortization, sales or exchanges, § 362(e), and other methods. Prop. Treas. Reg. § 1.951A-3(h)(2)(ii)(A). The final regulations provide the circumstances under which disqualified basis is reduced. Specifically, the final regulations provide that disqualified basis in property is reduced to the extent that a deduction or loss attributable to the disqualified basis in the property is taken into account in reducing gross income, including any deduction or loss allocated to residual CFC gross income by reason of the rule in Treas. Reg. § 1.951A-2(c)(5). Treas. Reg. § 1.951A-3(h)(2)(ii)(B)(1)(i).

- v. The proposed regulations provided that, if the adjusted basis in property with disqualified basis and adjusted basis other than disqualified basis is reduced or eliminated, then the disqualified basis in the property is reduced or eliminated in the same proportion that the disqualified basis bears to the total adjusted basis in the property. Prop. Treas. Reg. § 1.951A-3(h)(2)(ii)(A).
- vi. The final regulations adopted this rule without substantial modification, except that they provide a special rule where a loss is recognized on a taxable sale or exchange. Treas. Reg. §§ 1.951A-2(c)(5)(ii) and 1.951A-3(h)(2)(ii)(B)(1)(i). In the case of a loss recognized on a taxable sale or exchange of the property, the loss is treated as attributable to disqualified basis to the extent thereof. Therefore, to the extent of the disqualified basis, the loss on the sale is allocated to residual CFC gross income and the disqualified basis in the property is reduced.
- vii. A comment said that the proposed regulations did not specify when the proportion of the disqualified basis to the total adjusted basis in the property is determined for purposes of determining the reduction to disqualified basis. The comment recommended that Treasury and the IRS clarify that this proportion is determined immediately after the disqualified transfer and does not change throughout the useful life of the property absent a subsequent disqualified transfer. The final regulations did not adopt this recommendation because the proportion of disqualified basis to total adjusted basis in property can change by reason of one or more transactions subsequent to a disqualified transfer. For instance, a loss recognized on a taxable sale of property with disqualified basis and adjusted basis other than disqualified basis, which reduces disqualified basis to the extent of the loss under Treas. Reg.

§ 1.951A-3(h)(2)(ii)(B)(1)(i), will have the effect of decreasing the proportion of disqualified basis to total adjusted basis. Treas. Reg. § 1.951A-3(h)(2)(ii)(B).

- viii. A comment recommended that Treasury and the IRS clarify that depreciation or amortization that is disregarded for purposes of determining tested income or tested loss under Prop. Treas. Reg. § 1.951A-2(c)(5) nonetheless reduces the adjusted basis in the property. The final regulations do not disregard a deduction or loss attributable to disqualified basis, but rather allocate and apportion such deduction or loss to residual CFC gross income. Depreciation or amortization that is allocated and apportioned to residual CFC gross income continues to reduce the adjusted basis in the property in accordance with § 1016(a)(2). Accordingly, clarification that any depreciation or amortization attributable to disqualified basis in property reduces adjusted basis in the property is unnecessary.
- ix. Disqualified basis in property is generally an attribute specific to the property itself, rather than an attribute of a CFC or a U.S. shareholder regarding the property. The final regulations, however, provide rules to treat basis in other property as disqualified basis if such basis was determined, in whole or in part, by reference to the basis in property with disqualified basis. Treas. Reg. § 1.951A-3(h)(2)(ii)(B)(2). These rules are intended to prevent taxpayers from eliminating disqualified basis in nonrecognition transactions that would otherwise have the effect of granting taxpayers the benefit of the disqualified basis.
- x. The preamble says this could occur, for example, if property with disqualified basis is transferred in a nonrecognition transaction, such as a like-kind exchange under § 1031, in exchange for other depreciable property. In that case, a portion of the basis in the newly acquired property is treated as disqualified basis. Also, disqualified basis may be duplicated through certain nonrecognition transactions. For example, if property with disqualified basis is transferred in a § 351 exchange, both the stock received by the transferor and the property received by the transferee will have disqualified basis, in each case determined by reference to the disqualified basis in the property in the hands of the transferor immediately before the transaction. Treas. Reg. § 1.951A-3(h)(2)(ii)(B)(2)(ii).

- xi. The final regulations also provide that basis arising from other transactions, such as distributions of property from a partnership to a partner, can create disqualified basis in property to the extent the transaction has the effect of shifting disqualified basis from one property to another. Treas. Reg. § 1.951A-3(h)(2)(ii)(B)(2)(i). This might occur, for example, if low-basis property is distributed in liquidation of a high-basis partner under § 732(b) resulting in a decrease to disqualified basis in other partnership property under § 734(b)(2)(B). Treas. Reg. § 1.951A-3(h)(2)(iii)(D) Example 4.
- xii. The final regulations also clarified how disqualified basis is disregarded under Treas. Reg. § 1.951A-3(h)(2)(i) in the case of dual use property and partnership specified tangible property for purposes of determining QBAI and partnership QBAI, respectively. The portion of the adjusted basis in dual use property with disqualified basis that is taken into account for determining QBAI is the average adjusted basis in the property, multiplied by the dual use ratio, and then reduced by the disqualified basis in the property. Treas. Reg. § 1.951A-3(h)(2)(i)(B); Treas. Reg. § 1.951A-3(d)(4) Example.
- xiii. For purposes of determining partnership QBAI, a CFC's partner adjusted basis regarding partnership specified tangible property with disqualified basis is first determined under the general rules of Treas. Reg. § 1.951A-3(g)(3)(i) and then reduced by the partner's share of the disqualified basis in the property. Treas. Reg. § 1.951A-3(h)(2)(i)(C). In either case, the allocation and apportionment rules of Treas. Reg. § 1.951A-2(c)(5) are not taken into account for purposes of applying the dual use ratio and the proportionate share ratio to determine the amount of the adjusted basis in property that is reduced by the disqualified basis. Treas. Reg. § 1.951A-3(h)(2)(i)(B) and (C).
- xiv. Treasury and the IRS requested comments on the application of the rules that reduce or increase disqualified basis including, for example, how the rules should apply in an exchange under § 1031 where property with disqualified basis is exchanged for property with no disqualified basis.

5. Treas. Reg. § 1.951A-4 – Tested Interest Expense and Tested Interest Income.

(a) Determination of specified interest expense under netting approach.

- i. Section 951A(b)(2)(B) reduces net DTIR of a U.S. shareholder by interest expense that reduces tested income (or increases tested loss) for the taxable year of the shareholder to the extent the interest income attributable to such expense is not taken into account in determining the shareholder's net CFC tested income. The proposed regulations utilized a netting approach to determine the amount of interest expense of a U.S. shareholder described in § 951A(b)(2)(B) ("specified interest expense"), defining such amount as the excess of such shareholder's pro rata share of "tested interest expense" of each CFC over its pro rata share of "tested interest income" of each CFC. Prop. Treas. Reg. § 1.951A-1(c)(3)(iii).
- ii. Several comments agreed with the adoption of the netting approach, principally on the grounds of administrability and policy. However, one comment noted that the netting approach for determining specified interest expense is potentially more favorable to taxpayers than permitted by the statute because it provides that specified interest expense is reduced by all interest income included in the tested income of the U.S. shareholder (subject to certain exceptions), even if earned from unrelated parties.
- iii. The final regulations retained the netting approach for determining specified interest expense, with certain modifications. Treas. Reg. § 1.951A-1(c)(3)(iii).

(b) Definition of tested interest expense and tested interest income.

- i. For purposes of determining specified interest expense, "tested interest expense" was defined in the proposed regulations as interest expense paid or accrued by a CFC that is taken into account in determining the tested income or tested loss of the CFC, reduced by the qualified interest expense of the CFC. Prop. Treas. Reg. § 1.951A-4(b)(1)(i). For this purpose, "interest expense" was defined as any expense or loss treated as interest expense under the Code or regulations, and 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 predominantly incurred in consideration of the time value of money. Prop. Treas. Reg. § 1.951A-4(b)(1)(ii). The proposed regulations included similar definitions for “tested interest income” and “interest income.” Prop. Treas. Reg. § 1.951A-4(b)(2)(i) and (ii).

- ii. One comment said that the concepts of “predominantly incurred in consideration of the time value of money” and “predominantly derived from consideration of the time value of money” are new and unclear, and lack analogies in other authorities. The comment also stated that this new standard is further complicated by references to “a transaction or series of integrated or related transactions.” Other comments said that creating a new standard for interest expense and interest income specifically for specified interest expense would result in additional confusion and complexity.
- iii. Treasury and the IRS did not intend to create a new standard of interest solely for purposes of determining specified interest expense. The reduction of net DTIR by specified interest expense under § 951A(b)(2)(B) and the limitation on business interest under § 163(j) were meant to achieve similar policy goals, namely preventing certain interest expense in excess of interest income from being taken into account in determining taxable income.
- iv. Further, because the amount of interest expense subject to each of these provisions is determined, in part, by reference to interest income received, each of these provisions need clear and consistent definitions of both interest expense and interest income, including when and to what extent transactions that result in a financing from an economic perspective may be treated as generating interest expense and interest income.
- v. As a result of the foregoing, and in order to reduce administrative complexity, Treasury and the IRS believe that taxpayers and the government would benefit from the application of a single definition of interest for both § 951A(b)(2)(B) and § 163(j) (rather than the application of two partially overlapping, but ultimately different standards). Accordingly, the final regulations define “interest expense” and “interest income” by reference to the definition of interest expense and interest income under § 163(j). Treas. Reg. § 1.951A-4(b)(1)(ii) and (2)(ii).

- vi. The regulations under § 163(j), when finalized, will address comments on the validity of the definition of interest expense and interest income that are used in those regulations. Because the final regulations adopt this definition for purposes of determining specified interest expense, the discussion in the regulations under § 163(j) will, by extension, address the validity of the definitions as used in these final regulations.
 - vii. Finally, the definition of tested interest expense was revised in the final regulations to mean interest expense that is “allocated and apportioned to gross tested income” of a CFC under Treas. Reg. § 1.951A-2(c)(3). Treas. Reg. § 1.951A-4(b)(1)(i). This revision does not reflect a substantive change to the definition in the proposed regulations – interest expense “taken into account in determining the tested income or tested loss” – but rather is intended to more clearly articulate that definition.
- (c) Determination of qualified interest expense and qualified interest income.
- i. The proposed regulations provided that, for purposes of determining the specified interest expense of a U.S. shareholder, the tested interest expense and tested interest income of a “qualified CFC” are reduced by its “qualified interest expense” and “qualified interest income,” respectively. Treas. Reg. § 1.951A-4(b)(1) and (2). The reduction for qualified interest expense and qualified interest income is intended to neutralize the effect of interest expense and interest income attributable to the active conduct of a financing or insurance business on a U.S. shareholder’s net DTIR.
 - ii. For example, absent the rule for qualified interest expense, the third-party interest expense of a captive finance company – to the extent its interest expense exceeds its interest income – could inappropriately increase specified interest expense (and thus reduce the net DTIR) of its U.S. shareholder. Alternatively, under a netting approach to calculating specified interest expense, the third-party interest income of a captive finance company – to the extent its interest income exceeds interest expense – could inappropriately reduce the specified interest expense (and thus increase the net DTIR) of its U.S. shareholder.

- iii. For purposes of these rules, the proposed regulations defined a “qualified CFC” as an eligible controlled foreign corporation (within the meaning of § 954(h)(2)) or a qualifying insurance company (within the meaning of § 953(e)(3)). Prop. Treas. Reg. § 1.951A-4(b)(1)(iv). Further, “qualified interest income” was defined as interest income included in the gross tested income of the qualified CFC that is excluded from FPHCI by reason of § 954(h) or (i). Prop. Treas. Reg. § 1.951A-4(b)(2)(iii). The proposed regulations defined “qualified interest expense” as the portion of the interest expense of a qualified CFC, which portion is determined based on a two-step approach. First, a qualified CFC’s interest expense was multiplied by a fraction, the numerator of which is the CFC’s average basis in assets which give rise to income excluded from FPHCI by reason of § 954(h) or (i), and the denominator is the CFC’s average basis in all its assets. Prop. Treas. Reg. § 1.951A-4(b)(1)(iii)(A). Second, the product of the first step was reduced by the interest income of the qualified CFC that is excluded from FPHCI by reason of § 954(c)(3) or (6). Prop. Treas. Reg. § 1.951A-4(b)(1)(iii)(B).
- iv. This two-step approach effectively treated all interest expense of a qualified CFC as attributable ratably to the assets of the qualified CFC that give rise to income excluded from FPHCI by reason of § 954(h) and (i), but then traces such interest expense, after attribution to such assets, to any interest income received from related CFCs to the extent thereof.
- v. Treasury and the IRS agreed with a comment that, under the two-step approach to the proposed regulations, related party receivables are effectively double-counted, and therefore the final regulations eliminate the second step reduction for interest income included in the gross tested income of a qualified CFC that is excluded from FPHCI by reason of § 954(c)(3) or (6). Treas. Reg. § 1.951A-4(b)(1)(iii)(A).
- vi. This revision ensures that a related party receivable is not double-counted in the determination of qualified interest expense, and thus qualified interest expense as calculated under the final regulations more accurately reflects the interest expense incurred to earn income earned from unrelated parties in an active financing or insurance business. Further, Treasury and the IRS preferred the elimination of the second step reduction for resolving the

double-counting issue, rather than the recommended alternative of excluding related party receivables from the fraction in the first step, because the elimination of an additional step substantially simplifies the calculation of qualified interest expense.

- vii. In addition, regarding the effect of related party receivables on the computation of qualified interest expense, the final regulations clarified that a receivable that gives rise to income that is excludible from FPHCI by reason of § 954(c)(3) or (6) is excluded from the numerator of the fraction (that is, the receivable is not a “qualified asset” within the meaning of Treas. Reg. § 1.951A-4(b)(1)(iii)(B), a new term in the final regulations), notwithstanding that such receivable may also give rise to income excluded from FPHCI by reason of § 954(h) or (i). Treas. Reg. § 1.951A-4(b)(1)(iii)(B)(2).
- viii. Similarly, the final regulations provide that interest income that is excludible from FPHCI by reason of § 954(c)(3) or (6) is excluded from qualified interest income, notwithstanding that such income may also be excluded from FPHCI by reason of § 954(h) or (i). Treas. Reg. § 1.951A-4(b)(2)(iii)(B). These modifications ensure that the computation of qualified interest income and qualified interest expense will be determined by reference only to interest expense and interest income attributable to a CFC’s active conduct of a financing or insurance business with unrelated persons.
- ix. A comment recommended that, for purposes of determining the amount of qualified interest expense of a CFC, instruments or obligations that give rise to interest income derived by active securities and derivatives dealers that is excluded from FPHCI under § 954(c)(2)(C) should also be included in the numerator for calculating qualified interest expense. The final regulations adopted this recommendation by including such instruments or obligations in the definition of qualified assets. Treas. Reg. § 1.951A-4(b)(1)(iii)(B)(1). Similarly, interest income excluded from FPHCI under § 954(c)(2)(C) is included in the definition of qualified interest income. Treas. Reg. § 1.951A-4(b)(2)(iii)(A).
- x. Another comment suggested that the benefit to some U.S. shareholders from the exclusion for qualified interest expense may not justify the difficulty and expense to

determine the amount excluded. Therefore, the comment recommended that the final regulations provide taxpayers the ability to either establish the amount of their qualified interest expense or, alternatively, to assume that none of their interest expense constitutes qualified interest expense.

- xi. Treasury and the IRS agreed that taxpayers should not be required to reduce their CFCs' tested interest expense by their CFCs' qualified interest expense if the taxpayer determines that the value of such reduction is outweighed by the cost of compliance. Accordingly, the final regulations provide that a CFC's qualified interest expense is taken into account only to the extent established by the CFC. Treas. Reg. § 1.951A-4(b)(1)(iii)(A).
- xii. Thus, if a CFC does not establish an amount of qualified interest expense, the taxpayer can assume that none of the CFC's interest expense is qualified interest expense. However, regardless of whether a CFC avails itself of the reduction for qualified interest expense, the exclusion for qualified interest income is mandatory. Treas. Reg. § 1.951A-4(b)(2)(iii)(A).
- xiii. A comment said that some foreign financial service groups borrow externally through a holding company to fund their qualifying insurance company subsidiaries that earn qualified interest income. The comment noted that the proposed regulations create a mismatch between the treatment of the interest income of the subsidiaries, which is qualified interest income of a qualified CFC and thus not taken into account in calculating specified interest expense, and the interest expense of the holding company, which is not qualified interest expense of a qualified CFC and thus is taken into account in calculating specified interest expense.
- xiv. To address this mismatch, the final regulations eliminate the term "qualified CFC." Therefore, if a holding company that is not engaged in an active financing or insurance business borrows to fund the activities of subsidiaries that are engaged in an active financing or insurance business, the interest expense of the holding company may constitute qualified interest expense and thus be disregarded in determining specified interest expense. In this regard, the final regulations retain the rule that the adjusted basis in stock of a subsidiary is treated as basis in a qualified asset to the extent that the assets of the subsidiary are qualified assets. Treas. Reg. § 1.951A-4(b)(1)(iii)(B)(3).

- xv. In addition, the final regulations provide a new rule that treats a CFC that owns 25% or more of the capital or profits interest in a partnership as owning its attributable share of any property held by the partnership, as determined under the principles of Treas. Reg. § 1.956-4(b). Treas. Reg. § 1.951A-4(b)(1)(iii)(B)(4). Therefore, under the final regulations, whether, and to what extent, the interest expense of a CFC is qualified interest expense depends entirely on the nature of the assets it holds directly and indirectly, and not on whether the CFC itself is engaged in an active financing or insurance business.
- xvi. Finally, the definition of qualified interest expense in the proposed regulations included a parenthetical that indicates that the fraction for determining qualified interest expense cannot exceed one. Prop. Treas. Reg. § 1.951A-4(b)(1)(iii). Treasury and the IRS have determined that, because the numerator (average basis in qualified assets) is a subset of the denominator (average basis in all assets), this fraction can never exceed one, even without regard to the parenthetical. Therefore, the final regulations eliminated the parenthetical from the definition of qualified interest expense as surplusage. Treas. Reg. § 1.951A-4(b)(1)(iii)(A).

(d) Interest expense paid or accrued by a tested loss CFC.

- i. Under the proposed regulations, tested interest expense included interest expense paid or accrued by a tested loss CFC, notwithstanding that the proposed regulations provide that a tested loss CFC has no QBAI. Prop. Treas. Reg. § 1.951A-3(b) and Treas. Reg. § 1.951A-4(b)(1). The final regulations continue to provide that a tested loss CFC has no QBAI. Treas. Reg. § 1.951A-3(b).
- ii. The final regulations did not adopt a recommendation to exclude all interest expense of a tested loss CFC, because such an exclusion would be inconsistent with the text of § 951A(d)(2)(A) and the Conference Report and could create an incentive to inappropriately shift interest expense to a tested loss CFC in order to avoid reducing a U.S. shareholder's net DTIR. The reference to § 951A(c)(2)(A)(ii) in § 951A(b)(2)(B) encompasses all deductions properly allocable to gross tested income, including deductions taken into account in determining tested loss. § 951A(c)(2)(B)(i) (defining tested loss as the

excess of deduction described in § 951A(c)(2)(A)(ii) over gross tested income described in § 951A(c)(2)(A)(i).

- iii. However, in response to other comments, the final regulations reduced a tested loss CFC's tested interest expense by its tested loss QBAI amount, an amount equal to 10% of the QBAI that the tested loss CFC would have had if it were instead a tested income CFC. Treas. Reg. § 1.951A-4(b)(1)(i) and (iv) and (c) Example 5. This rule has the effect of not taking into account the tested interest expense of a tested loss CFC to the extent that such tested interest expense is less than or equal to a notional 10% return on the tested loss CFC's tangible assets that are used in the production of gross tested income.

(e) Interest expense paid or accrued to a U.S. shareholder.

- i. The proposed regulations adopted a netting approach with the result that specified interest expense is the excess of a U.S. shareholder's pro rata share of tested interest expense of each CFC over its pro rata share of tested interest income of each CFC. Prop. Treas. Reg. § 1.951A-1(c)(3)(ii).
- ii. The final regulations did not adopt recommendations regarding these rules. Section 951A(b)(2)(B) generally reduces net DTIR of a U.S. shareholder by the full amount of its pro rata share of the interest expense of a CFC, but then provides a limited exception for the CFC's interest expense to the extent the related interest income is taken into account in determining the net CFC tested income of the U.S. shareholder. In effect, the rule generally reduces net DTIR of a U.S. shareholder by its pro rata share of the net external interest expense incurred by its CFCs. Thus, borrowing between commonly-owned CFCs generally does not reduce net DTIR, whereas external borrowing generally does.
- iii. The statute does not provide a similar exception for any payment of interest to the extent the related interest income is subject to U.S. tax, nor is there any indication in the legislative history of the TCJA that Congress intended that Treasury and the IRS should provide such an exception. Further, an exception for interest paid to U.S. persons could permit taxpayers to circumvent § 951A(b)(2)(B) by borrowing externally at the U.S. shareholder level and then on-lending the borrowed funds to CFCs. In this case, the

borrowing by the U.S. shareholder would not reduce net DTIR, notwithstanding that the borrowing is factually traceable to the acquisition by the CFC of specified tangible property and net DTIR would have been reduced if instead the CFC had borrowed directly from the third party.

6. Treas. Reg. § 1.951A-5 – Domestic Partnerships and Their Partners.

(a) Proposed hybrid approach.

- i. The proposed regulations provided that, in general, a domestic partnership that is a U.S. shareholder (“U.S. shareholder partnership”) of a CFC (“partnership CFC”) determines a GILTI inclusion amount, and partners of the partnership that are not also U.S. shareholders of the partnership CFC take into account their distributive share of the partnership’s GILTI inclusion amount. Prop. Treas. Reg. § 1.951A-5(b). Partners that are U.S. shareholders of a partnership CFC (“U.S. shareholder partners”), however, would not take into account their distributive share of the partnership’s GILTI inclusion amount to the extent determined by reference to the partnership CFC but instead are treated as proportionately owning the stock of the partnership CFC within the meaning of § 958(a) as if the domestic partnership were an aggregate of its partners.
- ii. To accomplish this result, the proposed regulations, regarding U.S. shareholder partners, treated the domestic partnership as an aggregate of its partners under § 958(a)(2). As a result, a U.S. shareholder partner determines its GILTI inclusion amount taking into account its pro rata share of any tested item of the partnership CFC. If the U.S. shareholder partnership holds other partnership CFCs in which the partner is not a U.S. shareholder, then a separate GILTI computation would be made at the partnership level regarding the partnership CFCs’ tested items, and the partner includes its distributive share of this separately determined GILTI inclusion amount as well. Prop. Treas. Reg. § 1.951A-5(c).
- iii. This hybrid approach (“proposed hybrid approach”) of treating a domestic partnership as an entity regarding partners that are not U.S. shareholders, but as an aggregate of its partners regarding partners that are U.S. shareholders, was intended to balance the policies underlying GILTI with the relevant statutory provisions. In particular, a domestic partnership is a U.S. person under §§ 957(c) and

7701(a)(30) and thus a U.S. shareholder under § 951(b), which suggests that a domestic partnership should generally be treated as an entity for purposes of Subpart F. On the other hand, if a domestic partnership were treated strictly as an entity for purposes of § 951A, a domestic partnership with a GILTI inclusion amount would be ineligible for foreign tax credits under § 960(d) or a deduction under § 250 regarding its GILTI inclusion amount.

- iv. In the proposed regulations, Treasury and the IRS rejected an approach that would treat a domestic partnership as an entity regarding all its partners (“pure entity approach”) for purposes of § 951A, because treating a domestic partnership as the § 958(a) owner of stock in all cases would frustrate the GILTI framework by creating unintended planning opportunities for well-advised taxpayers and traps for the unwary. However, Treasury and the IRS also did not adopt an approach that would treat a domestic partnership as an aggregate regarding all its partners (“pure aggregate approach”) for purposes of GILTI, because such an approach would be inconsistent with the treatment of domestic partnerships as entities for purposes of Subpart F.

(b) Adoption of aggregate treatment for purposes of determining GILTI inclusion amounts.

- i. After consideration of comments received, Treasury and the IRS have decided not to adopt the proposed hybrid approach in the final regulations. Instead, the final regulations adopt an approach that treats a domestic partnership as an aggregate for purposes of determining the level (that is, partnership or partner) at which a GILTI inclusion amount is calculated and taken into gross income. Specifically, the final regulations provide that, in general, for purposes of § 951A and the § 951A regulations, and for purposes of any other provision that applies by reference to § 951A or the § 951A regulations (for instance, §§ 959, 960, and 961), a domestic partnership is not treated as owning stock of a foreign corporation within the meaning of § 958(a). Treas. Reg. § 1.951A-1(e)(1).
- ii. Rather, the partners of a domestic partnership are treated as owning proportionately the stock of CFCs owned by the partnership. Because a domestic partnership is not treated as owning § 958(a) stock for purposes of § 951A, a

domestic partnership does not have a GILTI inclusion amount and thus no partner of the partnership has a distributive share of a GILTI inclusion amount. Furthermore, because only a U.S. shareholder can have a pro rata share of a tested item of a CFC under § 951A(e)(1) and Treas. Reg. § 1.951A-1(d), a partner that is not a U.S. shareholder of a CFC owned by the partnership does not have a pro rata share of any tested item of the CFC. Treasury and the IRS believe that this approach best reconciles the relevant statutory provisions, the policies underlying GILTI, and the administrative and compliance concerns raised by the comments.

- iii. The final regulations did not adopt a recommendation to extend the treatment of a domestic partnership as an aggregate of its partners to the determination of U.S. shareholder and CFC status. Treasury and the IRS believe that an approach that treats a domestic partnership as an aggregate of its partners for purposes of determining CFC status would not be consistent with the relevant statutory provisions. A domestic partnership is a U.S. person under § 957(c) and § 7701(a)(30) and, therefore, can be a U.S. shareholder under § 951(b). Indeed, when Subpart F was enacted in 1962, the legislative history indicated that domestic partnerships generally should be treated as U.S. shareholders.
- iv. The final regulations also do not extend aggregate treatment to the determination of the controlling domestic shareholders (as defined in Treas. Reg. § 1.964-1(c)(5)) of a CFC for purposes of any election made under the § 951A regulations. Treas. Reg. § 1.951A-3(e)(3)(ii) (election to use a non-ADS depreciation method for pre-enactment property) and Treas. Reg. § 1.951A-3(h)(2)(ii)(B)(3) (election to eliminate disqualified basis). As a result, a domestic partnership that satisfies the ownership requirements of Treas. Reg. § 1.964-1(c)(5) regarding a CFC, and not its partners, is treated as the controlling domestic shareholder of the CFC and the partnership files the relevant elections regarding the CFC.
- v. The treatment of a domestic partnership as the controlling domestic shareholder reduces the number of persons that need to comply with the rules of Treas. Reg. § 1.964-1(c)(3), and ensures that any election regarding a CFC that could affect the tax consequences of a U.S. person that is a partner of a domestic partnership is made by such

partnership. Accordingly, the final regulations provide that the aggregation rule for domestic partnerships does not apply for purposes of determining whether a U.S. person is a U.S. shareholder, whether a U.S. shareholder is a controlling domestic shareholder (as defined in Treas. Reg. § 1.964-1(c)(5)), or whether a foreign corporation is a CFC. Treas. Reg. § 1.951A-1(e)(2).

- vi. Conforming changes were made to other aspects of the final regulations to account for the aggregate treatment of domestic partnerships under Treas. Reg. § 1.951A-1(e). For instance, the proposed regulations provided that, for purposes of determining whether a U.S. shareholder has a pro rata share of an accrual for purposes of §§ 163(e)(3)(B)(i) and 267(a)(3)(B), a domestic partnership's pro rata share of the accrual is taken into account only to the extent that U.S. persons include in gross income a distributive share of the domestic partnership's GILTI inclusion amount. Treas. Reg. § 1.951A-5(c)(2).
- vii. This rule is no longer necessary under the final regulations because a domestic partnership does not have a GILTI inclusion amount, and partners that are U.S. shareholders have their own pro rata shares of the accrual. Therefore, this rule was eliminated in the final regulations. Treas. Reg. § 1.951A-5(c).
- viii. In addition, the partnership blocker rule was modified so that it no longer applies for purposes of § 951A. Treas. Reg. § 1.951-1(h)(1). It is no longer necessary to apply the rule for purposes of § 951A because, for such purposes, a domestic partnership is not treated as owning stock of a foreign corporation within the meaning of § 958(a).
- ix. Treasury and the IRS also proposed changes in the treatment of domestic partnership for Subpart F purposes, as well, to conform the Subpart F and GILTI treatment of these entities. These proposed regulations are discussed below.

7. Treas. Reg. § 1.951A-6 – Treatment of GILTI Inclusion Amount and Adjustments to E&P and Basis Related to Tested Loss CFCs.

- (a) Increase of E&P by tested losses for purposes of § 952(c)(1)(A).
 - i. Section 951A(c)(2)(B)(ii) provides that § 952(c)(1)(A) is applied by increasing the E&P of a tested loss CFC by the

amount of its tested loss. Comments said that Prop. Treas. Reg. § 1.951A-6(d) had the effect of increasing E&P by a tested loss even if, and to the extent, the tested loss does not provide a benefit to a U.S. shareholder because its aggregate pro rata share of tested losses exceeds its aggregate pro rata share of tested income. These comments said that this result is not appropriate because, based on the heading of § 951A(c)(2)(B)(ii) (“Coordination with Subpart F to deny double benefit of losses”), the provision is limited to denying a double benefit from a tested loss (that is, a reduction in both net CFC tested income and Subpart F income), and that there can be no double benefit to the extent that the tested loss does not reduce a U.S. shareholder’s net CFC tested income. These comments recommended that Prop. Treas. Reg. § 1.951A-6(d) be modified so that it applies only to a tested loss to the extent the tested loss is “used” within the meaning of Prop. Treas. Reg. § 1.951A-6(e).

- ii. The final regulations did not adopt this recommendation. Section 951A(c)(2)(B)(ii), by its terms, increases E&P for purposes of § 952(c)(1)(A) by the amount of any tested loss. There is no indication in the provision or legislative history that limiting the application of § 951A(c)(2)(B)(ii) to a tested loss that reduces net CFC tested income would be appropriate, and the heading of the provision has no legal effect. § 7806(b). Accordingly, the rule was adopted without modification in Treas. Reg. § 1.951A-6(b).

(b) Treating GILTI inclusion amounts as Subpart F inclusions for purposes of the personal holding company rules.

- i. A comment requested clarification regarding the treatment of a GILTI inclusion amount for purposes of the personal holding company rules in §§ 541 through 547. Section 541(a) imposes a 20-percent tax on the undistributed personal holding company income of a personal holding company. Section 542(a) defines a “personal holding company” as a corporation if at least 60% of its adjusted ordinary gross income for the taxable year is personal holding company income and certain ownership requirements are satisfied.
- ii. The comment noted that the existing regulations under § 951 provide that for purposes of determining whether a corporate U.S. shareholder is a personal holding company, the character of a Subpart F inclusion of such domestic

corporation is determined as if the amount that results in the Subpart F inclusion were realized directly by the corporation from the source from which it is realized by the CFC. Treas. Reg. § 1.951-1(a)(3).

- iii. Treasury and the IRS believe that it would be inappropriate to treat any portion of a GILTI inclusion amount as personal holding company income. A GILTI inclusion amount is determined by reference to income that would have been taxed, if at all, as dividends from CFCs before the enactment of § 951A, which are specifically excluded from the definition of personal holding company income under § 543(a)(1)(C).
- iv. Accordingly, the final regulations clarify that in determining whether a corporate U.S. shareholder is a personal holding company, a GILTI inclusion amount is not treated as personal holding company income (as defined in § 543(a)). Treas. Reg. § 1.951A-5(d).

(c) Adjustments to basis related to net used tested loss.

- i. To eliminate the potential for the duplicative use of a loss, the proposed regulations set forth rules providing for downward adjustments to the adjusted basis in stock of a tested loss CFC to the extent its tested loss was used to offset tested income of another CFC. Prop. Treas. Reg. § 1.951A-6(e). These adjustments were generally to be made at the time of a direct or indirect disposition of stock of the tested loss CFC. Prop. Treas. Reg. § 1.951A-6(e)(1). Comments raised many significant issues regarding these rules.
- ii. Treasury and the IRS remain concerned that, absent basis adjustments, a tested loss can result in the creation of uneconomic or duplicative loss, but have determined that the rules in the proposed regulations related to basis adjustments should not be adopted in the final regulations. Instead, rules related to basis adjustments, including the comments received regarding such rules, will be considered in a separate project.
- iii. Accordingly, the final regulations reserved on the rules related to adjustments to stock of tested loss CFCs. Treas. Reg. § 1.951A-6(c). Any rules issued under Treas. Reg. § 1.951A-6(c) will apply only regarding tested losses incurred in taxable years of CFCs and their U.S.

shareholders ending after the date of publication of any future guidance.

8. Treas. Reg. §§ 1.1502-13, 1.1502-32, and 1.1502-51 – Consolidated § 951A.

(a) Calculation of GILTI inclusion amount.

- i. Section 1502 provides that consolidated return regulations will be promulgated to clearly reflect the income tax liability of a consolidated group and each member of the consolidated group (a “member”). Treasury and the IRS believe that a clear reflection of a § 951A GILTI inclusion of both individual members and the consolidated group as a whole is not feasible. Section 951A requires a U.S. shareholder-level calculation, where, for example, the shareholder’s pro rata share of the tested income of one CFC may be offset by its pro rata share of the tested loss or QBAI of another CFC, to produce a smaller GILTI inclusion amount.
- ii. Accordingly, calculating a member’s GILTI inclusion amount on a completely separate-entity basis, solely based on its pro rata share of the items of its CFCs, would clearly reflect the income tax liability of the member. However, such an approach would mean that the consolidated group’s GILTI inclusion amount would vary depending on which members own each CFC, particularly in cases in which the CFCs held by some members produce tested income, but the CFCs held by other members produce tested loss. This variability undermines the clear reflection of the income tax liability of the consolidated group as a whole.
- iii. Under the proposed regulations members’ GILTI inclusion amounts were determined in a manner that clearly reflected the income tax liability of the consolidated group and that created consistent results regardless of which member of a consolidated group owned the stock of the CFCs (“single-entity treatment”). This approach removed incentives for inappropriate planning and also eliminated traps for the unwary.
- iv. The proposed regulations accomplished these goals by providing that the GILTI inclusion amount of a member is determined pursuant to a multi-step process. As in the case of a non-member, the GILTI inclusion amount of a member equals the excess (if any) of the member’s net CFC tested

income over the member's net DTIR for the taxable year. Prop. Treas. Reg. § 1.951A-1(c)(1) and Prop. Treas. Reg. § 1.1502-51(b). For purposes of determining a member's net CFC tested income, a member's aggregate pro rata share of tested income was determined on a separate-entity basis by aggregating its pro rata share of the tested income of each of its CFCs. Prop. Treas. Reg. § 1.1502-51(e)(1) and (12).

- v. However, a member's aggregate pro rata share of tested loss and its net DTIR for the taxable year was calculated in three steps – first, each member's pro rata share of each tested item other than tested income is determined on a separate-entity basis by reference to its pro rata share of each CFC; second, each member's pro rata share of each tested item other than tested income is aggregated into a consolidated sum; and third, each member is then allocated a portion of the consolidated sum of each such tested item based on its relative amount of tested income (the “aggregation approach”). Prop. Treas. Reg. § 1.1502-51(e)(2), (3), (4), (5), (7), and (10).
- vi. This aggregation approach had the effect of determining the aggregate amount of GILTI inclusion amounts of members on a single-entity basis, but then determining each member's share of the consolidated group's aggregate GILTI inclusion amount based on its relative pro rata share of tested income as determined on a separate-entity basis.
- vii. Treasury and the IRS received several comments addressing the calculation of a member's GILTI inclusion amount. These comments generally supported single-entity treatment, but they expressed concern about the lack of clear reflection of income at the member level. The concern arises from the movement of the economic benefit (in the GILTI computation) of one member's pro rata share of a tested loss regarding stock held by the member to other members, including those not holding such stock. The comments considered whether alternative methods could be used that both provide for single-entity treatment and minimize uneconomic results to members. In particular, the comments raised the possibility that the tested loss of a CFC should first offset the tested income of a CFC owned by the same member (the “priority allocation approach”).
- viii. Treasury and the IRS declined to adopt these comments because they do not produce reasonable results that are

consistent with single-entity treatment. In particular, the first of these comments does not provide for single-entity treatment when foreign tax credits are taken into account, instead allowing for wide variation in the availability of foreign tax credits depending on which member of a consolidated group owns the stock of the CFCs. The variation arises because a corporate U.S. shareholder is deemed to pay a portion of the foreign income taxes paid or accrued by its CFCs based on the shareholder's GILTI inclusion amount. § 960(d).

- ix. A priority allocation approach, like the separate entity calculations discussed in a preceding paragraph, would change members' GILTI inclusion amounts based on which member owns the stock of the CFCs. By extension, a priority allocation approach would also change the amount of foreign tax credits that are available to the consolidated group based on which member owns the stock of the CFCs. This disparity would allow for tax planning to maximize the availability of foreign tax credits regarding tested income.
- x. Based on the foregoing, Treasury and the IRS continue to believe that the aggregation approach balances, to the greatest extent possible, the clear reflection of the income tax liability under § 951A of a consolidated group with reasonable results to its individual members. Accordingly, the final regulations generally adopted the aggregation approach from the proposed regulations without substantial changes.

(b) Basis adjustments to member stock.

- i. The proposed regulations contained special rules, applicable to consolidated groups, that reflect the downward basis adjustments set forth in Prop. Treas. Reg. § 1.951A-6(e) regarding the stock of tested loss CFCs. Prop. Treas. Reg. §§ 1.1502-32(b)(3)(ii)(E) and (b)(3)(iii)(C), and 1.1502-51(c) and (d). Treasury and the IRS have determined that the rules related to basis adjustments for tested loss CFCs should not be adopted in the final regulations and will instead be considered in a separate project. Correspondingly, the special rules for consolidated groups that reflect such rules were likewise reserved. Treas. Reg. §§ 1.1502-32(b)(3)(ii)(E) and (b)(3)(iii)(C), and 1.1502-51(c) and (d).

- ii. These special rules, along with related comments, will be considered in the same project as the rules related to basis adjustments for tested loss CFCs and will apply only to taxable years of U.S. shareholders that are members of a consolidated group ending after the date of publication of the final rules.

(c) Portion of proposed regulations not being finalized.

- i. The proposed regulations would treat a member as receiving tax-exempt income immediately before another member recognizes income, gain, deduction, or loss regarding a share of the first member's stock (the "F adjustment"). Prop. Treas. Reg. § 1.1502-32(b)(3)(ii)(F). The amount of the tax-exempt income would be determined based in part on the aggregate tested income and aggregate tested losses of the member's CFCs in prior taxable years.
- ii. Treasury and the IRS believe there are serious flaws with the F adjustment. Examples of the problems include unintended and duplicative tax benefits, distortive effects, and possible avoidance of Code provisions and regulations. Therefore, Treasury and the IRS did not finalize the F adjustment rules. As a result, taxpayers may not rely on the F adjustment. Treasury and the IRS continue to study a number of issues regarding consolidated stock basis in this area.

9. Applicability Dates.

- (a) The proposed regulations provided that Treas. Reg. § 1.951-1(e), other than paragraph (e)(1)(ii)(B) (regarding the determination of allocable E&P), applies to taxable years of U.S. shareholders ending on or after October 3, 2018. Comments requested certain changes and guidance related to the applicability date of Prop. Treas. Reg. § 1.951-1(e)(6).
- (b) Comments recommended that the pro rata share anti-abuse rule in Prop. Treas. Reg. § 1.951-1(e)(6) not be applied to transactions or arrangements entered into before the general applicability date of Treas. Reg. § 1.951-1(e). Under this recommendation, transactions or arrangements entered into before the general applicability date of Treas. Reg. § 1.951-1(e)(6), regardless of whether they would be subject to the pro rata share anti-abuse rule, would be given effect for purposes of determining a U.S. shareholder's pro rata share of Subpart F income and tested items for taxable years ending after the general applicability date.

- (c) Treasury and the IRS did not adopt this recommendation because it would have the effect of grandfathering existing transactions or arrangements entered into with a principal purpose of avoiding Federal income taxation.
- (d) A comment also recommended that taxpayers be permitted, but not required, to apply the facts and circumstances method under Treas. Reg. § 1.951-1(e)(3), the substance to taxable years ending on or after December 31, 2017, and before October 3, 2018. The comment stated that, under § 965, a U.S. shareholder with a taxable year ending on December 31 may be required to determine its pro rata share of the increase to Subpart F income of its foreign subsidiaries in both its 2017 taxable year regarding foreign subsidiaries with a taxable year ending December 31, and its 2018 taxable year regarding foreign subsidiaries with a taxable year ending November 30.
- (e) Accordingly, given the applicability date in the proposed regulations, for purposes of determining such U.S. shareholder's inclusion under § 965, the U.S. shareholder could be required to apply, regarding its calendar year foreign subsidiaries, the fair market value method under the existing regulations for classes of stock with discretionary distribution rights, but then apply, regarding its fiscal year foreign subsidiaries, the facts and circumstances method for stock with the same characteristics.
- (f) The comment suggested that allowing U.S. shareholders to rely on the facts and circumstances method for taxable years ending on or after December 31, 2017, and before October 3, 2018, would enable taxpayers to apply a uniform method for allocating the § 965(a) earnings amounts of all relevant foreign subsidiaries among or between U.S. shareholders, would provide more certainty, would be less administratively burdensome, and would not result in improper allocations of Subpart F income because the method is consistent with each shareholder's economic rights and interests.
- (g) Treasury and the IRS believe that it would be inappropriate to permit U.S. shareholders the ability to choose whether to rely on the new allocation rules under Treas. Reg. § 1.951-1(e)(3) for taxable years of foreign corporations that end within the U.S. shareholder's taxable year ending before October 3, 2018, the general applicability date of Treas. Reg. § 1.951-1(e). Treas. Reg. § 1.951-1(i).
- (h) Rather than simplifying the process of determining their pro rata shares regarding their calendar year foreign subsidiaries, the

proposal would incentivize taxpayers to invest additional time and resources to determine their U.S. tax liability under both sets of pro rata share rules in order to determine the rules that result in the least amount of U.S. tax liability. In addition, because most tax returns of U.S. shareholders that include income from a foreign subsidiary with a taxable year ending on December 31, 2017, by reason of § 965 have already been filed, the proposal would increase the number of amended returns filed for those taxable years, thus creating additional compliance burdens for taxpayers and administrative costs for the government. Accordingly, the final regulations did not adopt this proposal.

- (i) There were no comments related to the applicability dates of other provisions of the proposed regulations. The final regulations adopt the applicability dates of the proposed regulations without substantial changes.
- (j) Therefore, consistent with the applicability date of § 951A, Treas. Reg. §§ 1.951A-1 through 1.951A-6, including Treas. Reg. §§ 1.951A-2(c)(5) and -3(h)(2), apply to taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end. The applicability dates regarding the rules in Treas. Reg. § 1.951-1 are as follows. Paragraphs (a), (b)(1)(ii), (b)(2), (e)(1)(ii)(B), and (g)(1) apply to taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end. Paragraph (e), except for paragraph (e)(1)(ii)(B), applies to taxable years of U.S. shareholders ending on or after October 3, 2018. Paragraph (h) applies to taxable years of domestic partnerships ending on or after May 14, 2010. Treas. Reg. §§ 1.6038-2(a) and 1.6038-5 apply to taxable years of foreign corporations beginning on or after October 3, 2018.
- (k) The final regulations modified applicability dates in the proposed regulations related to consolidated groups. Prop. Treas. Reg. § 1.1502-51 applies to taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end. Treasury and the IRS have determined that for U.S. shareholders that are members of a consolidated group, the applicability date for Treas. Reg. § 1.1502-51 should be postponed to taxable years of such members for which the due date (without extensions) of the consolidated return is after the date on which these final regulations are published in the Federal Register. However, the final regulations provide that a consolidated group

may apply the rules of Treas. Reg. § 1.1502-51 in their entirety to all of its members for all taxable years described in Treas. Reg. § 1.951A-7. Treas. Reg. § 1.1502-51(g).

B. Proposed Regulations: GILTI High Tax Exclusion.

1. High-Tax Gross Tested Income.

- (a) Section 951A(c)(2)(A)(i) provides that the gross tested income of a CFC for a taxable year is all the gross income of the CFC for the year, determined without regard to certain items. Treas. Reg. § 1.951A-2(c)(1). In particular, § 951A(c)(2)(A)(i)(III) excludes from gross tested income any gross income excluded from foreign base company income (as defined in § 954) (“FBCI”) or insurance income (as defined in § 953) of a CFC by reason of the exception under § 954(b)(4) (the “GILTI high tax exclusion”).
- (b) The GILTI proposed regulations clarified that the GILTI high tax exclusion applies only to income that is excluded from FBCI and insurance income solely by reason of an election made to exclude the income under the high tax exception of § 954(b)(4) and Treas. Reg. § 1.954-1(d)(5). Prop. Treas. Reg. § 1.951A-2(c)(1)(iii).
- (c) Numerous comments requested that the scope of the GILTI high tax exclusion be expanded in the final regulations. These comments asserted that the legislative history of § 951A indicates that Congress intended that income of a CFC should be taxed as GILTI only if it is subject to a low rate of foreign tax, regardless of whether the income is active or passive.
- (d) Comments also suggested that the GILTI high tax exclusion does not require that income be excluded “solely” by reason of § 954(b)(4). The comments said that the GILTI high tax exclusion could be interpreted to exclude any item of income that would be FBCI or insurance income, but for another exception to FBCI (for instance, the active financing exception under § 954(h) and the active insurance exception under § 954(i)).
- (e) Of the comments recommending an expansion of the GILTI high tax exclusion, some recommended that the GILTI high tax exclusion apply to income taxed at a rate above 13.125%, while others recommended that the GILTI high tax exclusion apply to income taxed at a rate above 90% of the maximum rate of tax specified in § 11, or 18.9%. The comments recommended that the GILTI high tax exclusion be applied either on a CFC-by-CFC basis or an item-by-item basis.

- (f) Alternatively, comments recommended that the scope of the GILTI high tax exclusion be expanded under § 951A(f) by treating, on an elective basis, a GILTI inclusion as a Subpart F inclusion that is potentially excludible from FBCI or insurance income under § 954(b)(4), or by modifying the GILTI high tax exclusion to exclude any item of income subject to a sufficiently high effective foreign tax rate such that it would be excludible under § 954(b)(4) if it were FBCI or insurance income.
- (g) Other comments recommended the creation of a rebuttable presumption that all income of a CFC is Subpart F income, regardless of whether such income is of a character included in FBCI or insurance income, and therefore, if the taxpayer chose not to rebut the presumption, the income would be excluded from gross tested income either because it is included in Subpart F income (and thus excluded from gross tested income by reason of the Subpart F exclusion under § 951A(c)(2)(A)(i)(II)) or because the income is excluded from Subpart F income by reason of § 954(b)(4) (and thus excluded from gross tested income by reason of the GILTI high tax exclusion).
- (h) The GILTI final regulations adopted the GILTI high tax exclusion of the proposed regulations without change.

2. Expansion to Exclude Other High-Taxed Income.

- (a) In response to these comments, Treasury and the IRS believe that the GILTI high tax exclusion should be expanded (on an elective basis) to include certain high-taxed income even if that income would not otherwise be FBCI or insurance income. In particular, they believe that taxpayers should be permitted to elect to apply the exception under § 954(b)(4) regarding certain classes of income that are subject to high foreign taxes within the meaning of that provision.
- (b) Before the TCJA, such an election would have had no effect regarding items of income that were excluded from FBCI or insurance income for other reasons. Nevertheless, § 954(b)(4) is not explicitly restricted in its application to an item of income that first qualifies as FBCI or insurance income. Rather, the provision applies to “any item of income received by a controlled foreign corporation.”
- (c) Therefore, any item of gross income, including an item that would otherwise be gross tested income, could be excluded from FBCI or insurance income “by reason of” § 954(b)(4) if the provision is one of the reasons for such exclusion, even if the exception under

§ 954(b)(4) is not the sole reason. Any item thus excluded from FBCI or insurance income by reason of § 954(b)(4) would then also be excluded from gross tested income under the GILTI high tax exclusion, as modified in these proposed regulations.

- (d) The legislative history evidences an intent to exclude high-taxed income from gross tested income. Senate Explanation at 371. The proposed regulations, which permit taxpayers to electively exclude a CFC's high-taxed income from gross tested income, are consistent, therefore, with this legislative history. Furthermore, an election to exclude a CFC's high-taxed income from gross tested income allows a U.S. shareholder to ensure that its high-taxed non-Subpart F income is eligible for the same treatment as its high-taxed FBCI and insurance income, and thus eliminates an incentive for taxpayers to restructure their CFC operations in order to convert gross tested income into FBCI for the sole purpose of availing themselves of § 954(b)(4) and, thus, the GILTI high tax exclusion.
- (e) For the foregoing reasons, the proposed regulations provide that an election may be made for a CFC to exclude under § 954(b)(4), and thus to exclude from gross tested income, gross income subject to foreign income tax at an effective rate that is greater than 90% of the rate that would apply if the income were subject to the maximum rate of tax specified in § 11 (18.9% based on the current rate of 21%). Prop. Treas. Reg. § 1.951A-2(c)(6)(i). The election is made by the CFC's controlling domestic shareholders regarding the CFC for a CFC inclusion year by attaching a statement to an amended or filed return in accordance with forms, instructions, or administrative pronouncements. Prop. Treas. Reg. § 1.951A-2(c)(6)(v)(A).
- (f) If an election is made regarding a CFC, the election applies to exclude from gross tested income all the CFC's items of income for the taxable year that meet the effective rate test in Prop. Treas. Reg. § 1.951A-2(c)(6)(iii) and is binding on all the U.S. shareholders of the CFC. Prop. Treas. Reg. § 1.951A-2(c)(6)(v)(B). The election is effective for a CFC for the CFC inclusion year for which it is made and all subsequent CFC inclusion years of the CFC unless revoked by the controlling domestic shareholders of the CFC. Prop. Treas. Reg. § 1.951A-2(c)(6)(v)(C).
- (g) An election may generally be revoked by the controlling domestic shareholders of the CFC for any CFC inclusion year. Prop. Treas. Reg. § 1.951A-2(c)(6)(v)(D)(1). However, after a revocation for a CFC inclusion year, a new election generally cannot be made for

any CFC inclusion year of the CFC that begins within sixty months after the close of the CFC inclusion year for which the election was revoked, and that subsequent election cannot be revoked for a CFC inclusion year that begins within sixty months after the close of the CFC inclusion year for which the subsequent election was made. Prop. Treas. Reg. § 1.951A-2(c)(6)(v)(D)(2)(i). An exception to this 60-month limitation may be permitted by IRS regarding a CFC if the CFC undergoes a change of control. Prop. Treas. Reg. § 1.951A-2(c)(6)(v)(D)(2)(ii).

- (h) Finally, if a CFC is a member of a controlling domestic shareholder group, the election applies regarding each member of the controlling domestic shareholder group. Prop. Treas. Reg. § 1.951A-2(c)(6)(v)(E)(1). A “controlling domestic shareholder group” is defined as two or more CFCs if more than 50 percent of the stock (by voting power) of each CFC is owned (within the meaning of § 958(a)) by the same controlling domestic shareholder (or persons related to such controlling domestic shareholder) or, if no single controlling domestic shareholder owns (within the meaning of § 958(a)) more than 50% of the stock (by voting power) of each corporation, more than 50% of the stock (by voting power) of each corporation is owned (within the meaning of § 958(a)) in the aggregate by the same controlling domestic shareholders and each controlling domestic shareholder owns (within the meaning of § 958(a)) the same percentage of stock in each CFC. Prop. Treas. Reg. § 1.951A-2(c)(6)(v)(E)(2).
- (i) Accordingly, an election made under Prop. Treas. Reg. § 1.951A-2(c)(6)(v) applies regarding each item of income of each CFC in a group of commonly controlled CFCs that meets the effective rate test in Prop. Treas. Reg. § 1.951A-2(c)(6)(iii).
- (j) Treasury and the IRS request comments on the manner and terms of the election for the exception from gross tested income, including whether the limitations regarding revocations and the consistency requirements should be modified, such as by allowing the election to be made on an item-by-item or a CFC-by-CFC basis.
- (k) In general, the relevant items of income for purposes of the election under § 954(b)(4) pursuant to Prop. Treas. Reg. § 1.951A-2(c)(6) are all items of gross tested income attributable to a qualified business unit (“QBU”). Prop. Treas. Reg. § 1.951A-2(c)(6)(ii)(A)(1). For example, a CFC that owns a disregarded entity that qualifies as a QBU may have one item of income regarding the CFC itself (which is a per se QBU) and another item of income regarding the disregarded entity.

- (l) The proposed regulations provide that the gross income attributable to a QBU is determined by reference to the items of gross income reflected on the books and records of the QBU, determined under federal income tax principles, except that income attributable to a QBU must be adjusted to account for certain disregarded payments. Prop. Treas. Reg. § 1.951A-2(c)(6)(ii)(A)(2). They also provide an example to illustrate the application of this rule. Prop. Treas. Reg. § 1.951A-2(c)(6)(vi).
- (m) Treasury and the IRS request comments regarding whether additional rules are needed to properly account for other instances in which the income base upon which foreign tax is imposed does not match the items of income reflected on the books and records of the QBU determined under Federal income tax principles. For example, comments are requested on whether special rules are needed for associating taxes with income regarding partnerships (including hybrid partnerships), disregarded entities, or reverse hybrid entities, and how to address circumstances in which QBUs are permitted to share losses or determine tax liability based on combined income for foreign tax purposes.
- (n) Comments are also requested as to whether all of a CFC's QBUs located within a single foreign country or possession should be combined for purposes of performing the effective rate test in Prop. Treas. Reg. § 1.951A-2(c)(6)(iii) and whether the definition of QBU should be modified for purposes of the GILTI high tax exclusion in respect of the requirement to have a trade or business, maintain books and records, or other rules relating to QBUs.
- (o) Under Treas. Reg. § 1.954-1(d)(3), the determination of taxes paid or accrued regarding an item of income for purposes of the exception under § 954(b)(4) is determined for each U.S. shareholder based on the amount of foreign income taxes that would be deemed paid under § 960 if the item of income were included by the U.S. shareholder under § 951(a)(1)(A). Calculating the effective tax rate for purposes of the election under § 954(b)(4) regarding gross tested income by reference to § 960(d) would not be consistent with the aggregate nature of the computation under § 960(d). Treasury and the IRS also believe that the TCJA's change to § 960(a) from a pooling based approach to an annual attribution of taxes to income requires revising Treas. Reg. § 1.954-1(d)(3).
- (p) Therefore, the proposed regulations provide that for purposes of both the exception under § 954(b)(4) and the GILTI high tax exclusion, the effective rate of foreign tax imposed on an item of income is determined solely at the CFC level by allocating and

apportioning the foreign income taxes paid or accrued by the CFC in the current year to the CFC's gross income in that year based on the rules described in the regulations under § 960 for determining foreign income taxes "properly attributable" to income. Treas. Reg. § 1.960-1(d), as proposed to be amended.

- (q) To the extent foreign income taxes are allocated and apportioned to items of income that are excluded from gross tested income by the GILTI high tax exclusion, none of those foreign income taxes are properly attributable to tested income and thus none are allowed as a deemed paid credit under § 960. Treas. Reg. § 1.960-1(e), as proposed to be amended. In addition, if an item of income is excluded from gross tested income by reason of the GILTI high tax exclusion, the property used to produce that income, because not used in the production of gross tested income, does not qualify as specified tangible property, in whole or in part, and therefore the adjusted basis in the property is not taken into account in determining qualified business asset investment. Treas. Reg. § 1.951A-3(b) and (c)(1).
- (r) The proposed regulations also clarify the scope of each item of income under Treas. Reg. § 1.954-1(c)(1)(iii), consistent with the rules under Treas. Reg. § 1.960-1(d)(2)(ii)(B), as proposed to be amended.

3. Applicability Date. The changes related to the election to exclude a CFC's gross income subject to high foreign income taxes under § 954(b)(4) are proposed to apply to taxable years of foreign corporations beginning on or after the date that final regulations are published in the Federal Register, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

4. Example.

The following example illustrates the application of these rules.

(A) Example: Effect of disregarded payments between QBUs--
(1) Facts--(i) FP, a controlled foreign corporation organized in Country A, conducts a trade or business in Country A (the Country A Business) and reflects items of income, gain, loss, and expense attributable to the Country A Business on the books and records of FP's home office. Under Treas. Reg. § 1.989(a)-1(b)(2)(i)(A), FP is a QBU. FP's functional currency is the U.S. dollar. FP has a calendar year taxable year in both the U.S. and Country A.

(ii) FP owns FDE, a Country B disregarded entity (within the meaning of Treas. Reg. § 1.904-4(f)(3)(i)). FDE conducts activities in

Country B that constitute a trade or business within the meaning of Treas. Reg. § 1.989(a)-1(c) (the Country B Business), and reflects items of income, gain, loss, and expense attributable to the Country B Business on the books and records of FDE. Under Treas. Reg. § 1.989(a)-1(b)(2)(ii)(B), the Country B Business conducted through FDE is a QBU. The Country B Business's functional currency is the U.S. dollar. FDE has a calendar year taxable year in Country B.

(iii) On Date A in Year 1, FDE accrues \$100x of interest income from X, an unrelated third party, and reflects the accrual on the books and records of the Country B business. FP excludes the \$100x from foreign personal holding company income by reason of section 954(h). Subsequently, on Date B in Year 1, FDE accrues and pays \$20x of interest to FP. FP reflects the interest income item on the books and records of the Country A Business. FDE reflects the \$20x of interest expense on the books and records of the Country B Business.

(iv) Country A imposes no tax on income. Country B imposes a 25% tax on income. For Country B income tax purposes, FDE (which is not disregarded under Country B income tax principles) recognizes \$80x of taxable income (\$100x interest income, less a \$20x deduction for the interest paid to FP). Accordingly, FDE incurs a Country B income tax liability regarding Year 1, the U.S. dollar amount of which is \$20x. For Federal income tax purposes, if FDE were not a disregarded entity (within the meaning of Treas. Reg. § 1.904-4(f)(3)(i)), FP would recognize \$20x of income in Year 1, and FDE would recognize \$80x of taxable income in Year 1. Other than the \$20x expense accrued regarding the income tax imposed by Country B, FP incurs no deductions in Year 1 for Federal income tax purposes.

(2) Analysis--(i) A separate tentative gross tested income item must be determined regarding FP's Country A Business and Country B Business (each of which is a QBU). To determine the separate tentative gross tested income items regarding its Country A Business and Country B Business, FP must determine the gross income that is attributable to the Country A Business and the Country B Business. Without regard to the \$20x interest payment from FDE to FP, gross income attributable to the Country A Business would be \$0 (that is, \$20x of interest income reflected on the books and records of the Country A Business, reduced by \$20x attributable to a payment that is disregarded for Federal income tax purposes). Similarly, without regard to the \$20x interest payment from FDE to FP, gross income attributable to the Country B Business would be \$100x (that is, \$100x of interest income reflected on the books and records of the Country B Business, unreduced by the \$20x payment from FDE to FP). However, the \$20x payment from FDE to FP is a disregarded payment within the meaning of Treas. Reg. § 1.904-4(f)(3)(ii), and would, under the principles of Treas. Reg. § 1.904-4(f)(2)(vi) (without regard to

the exclusion described in Treas. Reg. § 1.904-4(f)(2)(vi)(C)(1)), adjust the gross income of the Country A Business from \$0 to \$20x and the gross income of the Country B Business from \$100x to \$80x (in each case, by virtue of the \$20x disregarded interest payment from FDE to FP). Accordingly, FP's tentative gross tested income attributable to the Country A Business is \$20x and its tentative gross tested income attributable to the Country B Business is \$80x.

(ii) Because there are no deductions allocated or apportioned under § 1.960-1(d)(3) to the tentative gross tested income items of the Country A Business, FP's tentative net tested income item attributable to the Country A Business is \$20x. Taking into account the \$20x deduction for Country B income taxes that are allocable to the Country B Business under Treas. Reg. § 1.960-1(d)(3), FP's tentative net tested income item attributable to the Country B Business is \$60x (tentative gross tested income of \$80x less the \$20x deduction).

(iii) For Year 1 (a CFC inclusion year of FP), the effective rate regarding FP's \$60x tentative net tested income item attributable to its Country B Business is 25%: \$20x (the U.S. dollar amount of the Country B taxes accrued regarding FP's tentative tested net income item attributable to the Country B Business) divided by \$80x (the U.S. dollar amount of FP's \$60x tentative net tested income item, increased by the \$20x amount of Country B income taxes accrued regarding that tentative net tested income item), expressed as a percentage. Therefore, FP's tentative net tested income item attributable to the Country B Business was subject to foreign income taxes at an effective rate (25%) that is greater than 18.9% (which is 90% of the rate that would apply if the income were subject to the maximum rate of tax specified in § 11, which is 21%). Accordingly, the requirement is satisfied regarding FP's tentative gross tested income item attributable to the Country B Business in Year 1. Further, the requirement is satisfied because an election was made regarding FP for Year 1. Accordingly, FP's \$80x item of tentative gross tested income attributable to its Country B Business qualifies for the high tax exception of § 954(b)(4).

(iv) FP's \$20x item of tentative net tested income attributable to its Country A Business is not subject to foreign income tax. Accordingly, FP's \$20x item of tentative gross tested income attributable to the Country A Business does not qualify for the high tax exception of § 954(b)(4).

III. FDII.

- A. Section 250(b) provides benefits for foreign-derived intangible income ("FDII").
 - 1. Under § 250(b)(4), the term FDII eligible income means income which is derived in connection with property which is sold ("sold" includes

licensed) by the taxpayer to any person who is not a United States person and which the taxpayer establishes to the satisfaction of the IRS is for a foreign use.

2. Services income qualifies if the services are rendered to persons not located in the U.S. or with respect to property not located within the U.S.
3. Under § 250(b)(5)(A), foreign use means any use, consumption or disposition which is not within the United States.
4. FDII is based on § 250(b)(3)'s definition of "Deduction Eligible Income." This means qualifying gross income less deductions "properly allocable" to such income.
5. A branch cannot earn FDII ("income attributable" to a branch cannot be FDII). § 250(b)(3)(A).

B. Unrelated Domestic Intermediaries.

1. Section 250(b)(5)(B) provides certain rules that relate to property or services provided to domestic intermediaries.
2. If a taxpayer sells property to another person (other than a related person) for further manufacture or other modification within the U.S., the property will not be treated as sold for a foreign use even if such other person subsequently uses the property for a foreign use.
3. The services rule's analog to this sales rule provides that if the taxpayer provides services to unrelated persons located in the U.S., the services do not qualify even if the other person uses the services in providing services which do so qualify.

C. Foreign Related-Party Transactions. Section 250(b)(5)(C) contains special rules with respect to related-party transactions.

1. If property is sold to a related party who is not a United States person, the sale will not be treated as for a foreign use unless the property is ultimately sold by a related party, or used by a related party in connection with the property which is sold or the provision of services, to another person who is an unrelated person who is not a United States person and the taxpayer establishes to the satisfaction of the IRS that the property is for a foreign use.
2. The services rule's analog provides that services provided to a related person who is not in the U.S. do not qualify unless the taxpayer proves the service is not substantially similar to services provided by such related person to persons located in the U.S.

D. FDII Regulations. The newly proposed Foreign-Derived Intangible Income (“FDII”) regulations provide guidance for determining the amount of the § 250 deduction allowed to a domestic corporation for its FDII and its Global Intangible Low-Taxed Income (“GILTI”). Prop. Treas. Reg. § 1.250(a)-1 provides rules for determining the amount of the deduction, including rules for applying the taxable income limitation of § 250(a)(2). Prop. Treas. Reg. § 1.250(b)-1 provides general rules for computing a domestic corporation’s FDII. Prop. Treas. Reg. § 1.250(b)-2 provides rules for determining a domestic corporation’s qualified business asset investment (“QBAI”), which is a component of the computation of FDII. Prop. Treas. Reg. § 1.250(b)-3 provides general rules for determining gross income included in gross foreign-derived deduction eligible income (“gross FDDEI”), which is a component of the computation of FDII. Prop. Treas. Reg. § 1.250(b)-4 provides rules for determining gross FDDEI from sales of property. Prop. Treas. Reg. § 1.250(b)-5 provides rules for determining gross FDDEI from the provision of services. Prop. Treas. Reg. § 1.250(b)-6 provides rules relating to the sale of property or the provision of a service to a related party.

1. Amount of Deduction Allowed Under § 250(A).

- (a) Prop. Treas. Reg. § 1.250(a)-1 provides general rules to determine the amount of a domestic corporation’s § 250 deduction and associated definitions that apply for purposes of the proposed regulations. The § 250 deduction is available only to domestic corporations. § 250(a)(1) and Prop. Treas. Reg. § 1.250(a)-1(b)(1). For this purpose, the term “domestic corporation” has the meaning set forth in § 7701(a) – an association, joint-stock company, or insurance company created or organized in the U.S. or under the law of the U.S. or of any state – but does not include a regulated investment company (as defined in § 851), a real estate investment trust (as defined in § 856), or an S corporation (as defined in § 1361). Prop. Treas. Reg. § 1.250(a)-1(c)(1). The § 250 deduction is not available to individuals except in certain cases where an individual makes an election under § 962.
- (b) According to the preamble, the deduction under § 250 is intended to reduce the effective rate of U.S. income tax on FDII and GILTI in order to help neutralize the role that tax considerations play when a domestic corporation chooses the location of intangible income attributable to foreign-market activity. Accordingly, the proposed regulations provide that a § 250 deduction is not treated as an ordinary and necessary expense paid or incurred for the production or collection of gross investment income within the meaning of § 4940(c)(3)(A). Prop. Treas. Reg. § 1.250(a)-1(b)(4).
- (c) The § 250 deduction is subject to a taxable income limitation. If, for any taxable year, the sum of a domestic corporation’s FDII and GILTI exceeds its taxable income, the excess is allocated pro rata

to reduce the corporation's FDII and GILTI solely for purposes of computing the amount of the § 250 deduction. § 250(a)(2) and Prop. Treas. Reg. § 1.250(a)-1(b)(2). For this purpose, a domestic corporation's taxable income is determined without regard to the § 250 deduction. § 250(a)(2)(A)(ii) and Prop. Treas. Reg. § 1.250(a)-1(c)(4).

- (d) In general, a taxpayer's taxable income is based, in part, upon the availability, and proper calculation, of deductions. However, multiple Code provisions simultaneously limit the availability of a deduction based, directly or indirectly, upon a taxpayer's taxable income, including §§ 163(j)(1) (limiting a deduction for business interest) and 172(a)(2) (limiting a net operating loss deduction). Sections 163(j)(2) and 172(b) also provide that any deduction not allowed to a taxpayer for a taxable year by reason of the limitation in § 163(j)(1) or 172(a)(2), respectively, may be allowed to the taxpayer, subject to the same limitation, in its succeeding taxable year. A taxpayer's net operating loss for a taxable year is determined without regard to the § 250 deduction (§ 172(d)(9)), and a taxpayer's adjusted taxable income is determined without regard to § 172. § 163(j)(8)(A)(iii). However, neither § 163(j) nor § 250 prescribes an ordering rule regarding the other provision.
- (e) The proposed regulations provide an ordering rule for applying §§ 163(j) and 172 in conjunction with § 250. Treasury and the IRS rejected requiring the use of simultaneous equations. They believe this is consistent with the statutory language. Specifically, the proposed regulations provide that a domestic corporation's taxable income for purposes of applying the taxable income limitation of § 250(a)(2) is determined after all of the corporation's other deductions are taken into account. Prop. Treas. Reg. § 1.250(a)-1(c)(4). Accordingly, a domestic corporation's taxable income for purposes of § 250(a)(2) is its taxable income determined without regard to § 250, but taking into account the application of §§ 163(j) and 172(a), including amounts permitted to be carried forward to the taxable year by reason of §§ 163(j)(2) and 172(b).
- (f) The proposed regulations issued under § 163(j) provide guidance on the interaction of §§ 163(j) and 250 that Treasury and the IRS believe is consistent with the proposed regulations under § 250. Specifically, the proposed regulations under § 163(j) provide that, for purposes of determining the limitation under § 163(j), a deduction under § 250(a)(1) that is properly allocable to a non-excepted trade or business is taken into account in determining a taxpayer's taxable income and thus its adjusted taxable income. *See* Prop. Treas. Reg. § 1.163(j)-1(b)(37)(ii). However, for this

purpose, the taxpayer's deduction under § 250(a)(1) is determined without regard to the limitations under §§ 250(a)(2) and 163(j).

- (g) As a result of the proposed regulations under § 250 and the proposed regulations under § 163(j), a domestic corporation's allowable business interest under § 163(j), its net operating loss deduction under § 172(a), and its § 250 deduction are determined in the following manner:

First, a domestic corporation computes the tentative amount of its FDII and the tentative amount of its § 250 deduction ("tentative § 250 deduction") taking into account all deductions, but without regard to any carryforwards or disallowances under § 163(j), the amount of any net operating loss deduction under § 172(a), or the taxable income limitation of § 250(a)(2) and Prop. Treas. Reg. § 1.250(a)-1(b)(2).

Second, the corporation computes the amount of its business interest allowed after the application of § 163(j), for this purpose taking into account the amount of its tentative § 250 deduction but without regard to the amount of any net operating loss deduction under § 172(a). § 163(j)(8)(A)(iii) and Prop. Treas. Regs. §§ 1.163(j)-1(b)(1)(i)(B) and (b)(37)(ii).

Third, the corporation computes the amount of its net operating loss deduction under § 172(a), for this purpose taking into account the amount of its business interest allowed after application of § 163(j) and the taxable income limitation of § 172(a)(2), but without regard to the amount of its § 250 deduction (including its tentative § 250 deduction). § 172(d)(9).

Fourth, the corporation computes the amount of its FDII, for this purpose taking into account the amount of its business interest allowed after application of § 163(j) and the amount of its net operating loss deduction under § 172(a) (determined in steps two and three, respectively).

Fifth, the corporation computes the amount of its § 250 deduction after the application of the taxable income limitation of § 250(a)(2) and Prop. Treas. Reg. § 1.250(a)-1(b)(2), for this purpose taking into account the amount of its business interest allowed after application of § 163(j) and the amount of its net operating loss deduction under § 172(a). Prop. Treas. Reg. § 1.250(a)-1(f)(2) (Example 2), which illustrates the interaction of §§ 163(j), 172, and 250.

2. Determination of FDII.

(a) Determination of DEI and FDDEI.

- i. A domestic corporation's deduction eligible income ("DEI") is the excess of its gross income without regard to certain excluded items ("gross DEI") over the deductions properly allocable to gross DEI. Prop. Treas. Reg. § 1.250(b)-1(c)(2). Gross DEI excludes six categories of gross income: any amount included in gross income under § 951(a), GILTI, financial services income, dividends from CFCs, domestic oil and gas extraction income, and foreign branch income. See Prop. Treas. Reg. § 1.250(b)-1(c)(14).
- ii. The proposed regulations provide that, for this purpose, a dividend includes any amount treated as a dividend under any other provision of subtitle A of the Internal Revenue Code, including the § 78 gross-up attributable to inclusions under §§ 951(a) and 951A(a). Prop. Treas. Reg. § 1.250(b)-1(c)(5). The proposed regulations also define foreign branch income by reference to Prop. Treas. Reg. § 1.904-4(f), except that it also includes the sale, directly or indirectly, of any asset (other than stock) that produces gross income attributable to a foreign branch, including by reason of the sale of a disregarded entity or partnership interest. Prop. Treas. Reg. § 1.250(b)-1(c)(11). The result is that income from the sale of these assets is not included in gross DEI.
- iii. For purposes of calculating the foreign-derived ratio, Foreign-Derived Deduction Eligible Income ("FDDEI") is the excess of gross FDDEI over deductions properly allocable to gross FDDEI. Prop. Treas. Reg. § 1.250(b)-1(c)(12). The proposed regulations define gross FDDEI as the portion of a corporation's gross DEI that is derived from all of its "FDDEI sales" and "FDDEI services" (collectively, "FDDEI transactions"). Prop. Treas. Reg. § 1.250(b)-1(c)(8), (9), (10), and (15).
- iv. The determination of whether a sale of property or a provision of a service is a FDDEI sale or a FDDEI service, respectively, is made under the provisions of Prop. Treas. Reg. §§ 1.250(b)-3 through 1.250(b)-6. The portion of a corporation's gross DEI that is not gross FDDEI is referred to as gross non-FDDEI. Prop. Treas. Reg. § 1.250(b)-1(c)(16).

- v. Therefore, all income included in gross DEI is included in either gross FDDEI or gross non-FDDEI, and all income included in either gross FDDEI or gross non-FDDEI is included in gross DEI.
- vi. In the case of property produced or acquired for resale, gross income is generally determined by subtracting cost of goods sold from gross sales receipts. In determining the amount of gross income included in gross DEI or gross FDDEI, cost of goods sold is attributed to gross receipts with respect to gross DEI and gross FDDEI using any reasonable method. Prop. Treas. Reg. § 1.250(b)-1(d)(1).
- vii. The proposed regulations provide that cost of goods sold that is associated with activities undertaken in an earlier taxable year cannot be segregated into component costs and attributed disproportionately to amounts excluded from gross FDDEI or to amounts excluded from gross DEI. This is similar to Prop. Treas. Reg. § 1.199-4(b)(2)(iii)(A) and is intended to preclude a method that attributes cost of goods sold of an inventory item to gross receipts other than gross receipts included in the computation of gross DEI or gross FDDEI if the gross receipts from the sale of that item are included in the computation of amounts included in the computation of gross DEI or gross FDDEI, respectively.
- viii. Section 250(b)(3)(A) defines DEI as the excess of a domestic corporation's gross income (excluding certain items) over "the deductions (including taxes) properly allocable to such gross income." FDDEI is defined as "any deduction eligible income" of the taxpayer generated through foreign-market sales and services. *See* § 250(b)(4). Therefore, a taxpayer's deductions that are "properly allocable" to gross DEI and gross FDDEI must be determined for purposes of calculating its DEI and FDDEI.
- ix. The statute does not specify how deductions should be allocated for purposes of determining DEI and FDDEI. The § 250 proposed regulations' preamble states that the rules set forth in Treas. Reg. §§ 1.861-8 through 1.861-14T and 1.861-17 apply for purposes of several other provisions in the Code which require the determination of taxable income from specific sources or activities, for example, for purposes of determining the foreign tax credit limitation under § 904 or qualified production activities income under former § 199. *See generally* Treas. Reg. §§ 1.199-4 and 1.861-8(f)(1).

- x. Accordingly, the proposed regulations provide that the rules set forth in Treas. Reg. §§ 1.861-8 through 1.861-14T and 1.861-17 apply for purposes of determining DEI and FDDEI. Prop. Treas. Reg. § 1.250(b)-1(d)(2)(i). In order to avoid circularity, in applying those rules for purposes of determining DEI and FDDEI, the § 250 deduction is not treated as giving rise to exempt income or assets. Prop. Treas. Reg. § 1.861-8(d)(2)(ii)(C)(4).
- xi. In certain circumstances, as a result of expense apportionment or attribution of cost of goods sold, a domestic corporation's FDDEI could exceed its DEI. For example, a domestic corporation could have \$80x of DEI and \$100x of FDDEI, with losses attributable to domestic market sales accounting for the \$20x difference between DEI and FDDEI.
- xii. It would be inconsistent with the statutory language to treat a domestic corporation as having a foreign-derived ratio in excess of one, and therefore FDII in excess of DII. In particular, § 250(b)(4) defines FDDEI as a subset of DEI, that is, "any deduction eligible income of such taxpayer which is derived in connection with" certain transactions. Therefore, the proposed regulations provide that the foreign-derived ratio cannot exceed one. Prop. Treas. Reg. § 1.250(b)-1(c)(13).

(b) Treatment of Partnerships.

- i. Section 250(a)(1) allows a deduction to a domestic corporation, but does not provide any rules for domestic corporations that are partners in a partnership. The conference report accompanying TCJA ("Conference Report") suggests that Congress intended that a domestic corporate partner of a partnership receive the benefit of a § 250 deduction for its FDII and GILTI. ("The Committee intends that the deduction allowed by new Code § 250 be treated as exempting the deducted income from tax. Thus, for example, the deduction for global intangible low-taxed income could give rise to an increase in a domestic corporate partner's basis in a domestic partnership under § 705(a)(1)(B).").
- ii. The proposed regulations give effect to this legislative intent by adopting an aggregate approach to partnerships for determining a domestic corporate partner's FDII attributable to the income and assets of a partnership.

Specifically, the proposed regulations provide that a domestic corporate partner of a partnership takes into account its distributive share of a partnership's gross DEI, gross FDDEI, and deductions in order to calculate the partner's FDII. Prop. Treas. Reg. § 1.250(b)-1(e)(1).

- iii. In addition, for purposes of determining a domestic corporate partner's DTIR, a domestic corporation's QBAI is increased by its share of the partnership's adjusted basis in partnership specified tangible property. Prop. Treas. Reg. § 1.250(b)-2(g).
- iv. Under the proposed regulations, the § 250 deduction is computed and allowed solely at the level of a domestic corporate partner. The Conference Report in footnote 1517 suggests that the § 250 deduction could give rise to an increase in a domestic corporate partner's basis in a domestic partnership under § 705(a)(1)(B) because some of the partnership's income may be treated as exempt income by reason of § 250. However, the preamble states that regardless of whether the deduction gives rise to exempt income in other contexts, because the § 250 deduction is computed and allowed solely at the level of a domestic corporate partner, the § 250 deduction does not exempt the deducted income from tax for purposes of applying § 705(a)(1)(B). As a result, Treasury and the IRS believe that a basis adjustment to a domestic corporate partner's interest in a domestic partnership is not appropriate to account for a § 250 deduction.

(c) Treatment of Tax-Exempt Corporations. A domestic corporation that is subject to the unrelated business income tax under § 511 may claim a § 250 deduction. The proposed regulations provide that the exempt corporation's FDII for this purpose is determined only with respect to the corporation's items of income, gain, deduction, or loss, and adjusted bases in property, that are taken into account in computing its unrelated business taxable income. Prop. Treas. Reg. § 1.250(b)-1(g). The proposed regulations also provide how a tax-exempt corporation subject to the unrelated business income tax under § 511 computes the dual use ratio with respect to property used in the production of gross DEI and income that is not gross DEI for purposes of determining its QBAI.

(d) Determination of QBAI.

- i. Section 250(b)(2)(B) provides that QBAI for purposes of § 250 is defined under § 951A(d), and is determined by

substituting “deduction eligible income” for “tested income” and without regard to whether the corporation is a CFC. Accordingly, the determination of QBAI for purposes of FDII is similar to the determination of QBAI for purposes of GILTI. Compare Prop. Treas. Reg. § 1.951A-3 with Prop. Treas. Reg. § 1.250(b)-2.

- ii. A domestic corporation’s QBAI for FDII is equal to its aggregate average adjusted bases in specified tangible property, which is defined as tangible property used in the production of gross DEI. Prop. Treas. Reg. § 1.250(b)-2(b) and (c). The proposed regulations also provide rules for dual use property, calculating QBAI in a short taxable year, and calculating a domestic corporate partner’s share of partnership QBAI. Prop. Treas. Reg. § 1.250(b)-2(d), (f), and (g).
- iii. All regulations in this tax era contain anti-abuse rules. Thus, in order to prevent the avoidance of the purposes of QBAI, the proposed regulations disregard certain transfers of specified tangible property by a domestic corporation to a related party where the corporation continues to use the property in production of gross DEI. *See* §§ 250(c) and 951A(d)(4).
- iv. Specifically, for purposes of calculating a domestic corporation’s QBAI, the proposed regulations disregard a transfer of specified tangible property by the domestic corporation to a related party (whose QBAI would not be taken into account in calculating the corporation’s DTIR) if, within a two-year period beginning one year before the transfer, the domestic corporation (or a related party whose QBAI would be taken into account in calculating the corporation’s DTIR) leases the same or substantially similar property from a related party and such transfer and lease occur pursuant to a principal purpose of reducing the domestic corporation’s DTIR. Prop. Treas. Reg. § 1.250(b)-2(h)(1) and (h)(4)(i) through (iv).
- v. A transfer and lease described in the preceding sentence is treated per se as occurring pursuant to a principal purpose of reducing a domestic corporation’s DTIR if both the transfer and the lease occur within the same six-month period. *See* Prop. Treas. Reg. § 1.250(b)-2(h)(3).
- vi. If the anti-avoidance rule applies, the domestic corporation that transferred the property is treated as owning such

property from the later of the beginning of the term of the lease or date of the transfer until the earlier of the end of the term of the lease or the end of the recovery period of the transferred property. Prop. Treas. Reg. § 1.250(b)-2(h)(1).

- vii. The anti-avoidance rule does not apply to a transfer to and lease from an unrelated party, unless the transfer to and lease from the unrelated party is pursuant to a structured arrangement. Prop. Treas. Reg. § 1.250(b)-2(h)(2). A structured arrangement exists only if either a reduction in the domestic corporation's DTIR is a material factor in the pricing of the arrangement with the transferee or, based on all the facts and circumstances, the reduction in the domestic corporation's DTIR is a principal purpose of the arrangement.
- viii. The proposed regulations provide a non-inclusive list of facts and circumstances indicating that a principal purpose of an arrangement is the reduction of DTIR. Prop. Treas. Reg. § 1.250(b)-2(h)(2)(ii)(A) through (D).

3. General Rules for FDDEI Transactions.

(a) Definitions of Sale, Foreign Person, and U.S. Person

- i. Prop. Treas. Reg. § 1.250(b)-3 provides rules relevant to determining whether a sale of property is a FDDEI sale and whether a provision of a service is a FDDEI service.
- ii. Section 250(b)(5)(E) provides that for purposes of § 250(b), the term "sale" includes any lease, license, exchange, or other disposition. Accordingly, for purposes of determining whether a sale of property is a FDDEI sale, the proposed regulations define "sale" to include a lease, license, exchange, or other disposition of property, including a transfer of property resulting in gain or an income inclusion under § 367. Prop. Treas. Reg. § 1.250(b)-3(b)(7).
- iii. The proposed regulations define a foreign person as a person that is not a U.S. person, which includes a foreign government or international organization for purposes of the proposed regulations. Prop. Treas. Reg. § 1.250(b)-3(b)(2). A U.S. person ("U.S. person") has the same meaning as under § 7701(a)(30), except that an individual that is a bona fide resident of a U.S. territory within the

meaning of § 937(a) is excluded. Prop. Treas. Reg. § 1.250(b)-3(b)(10).

- iv. While corporations formed in U.S. territories are generally treated as foreign corporations, under § 7701(a)(30), U.S. persons include all U.S. citizens or residents, regardless of whether they reside in a U.S. territory. However, a bona fide resident of a U.S. territory is generally exempt from U.S. tax on income sourced in that territory. See §§ 931(a), 932(c)(4), 933(1), and 935. Therefore, to prevent the disparate treatment of sales to entities in a U.S. territory (potentially qualifying as a FDDEI sale) and sales to individuals in a U.S. territory (not qualifying as a FDDEI sale), the proposed regulations exclude bona fide residents of a U.S. territory from the definition of U.S. person.
- v. A partnership is generally a “person” for purposes of the Code. § 7701(a)(1). Accordingly, in determining whether a sale of property to or by a partnership qualifies as a FDDEI sale, or the provision of a service to or by a partnership qualifies as a FDDEI service, the proposed regulations treat a partnership as a person. Prop. Treas. Reg. § 1.250(b)-3(g). Therefore, for example, a sale of property to a foreign partnership for a foreign use may constitute a FDDEI sale because the sale is to a foreign person, whereas a sale of property to a domestic partnership, even if for a foreign use, will not constitute a FDDEI sale because such sale is to a domestic person.
- vi. The proposed regulations provide that the term “United States” generally has the meaning described in § 7701(a)(9). Prop. Treas. Reg. § 1.250(b)-3(b)(9). However, with respect to mines, oil and gas wells, and other natural deposits, the term United States includes certain seabed and subsoil of submarine areas adjacent to the territorial waters of the United States, as described in § 638(1).

(b) Foreign Military Sales.

- i. Treasury and the IRS recognize that the statute is unclear regarding whether a sale of property or the provision of a service to the U.S. government for resale or on-service to a foreign government under the Arms Export Control Act of 1976, as amended (“AECA”), can qualify for the § 250 deduction. In general, the AECA governs the export of certain sales and services to foreign governments. Under

the AECA, a seller or service provider provides sales or services to the U.S. government that are for the ultimate benefit of a foreign government. The concern is that such sale or service to the U.S. government governed by the AECA is not a sale to a “person who is not a United States person” within the meaning of § 250(b)(4)(A) or a service to a “person not located within the United States” within the meaning of § 250(b)(4)(B), notwithstanding that such a sale or service is ultimately provided to the foreign government.

- ii. Prop. Treas. Reg. § 1.250(b)-3(c) provides that, for purposes of § 250, a sale of property or the provision of a service to the U.S. government under the AECA is treated as a sale of property or provision of a service to a foreign government.
 - iii. A foreign government or international organization is a foreign person for purposes of § 250 and the proposed regulations. Prop. Treas. Reg. § 1.250(b)-3(b)(2). Therefore, a sale of property or provision of a service to the U.S. government under the AECA may qualify as a FDDEI transaction if the other requirements under Prop. Treas. Reg. §§ 1.250(b)-3 through 1.250(b)-6 are satisfied. To the extent other requirements under Prop. Treas. Reg. §§ 1.250(b)-3 through 1.250(b)-6 are not satisfied, a sale or service will not qualify as a FDDEI transaction regardless of whether such sale or service is pursuant to the AECA.
 - iv. Treasury and the IRS have not identified readily available documentation sufficient to demonstrate that a particular sale or service was made pursuant to the AECA. Comments were requested on whether final regulations should provide guidance on how taxpayers can demonstrate that a sale or service has been made pursuant to the AECA.
- (c) Knowledge and Reason to Know. The proposed regulations provide that a sale of property qualifies as a FDDEI sale only if the seller or renderer does not know or have reason to know that the recipient is not a foreign person or that the property will not be for a foreign use. Prop. Treas. Reg. § 1.250(b)-4(c), (d), and (e). In addition, the proposed regulations provide that the provision of a general service (as defined in Prop. Treas. Reg. § 1.250(b)-5(c)(4)) qualifies as a FDDEI service only if the renderer of the service does not know or have reason to know that the recipient is located within the U.S. Prop. Treas. Reg. § 1.250(b)-5(d)(1) and (e)(1).

(d) Reliability of Documentation.

- i. In order for a transaction to constitute a FDDEI transaction, the proposed regulations prescribe different types of documentation that are required to be obtained for each type of transaction. For example, in the case of a sale of property, the seller must obtain documentation that establishes the recipient's status as a foreign person. Prop. Treas. Reg. § 1.250(b)-4(c)(2).
- ii. The proposed regulations provide that, for any documentation described in the proposed regulations to be relied upon, the seller or renderer must obtain the documentation by the FDII filing date, the documentation must be obtained no earlier than one year before the sale or service, and the seller or renderer must not know or have reason to know that the documentation is incorrect or unreliable. Prop. Treas. Reg. § 1.250(b)-3(d); *see also* Prop. Treas. Reg. § 1.250(b)-3(b)(1) (defining the term "FDII filing date").
- iii. Specifically, Prop. Treas. Reg. § 1.250(b)-3(d) provides:

Reliability of Documentation. Documentation is reliable only if each of the requirements described below is satisfied:

(1) As of the FDII filing date, the seller or renderer does not know and does not have reason to know that the documentation is unrealizable or incorrect. For this purpose, a seller or renderer has reason to know that documentation is unreliable or incorrect if its knowledge of all the relevant facts or statements contained in the documentation is such that a reasonably prudent person in the position of the seller or renderer would question the accuracy of reliability of the documentation.

(2) The documentation is obtained by the seller or renderer by the FDII filing date with respect to the sale or service.

(3) The documentation is obtained no earlier than one year before the date of the sale or service.

- iv. Thus, the proposed regulations adopt the approach of a reasonably prudent person in the position of the seller or renderer in determining whether the accuracy of the

documentation should be questioned. Prop. Treas. Reg. § 1.250(b)-3(d)(1).

(e) Transactions Consisting of Both Sales and Services.

- i. Under § 250(b)(4) and (5) and these proposed regulations, the criteria for establishing that a transaction is foreign-derived is different for sales and services. For example, a transaction with a U.S. person that is located outside of the U.S. might qualify as a FDDEI service, but cannot qualify as a FDDEI sale. Because a transaction could include elements of both a sale and a service, the proposed regulations clarify that a transaction is classified according to the overall predominant character of the transaction. Prop. Treas. Reg. § 1.250(b)-3(e).
- ii. For example, a sale of equipment that includes incidental support services from the seller at no additional cost would be classified as a sale, and therefore the provisions of Prop. Treas. Reg. § 1.250(b)-4 would apply to determine whether gross income from the transaction is included in gross FDDEI.

(f) Special Rule for Certain Loss Transactions.

- i. A domestic corporation's FDDEI includes all gross income included in gross DEI that is derived from FDDEI sales and FDDEI services in a taxable year, reduced by the amount of deductions properly allocable to such income. Prop. Treas. Reg. § 1.250(b)-1(c)(12). In most cases, a FDDEI sale or FDDEI service will increase a domestic corporation's § 250 deduction, because the income from such sale or service will increase the corporation's FDDEI and thus its foreign-derived ratio. However, in some cases, a FDDEI sale or a FDDEI service could have the effect of reducing FDDEI and thus a domestic corporation's § 250 deduction for the year.
- ii. This could happen where, for instance, the domestic corporation's cost of goods sold attributed to property sold in a FDDEI sale exceeds its gross receipts from the sale, or the expenses allocated to the gross income from a FDDEI sale or FDDEI service exceed the gross income arising from the sale or service.
- iii. In this case, absent a rule to the contrary, a domestic corporation could intentionally fail to satisfy the

documentation requirements with respect to a transaction that would otherwise qualify as a FDDEI sale or FDDEI service in order to prevent the transaction from reducing its FDDEI and thereby its § 250 deduction.

- iv. Section 250(b) does not contemplate a transaction-by-transaction determination of FDII, but rather an aggregate calculation based on all gross income “which is derived in connection with” sales and services described in § 250(b)(4).
 - v. Treasury and the IRS believe that it would be inappropriate to permit taxpayers to elect to exclude losses related to sales to foreign persons for a foreign use and services to persons located outside the U.S. by merely failing the documentation requirements. Accordingly, under another anti-abuse rule, the proposed regulations provide that if a seller or renderer knows or has reason to know that property is sold to a foreign person for a foreign use or a general service is provided to a person located outside the U.S., but the seller or renderer does not satisfy the documentation requirements applicable to such sale or service, the sale of property or provision of a service is nonetheless deemed a FDDEI transaction if treating the sale or service as a FDDEI transaction would reduce a domestic corporation’s FDDEI. Prop. Treas. Reg. § 1.250(b)-3(f).
 - vi. The special loss transaction rule in Prop. Treas. Reg. § 1.250(b)-3(f) does not apply to proximate services, property services, and transportation services, each of which is defined and discussed separately below, because the proposed regulations do not require documentation with respect to such services. Therefore, a proximate service, property service, or transportation service is a FDDEI service if it meets the applicable substantive requirements for a FDDEI service described in Prop. Treas. Reg. § 1.250(b)-5(f), (g), and (h), respectively.
4. FDDEI Sales. Section 250(b)(4)(A) provides that FDDEI includes income from property the taxpayer sells to any person who is not a U.S. person, and which the taxpayer establishes to the satisfaction of the Secretary is for a foreign use. Accordingly, the proposed regulations define a FDDEI sale as a sale of property to a foreign person for a foreign use. Prop. Treas. Reg. § 1.250(b)-4(b).

(a) Foreign Person.

i. The proposed regulations provide that a recipient is treated as a foreign person only if the seller obtains documentation of the recipient's foreign status and does not know or have reason to know that the recipient is not a foreign person. Prop. Treas. Reg. § 1.250(b)-4(c)(1). The proposed regulations provide several types of permissible documentation for this purpose, such as a written statement by the recipient indicating that the recipient is a foreign person. Prop. Treas. Reg. § 1.250(b)-4(c)(2)(i).

ii. Specifically, Prop. Treas. Reg. § 1.250(b)-4(c)(2) provides:

Documentation of status as a foreign person. A seller generally establishes the status of a recipient as a foreign person by obtaining one or more of the following types of documentation with respect to the person—

(1) A written statement by the recipient that the recipient is a foreign person;

(2) With respect to a recipient that is an entity, documentation that establishes that the entity is organized or created under the laws of a foreign jurisdiction;

(3) With respect to an individual, any valid identification issued by a foreign government or agency thereof that is typically used for identification purposes;

(4) Documents filed with a government or an agency or instrumentality thereof that provide the foreign jurisdiction or organization or residence of an entity (for example, a publicly traded corporations' annual report filed with the U.S. Securities and Exchange commission that includes the jurisdiction of organization or residence of foreign subsidiaries of the corporation); or

(5) Any other forms of documentation as prescribed by the Secretary in forms, instructions, or other guidance.

iii. To alleviate the burden of documentation on small businesses and small transactions, the proposed regulations allow a seller that has less than \$10,000,000 of gross receipts in the prior taxable year, or less than \$5,000 in gross receipts from a single recipient during the current taxable year, to treat a recipient as a foreign person if the

seller has a shipping address for the recipient that is outside the U.S. Prop. Treas. Reg. § 1.250(b)-4(c)(2)(ii).³

- iv. A Treasury official stated at a Federal Bar Association conference that the documentation options in the final regulations will be expanded beyond those set forth in the proposed regulations. Attorney-advisor Gary Scanlon stated that generally, the rules were intended to allow taxpayers to document through their normal business records, and requested comments from taxpayers. *See* Velarde, U.S. Treasury Promises Expansion of FDII Documentation Rules, Tax Notes Today, 2019 WTD 66-3 (Apr. 5, 2019).

(b) Foreign Use.

- i. Under the proposed regulations, the rules applicable to the determination of whether a sale of property is for a foreign use depends on whether the property sold is “general property” or “intangible property.” Prop. Treas. Reg. § 1.250(b)-4(d) and (e). The proposed regulations define general property as property other than intangible property, a security (as defined in § 475(c)(2)), or a commodity (as defined in § 475(e)(2)(B) through (D)). *See* Prop. Treas. Reg. § 1.250(b)-3(b)(3). The proposed regulations define intangible property by cross-reference to § 367(d)(4). Prop. Treas. Reg. § 1.250(b)-3(b)(4).
- ii. The proposed regulations provide that a sale of a security (as defined in § 475(c)(2)) or a commodity (as defined in § 475(e)(2)(B) through (D)) is not a FDDEI sale because such financial instruments are not subject to “any use, consumption, or disposition” outside the U.S. within the meaning of § 250(b)(5)(A). Prop. Treas. Reg. § 1.250(b)-4(f).
- iii. The proposed regulations provide that a sale of property (whether general property or intangible property) is treated as for a foreign use only if the seller obtains documentation that the property is for a foreign use and does not know or have reason to know, as of the FDII filing date, that the property is not for a foreign use (or, in the case of intangible property, that the portion of the sale of the

³ The proposed regulation says “a” prior year for the less-than \$10,000 rule; the preamble says “the” prior year. The proposed regulation also is more clear than the preamble in that the less-than-\$5,000 rule applies to each less-than \$5,000 recipient.

intangible property for which the seller establishes foreign use is not for a foreign use). Prop. Treas. Reg. § 1.250(b)-4(d)(1) and (e)(1).

- iv. Accordingly, if, as of the FDII filing date, the seller does not know or have reason to know that either the documentation obtained with respect to the sale is not reliable or that the property is not for a foreign use within the meaning of Prop. Treas. Reg. § 1.250(b)-4(d)(2) or (e)(2), then the sale of the property is treated as for a foreign use under Prop. Treas. Reg. § 1.250(b)-4(d)(1) or (e)(1) even if, in fact, the sale of such property is not for a foreign use within the meaning of Prop. Treas. Reg. § 1.250(b)-4(d)(2) or (e)(2).

(c) Foreign Use for General Property.

- i. The sale of general property is for a foreign use if either the property is not subject to domestic use within three years of delivery of the property or the property is subject to manufacture, assembly, or other processing outside the U.S. before any domestic use of the property. Prop. Treas. Reg. § 1.250(b)-4(d)(2)(i) and Conf. Rep. at 625, fn. 1522 (“If property is sold by a taxpayer to a person who is not a U.S. person, and after such sale the property is subject to manufacture, assembly, or other processing (including the incorporation of such property, as a component, into a second product by means of production, manufacture, or assembly) outside the U.S. by such person, then the property is for a foreign use.”).
- ii. Domestic use is defined as the use, consumption, or disposition of property within the U.S., including manufacture, assembly, or other processing within the U.S. Prop. Treas. Reg. § 1.250(b)-4(d)(2)(ii).
- iii. Specifically, Prop. Treas. Reg. § 1.250(b)-4(d)(2)(i) provides:

Determination of foreign use. The sale of general property is for a foreign use if –

(1) The property is not subject to a domestic use within three years of the date of delivery, or

(2) The property is subject to manufacture, assembly, or other processing outside the U.S. before the property is subject to a domestic use.

Prop. Treas. Reg. § 1.250(b)-4(d)(2)(ii) provides:

Determination of domestic use. General property is subject to domestic use if –

- (1) The property is subject to any use, consumption, or disposition within the U.S., or
 - (2) The property is subject to manufacture, assembly, or other processing within the U.S.
- iv. General property is subject to manufacturing, assembly, or other processing only if it meets either of the following two tests: (1) there is a physical and material change to the property, or (2) the property is incorporated as a component into a second product. Prop. Treas. Reg. § 1.250(b)-4(d)(2)(iii)(A). The proposed regulations clarify that a physical and material change does not include “minor assembly, packaging, or labeling.” Prop. Treas. Reg. § 1.250(b)-4(d)(2)(iii)(B.) However, whether property has undergone a physical and material change (as opposed to minor assembly, packaging, or labeling) is determined based on all the relevant facts and circumstances.
- v. General property is incorporated as a component into a second product only if the fair market value of the property when it is delivered to the recipient constitutes no more than 20% of the fair market value of the second product, determined when the second product is completed. Prop. Treas. Reg. § 1.250(b)-4(d)(2)(iii)(C). If the seller sells multiple items of property that are incorporated into the second product, an aggregation rule treats all of the property sold by the seller that is incorporated into the second product as a single item of property for purposes of determining whether the property constitutes more than 20% of the fair market value of the second product.
- vi. Prop. Treas. Reg. § 1.250(b)-4(d)(4) illustrates the above rules with examples as follows:

DC is a domestic corporation; FP is a foreign person that is a foreign unrelated party with respect to DC, and DC obtains documentation establishing that FP is a foreign person; any documentation obtained meets the reliability requirements; and the treatment of any sale as a FDDEI sale would not reduce DC’s FDDEI for the year.

Example 1: Manufacturing outside the United States

– (1) Facts. DC sells general property for \$18x to FP for manufacture outside the U.S. and obtains documentation of shipment of the property to a location outside the U.S. DC does not know or have reason to know that the property will be subject to a domestic use after manufacture and within three years of delivered to FP. FP will incorporate the property into a second product outside the U.S. that FP will sell to a U.S. person for \$100x. The property is not physically or materially changed in the process of its incorporation into the second product.

Analysis. Because the fair market value of the general property FP purchases from DC and incorporates into the second product does not exceed 20% of the fair market value of the second product, the general property FP purchases from DC is a component, and therefore the property is treated as subject to manufacture, assembly or other processing outside the U.S. As a result, notwithstanding that DC knows or has reason to know that the property will be subject to a domestic use with three years of delivery, DC does not know or have reason to know that its sale of general property to FP is not for a foreign use. Accordingly, DC's sale of property to FP is for a foreign use, and the sale is a FDDEI sale.

Example 2: Manufacturing outside the United States –

(1) Facts. The facts are the same as in Example 1, except FP purchases the general property from DC for \$25x.

(2) Analysis. Because the fair market value of the general property FP purchases from DC and incorporates into the second product exceeds 20% of the fair market value of the second product, the general property is not treated as a component of the second product. Because the property is also not subject to a physical and material change in the process of incorporation into the second product, the property is not subject to manufacture, assembly or other processing outside the U.S. As a result, because DC knows or has reason to know that FP will sell the second product, which includes the property, for domestic use, DC knows or has reason to know that its sale of general property to FP is not for a foreign use. Accordingly, DC's sale of the property to FP is not for a foreign use and the sale is not a FDDEI sale.

(d) Foreign Use Documentation.

- i. In order to establish that general property is for a foreign use, the seller must generally obtain documentation regarding the sale. Prop. Treas. Reg. § 1.250(b)-4(d)(3). This documentation could include, for example, proof of shipment of the property to a foreign address. Prop. Treas. Reg. § 1.250(b)-4(d)(3)(i). However, in the case of certain small businesses and small transactions, the seller may rely on a foreign shipping address for the recipient instead of obtaining documentation. Prop. Treas. Reg. § 1.250(b)-4(d)(3)(ii).
- ii. Specifically, Prop. Treas. Reg. § 1.250(b)-4(d)(3) provides:

Documentation of foreign use of general property. A seller generally establishes that general property, or a portion of a particular class of fungible general property, is for a foreign use only if the seller obtains one or more of the following types of documentation with respect to the sale:

(1) A written statement from the recipient or a related party of the recipient that the recipient's use or intended use of the property is for a foreign use;

(2) A binding contract between the seller and the recipient which provides that the recipient's use or intended use of the property is for a foreign use;

(3) Except in the case of international transportation property, documentation of shipment of the general property (including both property located within the U.S. or outside the U.S., such as in a warehouse, storage facility, or assembly site located outside U.S.) to a location outside the U.S. (for example, a copy of the export bill of lading issued by the carrier that delivered the property, or a copy of the certificate of lading for the property executed by a customs officer of the country to which the property is delivered); or

(4) Any other forms of documentation as prescribed by the Secretary in forms, instructions or other guidance.

(e) Fungible Property.

- i. In lieu of the general documentation requirements for determining foreign use for sales of general property, in the case of a sale of multiple items of general property, which because of their fungible nature cannot reasonably be

specifically traced to the location of use (“fungible mass”), a seller may establish that some, but not all, of the property is for a foreign use through market research, including statistical sampling, economic modeling, and other similar methods. Prop. Treas. Reg. § 1.250(b)-4(d)(3)(iii).

- ii. A de minimis rule applies to treat the entire fungible mass as for a foreign use if a seller obtains documentation establishing that 90% or more of the fungible mass is for a foreign use. Conversely, no portion of the fungible mass is treated as for a foreign use if the seller does not obtain documentation establishing that 10% or more of the fungible mass is for a foreign use.

(f) Transportation Properties.

- i. A special rule applies for purposes of determining whether the sale of certain transportation property is for a foreign use, which takes into account the special nature of property used for international transportation. Specifically, the sale of aircraft, railroad rolling stock, vessel, motor vehicle, or similar property that provides a mode of transportation and is capable of traveling internationally is for a foreign use only if, during the three-year period from the date of delivery of the property, the property is located outside the U.S. more than 50% of the time and more than 50% of the miles traversed in the use of such property will be traversed outside the U.S. Prop. Treas. Reg. § 1.250(b)-4(d)(2)(iv).
- ii. The seller can establish that a sale of general property used for international transportation is for a foreign use through, for example, a written statement from the recipient that the property is anticipated to satisfy the test described in the preceding sentence. Prop. Treas. Reg. § 1.250(b)-4(d)(3)(i)(A).

(g) Foreign Use for Intangible Property.

- i. A sale includes a license and any transfer of property in which gain or income is recognized under § 367, including a transfer of intangible property subject to § 367(d). See Prop. Treas. Reg. § 1.250(b)-3(b)(7).
- ii. The proposed regulations provide that a sale of intangible property is for a foreign use to the extent revenue is earned from exploiting the intangible property outside the U.S., the documentation requirements are satisfied, and the seller

does not know or have reason to know that the portion of the sale of the intangible property for which the seller establishes foreign use is not for a foreign use. *See* Prop. Treas. Reg. § 1.250(b)-4(e)(1).

- iii. Unlike a sale of general property (other than a sale of a fungible mass), a seller may establish foreign use for a portion of the income from the sale of intangible property. For purposes of determining whether a sale of intangible property is for a foreign use, the location where revenue is earned is generally determined based on the location of end-user customers licensing the intangible property or purchasing products for which the intangible property was used in development, manufacture, sale, or distribution. *See* Prop. Treas. Reg. § 1.250(b)-4(e)(2). This determination is generally made on an annual basis based on the actual revenue earned by the recipient.
- iv. Special rules apply to lump sum sales because, in these cases, it may be difficult or impossible to know the location where revenue will be generated when the sale occurs. The determination of foreign use in these cases is made based on the net present value of revenue the seller would have reasonably expected to earn from the exploitation of the intangible property. *See* Prop. Treas. Reg. § 1.250(b)-4(e)(2)(iii).
- v. For sales of rights to intangible property for use both within and outside the U.S., the seller must establish the proportionate amount of revenue earned within and outside the U.S. from use of the intangible property to establish foreign use. The proposed regulations describe documentation that can be used to establish where revenue is earned from use of the intangible property. Prop. Treas. Reg. § 1.250(b)-4(e)(3)(i).
- vi. For example, if a domestic corporation licenses to a foreign person the worldwide rights to market and sell an item protected by a copyright, the domestic corporation would need to obtain documentation, as provided in the proposed regulations, establishing where revenue is earned from sales of the copyright-protected item.
- vii. A seller may establish the extent to which a sale of intangible property for a lump sum is for a foreign use through documentation containing reasonable projections of the amount and location of revenue that the seller would

have reasonably expected to earn from the use of intangible property. *See* Prop. Treas. Reg. § 1.250(b)-4(e)(3)(iii). To be considered reasonable, the net present value must be consistent with the financial data and projections used by the seller to determine the sales price to the foreign person.

- viii. The same rule for documentation applies to a sale to a foreign person (other than a related party of the seller) for annual payments that are not contingent on revenue or profit unless the seller has access to reliable information to determine the actual revenue earned by the foreign unrelated party from the exploitation of the intangible property. *See* Prop. Treas. Reg. § 1.250(b)-4(e)(3)(ii).
- ix. Specifically, Prop. Treas. Reg. § 1.250(b)-4(e)(3) provides:

Documentation of foreign use of intangible property

A. Documentation for sale for periodic payments.

A seller establishes the extent to which a sale of intangible property is for a foreign use by obtaining one or more of the following types of documentation with respect to the sale—

(1) A written statement from the recipient providing the amount of the annual revenue from sales of sublicenses of the intangible property or sales of products with respect to which the intangible property is used that is generated as a result of exploitation of the intangible property outside the U.S. and the total amount of revenue from such sales or sublicenses worldwide;

(2) A binding contract for the sale of the intangible property that provides that the intangible property can be exploited solely outside the U.S.;

(3) Audited financial statements or annual reports of the recipient stating the amount of annual revenue earned within the U.S. and outside the U.S. from sale of products with respect to which the intangible property is used;

(4) Any statements or documents used by the seller and the recipient to determine the amount of payment due for exploitation of the intangible property if those statements or documents provide reliable data on revenue earned within the U.S. and outside the U.S.; or

(5) Any other forms of documentation or prescribed by the Secretary in forms, instructions, or other guidance.

(B) Certain sales to foreign unrelated parties. In the case of a sale of intangible property that is not contingent on revenue or profit to a foreign unrelated party where the seller is unable to obtain the documentation described above without undue burden, a seller establishes the extent to which the sale of intangible property is for a foreign use using the principles below, except that the seller must make reasonable projections on an annual basis.

(C) Documentation for sales in exchange for a lump sum. A seller establishes the extent to which a sale of intangible property is for a foreign use through documentation containing reasonable projections of the amount and location of revenue that the seller would have reasonably been expected to earn from exploiting the intangible property. To be considered reasonable, the projections must be consistent with the financial data and projections used by the seller to determine the price at which it sold the intangible property to the foreign person.

- x. A sale of general property is treated as for a foreign use if the property is subject to manufacturing, assembly, or other processing outside the United States. *See* Prop. Treas. Reg. § 1.250(b)-4(d)(2)(i)(B). This rule is based on footnote 1522 of the Conference Report, which provides that “[i]f property is sold by a taxpayer to a person who is not a U.S. person, and after such sale the property is subject to manufacture, assembly, or other processing (including the incorporation of such property, as a component, into a second product by means of production, manufacture, or assembly) outside the U.S. by such person, then the property is for a foreign use.”
- xi. Intangible property is not “subject to” manufacture, assembly, or processing, and there is no other discussion in the Conference Report that indicates an intent to provide an analogous rule for intangible property otherwise used in the manufacturing process. However, comments are requested on whether a rule for intangible property similar to Prop. Treas. Reg. § 1.250(b)-4(d)(2)(i)(B) is appropriate.

5. FDDEI Services.

- (a) Section 250(b)(4)(B) provides that FDDEI includes income from services provided by a domestic corporation to any person, or with respect to property, not located within the U.S. Section 250 does not prescribe rules for determining whether a person or property is “not located within the United States.” Prop. Treas. Reg. § 1.250(b)-5 provides rules for determining whether a service is provided to a person, or with respect to property, located outside the U.S.
- (b) Under the proposed regulations, whether a service is provided to a person, or with respect to property, located outside the U.S., depends on the type of service provided and, in the case of a general service (defined below), the type of recipient of the service. The proposed regulations distinguish between:
 - (1) services where the service provider (the “renderer”) and the recipient are in physical proximity when the service is performed (“proximate services”),
 - (2) services with respect to tangible property (“property services”),
 - (3) services to transport people or property (“transportation services”), and
 - (4) all other services (“general services”)
- (c) Prop. Treas. Reg. § 1.250(b)-5(b) and (c)(4) through (7).
- (d) For purposes of determining whether a service constitutes a FDDEI service, the proposed regulations look to the location of the performance of the service for proximate services, the location of the property for property services, the origin and destination of transportation services, and the location of the recipient for general services. Prop. Treas. Reg. § 1.250(b)-5(d) through (h).
- (e) Each category of service described in Prop. Treas. Reg. § 1.250(b)-5 is mutually exclusive of each other category, and every possible service is described in a single category. Therefore, whether a service is a FDDEI service is determined under the rules relevant to one, and only one, category of service described in Prop. Treas. Reg. § 1.250(b)-5. For example, a general service that is provided to a recipient located within the U.S. is not a FDDEI service, even if the service is performed outside the U.S., whereas a property service that is performed outside the U.S. is a FDDEI service, even if the recipient of the service is located within the U.S.

6. General Services to Persons Located Outside the U.S.

- (a) A general service is a service other than a proximate service, a property service, or a transportation service. Prop. Treas. Reg. § 1.250(b)-5(c)(4). General services is the residual category of services. Accordingly, a service that is not a property service, a transportation service, or a proximate service is analyzed as a general service.
- (b) For general services, the proposed regulations distinguish between services provided to “consumers” and services provided to “business recipients.” A consumer is defined as an individual that purchases a service for personal consumption. Prop. Treas. Reg. § 1.250(b)-5(c)(3). A business recipient is defined as any recipient other than a consumer. Prop. Treas. Reg. § 1.250(b)-5(c)(2). In both cases, general services are treated as provided to a person located outside the U.S. if the renderer does not know or have reason to know that the consumer or business recipient is located within the U.S. and obtains appropriate documentation. Prop. Treas. Reg. § 1.250(b)-5(d)(1) and (e)(1).

(c) General Services to Consumers.

- i. The provision of a general service to a consumer located outside the U.S. is a FDDEI service. Prop. Treas. Reg. § 1.250(b)-5(b)(1). The proposed regulations provide that the consumer is located where a consumer resides when the service is provided. Prop. Treas. Reg. § 1.250(b)-5(d)(2).
- ii. The proposed regulations require a domestic corporation to document the location of the consumer. Prop. Treas. Reg. § 1.250(b)-5(d)(1) and (3). The proposed regulations provide several types of permissible documentation for this purpose, including a written statement by the consumer indicating the residence of the consumer when the service is provided. Prop. Treas. Reg. § 1.250(b)-5(d)(3)(i). However, in the case of certain small businesses and small transactions, the renderer may rely on a foreign billing address for the consumer instead of obtaining documentation. Prop. Treas. Reg. § 1.250(b)-5(d)(3)(ii).

(d) General Services to Business Recipients.

- i. The provision of a general service to a business recipient located outside the U.S. is a FDDEI service. Prop. Treas. Reg. § 1.250(b)-5(b)(2). Under the proposed regulations, all general services that are not provided to consumers are

treated as services provided to business recipients, regardless of whether the recipient is engaged in a trade or business. Prop. Treas. Reg. § 1.250(b)-5(c)(2).

- ii. The proposed regulations determine the location of a business recipient based on the location of the business recipient's operations, and the operations of any related party of the recipient, that receive a benefit (as defined in Prop. Treas. Reg. § 1.482-9(1)(3)) from such service. Prop. Treas. Reg. § 1.250(b)-5(e)(2) and (4).
- iii. For purposes of this determination, the location of residence, incorporation, or formation of a business recipient is not relevant. For example, a general service that confers a benefit only on the U.S. operations of a foreign person will generally not qualify as a FDDEI service. For purposes of this rule, a business recipient is treated as having operations in any location where it maintains an office or other fixed place of business. Prop. Treas. Reg. § 1.250(b)-5(e)(2)(ii).
- iv. The proposed regulations provide that a service is generally provided to a business recipient located outside the U.S. to the extent that the renderer's gross income from providing the service is allocated to the business recipient's operations outside the U.S. Prop. Treas. Reg. § 1.250(b)-5(e)(2)(i). To make this allocation, the renderer must first determine which of the business recipient's operations receive a benefit from the service. Prop. Treas. Reg. § 1.250(b)-5(e)(2)(i)(A).
- v. Where the service confers a benefit on the operations of the business recipient in specific locations, gross income of the renderer is allocated based on the location of the operations in specific locations that receive the benefit.
- vi. Where a service confers a benefit on the recipient's business as a whole, or where reliable information about the particular portion of the operations that specifically receive a benefit from the service is unavailable, the proposed regulations provide that the service is deemed to confer a benefit on all of the business recipient's operations. The renderer then must allocate its gross income from providing the service between the operations that receive a benefit from the service that are located within and outside the U.S. See Prop. Treas. Reg. § 1.250(b)-5(e)(2)(i)(B).

- vii. For this purpose, any reasonable method may be used, and the principles of Treas. Reg. § 1.482-9(k) apply to determine whether a method is reasonable. A reasonable method may include, for example, an allocation based on the renderer's time spent working with different offices of the business recipient or publicly available information about the business recipient's revenue from different markets.
- viii. Prop. Treas. Reg. § 1.250(b)-5(e) provides regarding general services that a business recipient is treated as having operations in any location where it maintains an office or other fixed places of business. It further provides:

Documentation of location of business recipient.

(1) A renderer establishes that a business recipient is located outside the U.S. only if the renderer obtains one or more of the types of documentation described below. The documentation must also support the renderer's allocation of income.

(A) A written statement from the business recipient that specifies the locations of the operations of the business recipient that benefit from the service.

(B) A binding contract that specifies the location of the operations of the business recipient that benefit from the service.

(C) Documentation obtained in the ordinary course of the provision of the service that specifies the locations of the operations of the business recipient that benefit from the service.

(D) Publicly available information that establishes the locations of the operations of the business recipient.

(E) Any other forms of documentation as prescribed by the Secretary in forms, instructions or other guidance.

- ix. A domestic corporation thus may establish the location of the business recipient using a written statement or binding contract, information provided in the ordinary course of the provision of a service or publicly available information. However, in the case of certain small businesses and small

transactions, the renderer may rely on a foreign billing address for the business recipient instead of obtaining documentation. Prop. Treas. Reg. § 1.250(b)-5(e)(3)(ii).

(e) Proximate Services.

- i. The provision of a proximate service to a recipient located outside the U.S. is a FDDEI service. Prop. Treas. Reg. § 1.250(b)-5(b)(3). A proximate service is defined as a service, other than a property service or a transportation service, substantially all of which is performed in the physical presence of the recipient or, in the case of a business recipient, its employees. Prop. Treas. Reg. § 1.250(b)-5(c)(6). For example, a training, consulting, or auditing service that is performed on-site would generally constitute a proximate service.
- ii. Substantially all of a service is performed in the physical presence of the recipient or its employees if the renderer spends more than 80% of the time providing the service in the physical presence of the recipient or its employees. Prop. Treas. Reg. § 1.250(b)-5(c)(6). The recipient of a proximate service is treated as located where the service is performed. Prop. Treas. Reg. § 1.250(b)-5(f). If a proximate service is performed partly within and partly outside the U.S., a proportionate amount of the service is treated as rendered to a person located outside the U.S. corresponding to the portion of time spent providing the proximate service outside the U.S.

(f) Property Services.

- i. The provision of a property service with respect to tangible property located outside the U.S. is a FDDEI service. Prop. Treas. Reg. § 1.250(b)-5(b)(4). A property service is defined as a service, other than a transportation service, provided with respect to tangible property, but only if substantially all of the service is performed at the location of the property and results in physical manipulation of the property such as through assembly, maintenance, or repair. Prop. Treas. Reg. § 1.250(b)-5(c)(5).
- ii. The proposed regulations provide that substantially all of a service is performed at the location of property if the renderer spends more than 80% of the time providing the service at or near the location of the property. A property service is a FDDEI service only if the tangible property

with respect to which the service is performed is located outside the U.S. for the duration of the period of performance. Prop. Treas. Reg. § 1.250(b)-5(g). As discussed below, a property service may qualify as a FDDEI service even if it is performed for a person located within the U.S.

- iii. Other services that relate to property but may not necessarily be provided in close proximity to tangible property or do not result in the physical manipulation of such property such as through assembly, maintenance, or repair may be subject to the rules for proximate services, transportation services, or general services. For example, an architectural or engineering service that is not performed in physical proximity to the property or the recipient will be evaluated as a general service even if the service relates to property located outside the U.S., and thus whether such a service is a FDDEI service will be determined based on the location of the recipient rather than the location of the property.

(g) Transportation Services.

- i. The provision of a transportation service to a recipient, or with respect to property, located outside the U.S. is a FDDEI service. Prop. Treas. Reg. § 1.250(b)-5(b)(5). A transportation service is defined as a service to transport a person or property using any mode of transportation (such as an airplane). Prop. Treas. Reg. § 1.250(b)-5(c)(7).
- ii. Basing the location of a transportation service on the residence of the recipient of the transportation service could provide inconsistent results with respect to similar services. Similarly, providing different rules for the transportation of a person or property could provide inconsistent results with respect to similar services.
- iii. Therefore, the proposed regulations provide that whether a “transportation service” is provided to a recipient, or with respect to property, located outside the U.S. is determined based on the origin and destination of the service. Prop. Treas. Reg. § 1.250(b)-5(h).
- iv. If both the origin and destination of a transportation service are outside of the U.S., then the service is a FDDEI service. If either the origin or the destination of the transportation service is outside of the U.S., but not both, then 50% of the

service is a FDDEI service and thus 50% of the gross income from the provision of the service is included in the renderer's gross FDDEI.

7. Domestic Intermediary Rules.

- (a) Section 250(b)(5)(B) describes special rules for “domestic intermediaries.” Section 250(b)(5)(B)(i) provides that if a seller sells property to another person (other than a related party) for further manufacture or other modification within the U.S., the property is not treated as sold for a foreign use even if such other person subsequently uses such property for a foreign use. Section 250(b)(5)(B)(ii) provides that services provided to a person (other than a related party) located within the U.S. are not treated as services described in § 250(b)(4)(B) even if such other person uses the services in providing services that are described in § 250(b)(4)(B).
- (b) The preamble states that the proposed regulations do not contain specific rules corresponding to the domestic intermediary rules because those rules are encompassed within the general rules relating to FDDEI sales and FDDEI services in the proposed regulations. With respect to sales of property, the proposed regulations provide that general property is not for a foreign use if, before being subject to manufacture, assembly, or other processing outside the U.S., the property is subject to a domestic use. Prop. Treas. Reg. § 1.250(b)-4(d)(2)(i).
- (c) For this purpose, domestic use includes manufacture, assembly, or other processing within the U.S. Prop. Treas. Reg. § 1.250(b)-4(d)(2)(ii)(B). In addition, a sale of property to a U.S. person cannot qualify as a FDDEI sale under any circumstance. § 250(b)(4)(A) and Prop. Treas. Reg. § 1.250(b)-4(b). Therefore, a sale of property to a foreign person for further manufacture in the U.S. or to a U.S. person does not qualify for a FDDEI sale, regardless of the ultimate use of the property by the recipient.
- (d) With respect to the provision of services, the proposed regulations provide that a service is a FDDEI service only if the recipient of the service, or the property to which the service relates, is located outside the U.S. Prop. Treas. Reg. § 1.250(b)-5(b)(1) through (5). Therefore, a service provided to a person, or with respect to property, located within the U.S. is not a FDDEI service, regardless of the ultimate use of the service by the recipient.
- (e) Section 250(b)(5)(B)(ii) could be read literally to provide that a FDDEI service includes only services provided to a person not

located within the U.S., in which case a service provided “with respect to property located outside the United States” would not qualify as a FDDEI service if the recipient of such service was located within the U.S. As discussed below, consistent with the general rule of § 250(b)(4)(B), the proposed regulations clarify that a service qualifies as a FDDEI service if it is provided either to a person located outside the U.S. or with respect to property located outside the U.S.

- (f) Treasury and the IRS have determined that an interpretation of § 250(b)(5)(B)(ii) that effectively eliminates the disjunctive test of § 250(b)(4)(B) would not be reasonable. Therefore, under the proposed regulations, whether a service that is treated as with respect to property -- a property service or a transportation service -- is a FDDEI service is determined solely by reference to the location of the property, and not the location of the recipient. Prop. Treas. Reg. § 1.250(b)-5(g) and (h).
- (g) Finally, the parenthetical references to related parties in the domestic intermediary rules could be read to imply the existence of an exception for further manufacture or modification in the U.S. by a related party or a service provided to a related party located within the U.S. However, the general rules of § 250(b)(4)(A) and (B) do not authorize such exceptions, and the domestic intermediary rules do not purport to expand these general rules, but rather to limit the transactions that qualify under them.
- (h) Therefore, with respect to related party domestic intermediaries, the proposed regulations do not provide an exception to the general rule that property must be sold to a foreign person to qualify as a FDDEI sale or that a service must be provided to a person located outside the U.S. to qualify as a FDDEI service.

8. Related Party Transactions.

- (a) A sale of property or a provision of a service may qualify as a FDDEI transaction, regardless of whether the recipient of such service is a related party of the seller or renderer. However, in the case of a sale of general property or a provision of a general service to a related party, § 250(b)(5)(C) and Prop. Treas. Reg. § 1.250(b)-6 provide additional requirements that must be satisfied for the transaction to qualify as a FDDEI sale or FDDEI service. These requirements must be satisfied in addition to the general requirements that apply to such sales and services as provided in Prop. Treas. Reg. §§ 1.250(b)-3 through 1.250(b)-5.

- (b) The proposed regulations define a related party with respect to any person as any member of a modified affiliated group that includes such person. Prop. Treas. Reg. § 1.250(b)-1(c)(19). A modified affiliated group is defined as an affiliated group as provided in § 1504(a) by substituting “more than 50%” for “at least 80%” each place it appears, and without regard to § 1504(b)(2) and (3). Prop. Treas. Reg. § 1.250(b)-1(c)(17)(i). A modified affiliated group also includes any person other than a corporation that is controlled by one or more members of a modified affiliated group or that controls such a member. Prop. Treas. Reg. § 1.250(b)-1(c)(17)(ii).
- (c) For this purpose, “control” is defined as provided in § 954(d)(3), meaning direct, indirect, or constructive ownership under § 958 of more than 50% of the value of the beneficial interests in such person. Prop. Treas. Reg. § 1.250(b)-1(c)(17)(iii).
- (d) Related Party Sales.
- i. Section 250(b)(5)(C)(i) provides that property sold to a related party that is not a U.S. person “shall not be treated as for a foreign use unless (a) such property is ultimately sold by a related party, or used by a related party in connection with property which is sold or the provision of services, to another person who is an unrelated party who is not a U.S. person, and (b) the taxpayer establishes to the satisfaction of the IRS that the property is for a foreign use.”
 - ii. Accordingly, the proposed regulations provide that a sale of general property to a foreign related party (a “related party sale”) qualifies as a FDDEI sale only if certain additional requirements described in Prop. Treas. Reg. § 1.250(b)-6(c)(1)(i) or (ii) are satisfied. Prop. Treas. Reg. § 1.250(b)-6(c)(1).
 - iii. If a foreign related party resells the purchased property (such as where the foreign related party is a distributor or a manufacturer of a product that incorporates the purchased property as a component), the sale to the foreign related party qualifies as a FDDEI sale only if an unrelated party transaction with respect to such sale occurs and the unrelated party transaction is a FDDEI sale.
 - iv. An unrelated party transaction is generally a transaction between the foreign related party and an unrelated foreign person in which the property purchased by the foreign related party is sold or used. Prop. Treas. Reg. § 1.250(b)-

- 6(b)(5). For purposes of this rule, whether property is a component of another property that is subsequently sold in an unrelated party transaction is determined without regard to the rule defining a “component” for purposes of determining whether general property is subject to manufacturing, assembly, or other processing.
- v. The unrelated party sale generally must occur on or before the FDII filing date; otherwise the gross income from the related party sale is included in the domestic corporation’s gross DEI for the taxable year of the related party sale, but is not included in its gross FDDEI. Prop. Treas. Reg. § 1.250(b)-6(c)(1)(i).
 - vi. However, if an unrelated party transaction occurs after the FDII filing date but within the period of limitations provided by § 6511, the proposed regulations provide that the domestic corporation may file an amended return for the taxable year in which the related party sale occurred claiming the related party sale as a FDDEI sale for purposes of determining the taxpayer’s foreign-derived intangible income for that taxable year, provided that the sale otherwise meets the requirements in Prop. Treas. Reg. § 1.250(b)-6(c)(1)(i).
 - vii. For transactions other than the resale of purchased property, such as where the foreign related party uses the purchased property to produce other property that is sold in unrelated party transactions, or where the foreign related party uses the property in the provision of a service in an unrelated party transaction, the sale of property does not qualify as a FDDEI sale unless, as of the FDII filing date, the seller reasonably expects that more than 80% of the revenue earned by the foreign related party from the use of the property in all transactions will be earned from unrelated party transactions that are FDDEI transactions (determined without regard to the documentation requirements in Prop. Treas. Reg. § 1.250(b)-4 or § 1.250(b)-5). Prop. Treas. Reg. § 1.250(b)-6(c)(1)(ii).
 - viii. The rules applicable to related party sales apply only to determine whether sales of general property qualify as a FDDEI sale. Prop. Treas. Reg. § 1.250(b)-6(c)(1). Sales of intangible property, whether to a related or an unrelated party, are for a foreign use only to the extent that the intangible property generated revenue from exploitation outside the U.S. Prop. Treas. Reg. § 1.250(b)-4(e)(2).

Thus, additional rules with respect to related party sales of intangible property are unnecessary to ensure that such sales are ultimately for a foreign use.

(e) Related Party Services.

- i. Section 250(b)(5)(C)(ii) provides that a service provided to a related party not located in the U.S. “shall not be treated [as a FDDEI service] unless the taxpayer establishe[s] to the satisfaction of the Secretary that such service is not substantially similar to services provided by such related party to persons located within the United States.”
- ii. Accordingly, the proposed regulations generally provide that a provision of a general service to a business recipient that is a related party qualifies as a FDDEI service only if the service is not substantially similar to a service provided by the related party to persons located within the U.S. Prop. Treas. Reg. § 1.250(b)-6(d)(1).
- iii. Absent § 250(b)(5)(C)(ii) and Prop. Treas. Reg. § 1.250(b)-6(d)(1) (the “related party services rule”), a domestic corporation could generate gross FDDEI from the provision of services that primarily benefit persons within the U.S. by using a related party located outside the U.S. as a conduit. The related party services rule prevents taxpayers from claiming gross FDDEI derived from such “round tripping” arrangements.
- iv. In contrast, proximate services, property services, and transportation services by their nature present minimal risk for “round tripping,” because the location of the recipient or property, as applicable, for purposes of such services is generally determined based on the place of performance. Prop. Treas. Reg. § 1.250(b)-5(f), (g), and (h).
- v. Further, a general service provided to a consumer that is a related party cannot be substantially similar to a service provided by a consumer to a person located within the U.S., because a consumer, by definition, is an individual that purchases the service for personal use. Prop. Treas. Reg. § 1.250(b)-5(c)(3). Accordingly, the proposed regulations provide that the related party services rule applies only to determine whether a general service provided to a business recipient that is a related party is a FDDEI service. Prop. Treas. Reg. § 1.250(b)-6(d)(1).

- vi. A service provided by a renderer to a related party is “substantially similar” to a service provided by the related party to a person located within the U.S. if the renderer’s service (or “related party service”) is used by the related party to provide a service to a person located within the U.S. and either the “benefit test” of Prop. Treas. Reg. § 1.250(b)-6(d)(2)(i) or the “price test” of Prop. Treas. Reg. § 1.250(b)-6(d)(2)(ii) is satisfied. The rules to determine the location of a recipient of a service provided by a related party are generally the same as the rules for determining the location of a recipient of a service provided by the renderer.
- vii. The benefit test is satisfied if 60% or more of the benefits conferred by the related party service are to persons located within the U.S. Prop. Treas. Reg. § 1.250(b)-6(d)(2)(i). For this purpose, the term “benefit” has the meaning provided in Treas. Reg. § 1.482-9(1)(3). Prop. Treas. Reg. § 1.250(b)-5(c)(1). Therefore, a related party service provides a benefit to a customer of the related party if it provides “a reasonably identifiable increment of economic or commercial value” to the customer, rather than an indirect or remote benefit. Treas. Reg. § 1.482-9(1)(e)(i) and (ii).
- viii. Because the benefit test compares the benefits from the service provided to persons located in the U.S. to the total benefits from the service provided by the renderer (rather than to the total benefits of the service provided by the related party), a service provided to a related party is “substantially similar” to a service provided by the related party to persons located within the U.S. if 60% or more of the benefits of the service are conferred on persons located within the U.S., even if the related party adds significant value to the service through, for instance, bundling the related party service with other high value services.
- ix. Under the price test, a service provided by a renderer to a related party is “substantially similar” to a service provided by the related party to a person located within the U.S. if the renderer’s service is used by the related party to provide a service to a person located within the U.S. and 60% or more of the price that persons located within the U.S. pay for the service provided by the related party is attributable to the renderer’s service. Prop. Treas. Reg. § 1.250(b)-6(d)(2)(ii).

- x. Therefore, the price test compares the value of the service that is provided by the renderer to the related party to the value of the service that is provided by the related party to its customers. Consequently, a related party service that is not treated as substantially similar to a service provided by the related party to persons located in the U.S. under the benefit test, because more than 40% of the benefits from the service are conferred to persons located outside the U.S., is nonetheless treated as “substantially similar” under the price test if the related party service accounts for 60% or more of the total price that is charged to customers located within the U.S.
- xi. If a related party service is treated as substantially similar to a service provided by the related party to a person located within the U.S. solely by reason of the price test, the general rule that wholly disqualifies the related party service as a FDDEI service does not apply. Rather, in such case, a portion of the gross income from the related party service will be treated as a FDDEI service corresponding to the ratio of benefits conferred by the related party service to persons not located within the U.S. to the sum of all benefits conferred by the related party service. Prop. Treas. Reg. § 1.250(b)-6(d)(1).

9. § 250 Deduction for Individuals Making a § 962 Election.

- (a) The § 250 deduction for FDII and GILTI is available only to domestic corporations. However, § 962(a)(1) provides that an individual that is a U.S. shareholder may generally elect to be taxed on amounts included in the individual’s gross income under § 951(a) in “an amount equal to the tax that would be imposed under § 11 if such amounts were received by a domestic corporation.” GILTI is treated as an amount included under § 951(a) for purpose of § 962. *See* § 951A(f)(1)(A) and Prop. Treas. Reg. § 1.951A-6(b)(1). A § 962 election can be made by an individual U.S. shareholder who is considered, by reason of § 958(b), to own stock of a foreign corporation owned (within the meaning of § 958(a)) by a domestic pass-through entity, including a partnership or an S Corporation. *See* Treas. Reg. § 1.962-2(a).
- (b) Congress enacted § 962 to ensure that individuals’ tax burdens with respect to undistributed foreign earnings of their CFCs “will be no heavier than they would have been had they invested in an American corporation doing business abroad.” Existing Treas. Reg. § 1.962-1(b)(1)(i) provides that a deduction of a U.S. shareholder does not reduce the amount included in gross income

under § 951(a) for purposes of computing the amount of tax that would be imposed under § 11.

- (c) However, allowing a § 250 deduction with respect to GILTI of an individual (including an individual that is a shareholder of an S corporation or a partner in a partnership) that makes an election under § 962 is consistent with the purpose of that provision of ensuring that such individual's tax burden with respect to its CFC's undistributed foreign earnings is no greater than if the individual owned such CFC through a domestic corporation.
- (d) Accordingly, the proposed regulations provide that, for purposes of § 962, "taxable income" as used in § 11 of an electing individual is reduced by the portion of the § 250 deduction that would be allowed to a domestic corporation with respect to the individual's GILTI and the § 78 gross-up attributable to the shareholder's GILTI. Prop. Treas. Reg. § 1.962-1(b)(1)(i)(B)(3).

10. Application of § 250 to Consolidated Groups.

- (a) Section 250 provides a domestic corporation a deduction for its FDII, GILTI, and the § 78 gross-up attributable to its GILTI. The § 250 deduction is available to a member of a consolidated group ("member") in the same manner as the deduction is available to any domestic corporation. However, a computation of a member's § 250 deduction based solely on its items of income and QBAI may not result in a clear reflection of the consolidated group's income tax liability.
- (b) For example, a consolidated group could segregate all of its QBAI in one member, thereby decreasing the DTIR of other members relative to the consolidated group's DTIR if determined at a group level. Alternatively, a strict, separate-entity application of § 250 could inappropriately decrease a consolidated group's aggregate amount of deduction of its FDII, for instance, because one member's DII (which is the excess of DEI over DTIR) would not be taken into account in calculating the FDII of another member that has FDDEI in excess of its DEI.
- (c) Based on the foregoing, the proposed regulations provide that a member's § 250 deduction is determined by reference to the relevant items of all members of the same consolidated group. Consistent with the authority provided by § 1502, the proposed regulations ensure that the aggregate amount of § 250 deductions allowed to members appropriately reflects the income, expenses, gains, losses, and property of all members. Definitions in Prop. Treas. Reg. § 1.1502-50(f) result in the aggregation of the DEI,

FDDEI, DTIR, and GILTI of all members. These aggregate numbers and the consolidated group's consolidated taxable income are then used to calculate an overall deduction amount for the group. Prop. Treas. Reg. § 1.1502-50(b) then allocates this overall deduction amount among the members on the basis of their respective contributions to the consolidated group's aggregate amount of FDDEI and the consolidated group's aggregate amount of GILTI.

- (d) The proposed regulations also address two issues relating to intercompany transactions. First, the proposed regulations add an example to Treas. Reg. § 1.1502-13 demonstrating the applicability of the attribute redetermination rule of Treas. Reg. § 1.1502-13(c)(1)(i) to the determination of FDDEI.
- (e) This example applies the intercompany transaction rules to clearly reflect consolidated taxable income. It does not indicate a change in the law. In this example, the attribute redetermination rule applies to gross DEI and gross FDDEI, which are attributes of an intercompany or corresponding item. Treasury and the IRS were concerned that applying Treas. Reg. § 1.1502-13(c) to DEI and FDDEI directly could result in circular computations due to the apportionment of certain expenses on a gross income basis. In addition, the example illustrates the applicability of the attribute redetermination rule in the context of an intercompany loss. In such circumstances, the application of the allocation and apportionment rules of Treas. Reg. § 1.861-8 through 1.861-14T and 1.861-17 may be modified in order to achieve the same overall result within the consolidated group that would occur if the members were divisions of a single corporation.
- (f) Second, the proposed regulations provide that, for purposes of determining a member's QBAI, the basis of specified tangible property will not be affected by an intercompany transaction. Prop. Treas. Reg. § 1.1502-50(c)(1). Accordingly, an intercompany transaction cannot result in the increase or decrease of a consolidated group's aggregate amount of DTIR or, in turn, aggregate amount of deduction.

11. Reporting Requirements.

- (a) To claim a deduction under § 250 by reason of having FDII, a taxpayer must calculate its deemed intangible income, deduction eligible income, and foreign-derived deduction eligible income. None of these terms are used in other provisions of the Code, and thus pre-existing forms do not collect data relevant to determining these amounts. In addition, when calculating its deduction under

§ 250, a taxpayer must determine the application of the taxable income limitation of § 250(a)(2). In order to effectively administer and enforce § 250, the proposed regulations require the collection of relevant information on new or existing forms.

- (b) A domestic corporation or an individual making an election under § 962 that claims a deduction under § 250 for a taxable year must make an annual return on Form 8993, “§ 250 Deduction for Foreign-Derived Intangible Income (“FDII”) and Global Intangible Low-Taxed Income (“GILTI”) (or any successor form) for such year, providing the information required by the form. Prop. Treas. Reg. § 1.250(a)-1(d).
- (c) Certain related party transactions are reported on various information returns under §§ 6038 and 6038A. Under § 6038(a)(1), U.S. persons that control foreign business entities (“controlling U.S. persons”) must report certain information with respect to those entities, which includes information listed in § 6038(a)(1)(A) through (E), as well as information that “the Secretary determines to be appropriate to carry out the provisions of this title.” This information is reported on Form 5471, “Information Return of U.S. Persons with Respect to Certain Foreign Corporations,” or Form 8865, “Return of U.S. Persons with Respect to Certain Foreign Partnerships,” as applicable.
- (d) Section 6038A requires 25% foreign-owned domestic corporations (“reporting corporations”) to file certain information returns with respect to those corporations, including information related to transactions between the reporting corporation and each foreign person which is a related party to the reporting corporation. This information is reported on Form 5472, “Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business.”
- (e) In order to effectively administer and enforce § 250, the proposed regulations provide that controlling U.S. persons or reporting corporations, as described above, that claim a deduction under § 250 determined by reference to FDII with respect to amounts reported on Form 5471, 5472, or 8865 must report certain information relating to transactions with foreign business entities or related parties in accordance with §§ 6038 and 6038A. Prop. Treas. Reg. §§ 1.6038-2(f)(15), 1.6038-3(g)(4), and 1.6038A-2(b)(5)(iv).
- (f) Certain partnerships and their partners also have reporting requirements under §§ 6031 and 6038 with respect to partnership income. A domestic partnership is generally required to file an

annual information return (Form 1065, “U.S. Return of Partnership Income”) and provide information to its partners on Schedule K-1 (Form 1065), “Partner’s Share of Income, Deductions, Credits, etc.,” with respect to each partner’s distributive share of partnership items and other information. § 6031 and § 1.6031(b)-1T.

- (g) The proposed regulations provide that a partnership that has one or more direct or indirect partners that are domestic corporations and that is required to file a return under § 6031 must furnish on Schedule K-1 (Form 1065) the partner’s share of the partnership’s gross DEI, gross FDDEI, deductions that are definitely related to the partnership’s gross DEI and gross FDDEI, and partnership QBAI for each taxable year in which the partnership has gross DEI, gross FDDEI, or partnership specified tangible property. Prop. Treas. Reg. § 1.250(b)-1(e)(2).
- (h) Although a foreign partnership that does not have income effectively connected with a trade or business within the U.S. or U.S. source income is not required to file Form 1065, a U.S. person who owns a 10% interest or a 50% interest of a foreign partnership controlled by U.S. persons is required to report certain information under § 6038.
- (i) Similar to the requirements for partnership reporting on Form 1065, the proposed regulations require controlling 10% partners and controlling 50% partners (as defined in Treas. Reg. § 1.6038-3(a)(1) and (2)) of certain foreign partnerships controlled by U.S. persons to report on Schedule K-1 (Form 8865), “Partner’s Share of Income, Deductions, Credits, etc.,” the partner’s share of the partnership’s gross DEI, gross FDDEI, deductions that are definitely related to the partnership’s gross DEI and gross FDDEI, and partnership QBAI. Prop. Treas. Reg. § 1.6038-3(9)(4).

12. Applicability Dates.

- (a) Prop. Treas. Reg. §§ 1.250(a)-1 through 1.250(b)-6 are proposed to apply to taxable years ending on or after March 4, 2019. *See* § 7805(b)(1)(B). However, Treasury and the IRS recognize that these rules may apply to transactions that have occurred before the filing of these proposed regulations and that taxpayers may not be able to obtain the documentation required for transactions that have already been completed. Accordingly, for taxable years beginning on or before March 4, 2019, taxpayers may use any reasonable documentation maintained in the ordinary course of the taxpayer’s business that establishes that a recipient is a foreign person, property is for a foreign use (within the meaning of Prop.

Treas. Reg. § 1.250(b)-4(d) and (e)), or a recipient of a general service is located outside the U.S. (within the meaning of Prop. Treas. Reg. § 1.250(b)-5(d)(2) and (e)(2)), as applicable, in lieu of the documentation required in Prop. Treas. Reg. § 1.250(b)-4(c)(2), (d)(3), and (e)(3) and 1.250(b)-5(d)(3) and (e)(3), provided that such documentation meets the reliability requirements described in Prop. Treas. Reg. § 1.250(b)-3(d).

- (b) Reasonable documentation includes, but is not limited to, documents described in or similar to the documents described in Prop. Treas. Reg. §§ 1.250(b)-4(c)(2), (d)(3), and (e)(3) and 1.250(b)-5(d)(3) and (e)(3). For this purpose, reasonable documentation also includes the documentation described in the special rules for small businesses and small transactions in Prop. Treas. Reg. § 1.250(b)-4(c)(2)(ii) and (d)(3)(ii) and 1.250(b)-5(d)(3)(ii) and (e)(3)(ii), even if the taxpayer would not otherwise qualify for the special rules.
- (c) Prop. Treas. Reg. § 1.962-1(b)(1)(i)(B)(3), which allows individuals making an election under § 962 to take into account the § 250 deduction, is proposed to apply to taxable years of a foreign corporation ending on or after March 4, 2019, and with respect to a U.S. person, for the taxable year in which or with which such taxable year of the foreign corporations ends. Taxpayers may rely on Prop. Treas. Reg. § 1.250(a)-1 through 1.250(b)-6 and § 1.962-1(b)(1)(i)(B)(3) for taxable years ending before May 4, 2019.
- (d) Prop. Treas. Reg. § 1.1502-50 is proposed to apply to consolidated return years ending on or after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register. *See* §§ 1503(a) and 7805(b)(1)(A). Taxpayers may rely on Prop. Treas. Reg. § 1.1502-50 for taxable years ending before the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register.
- (e) Prop. Treas. Reg. §§ 1.6038-2(f)(15) and 1.6038A-2(b)(5)(iv) are proposed to apply with respect to information for annual accounting periods beginning on or after May 4, 2019. *See* §§ 6038(a)(3) and 7805(b)(1)(B). Prop. Treas. Reg. § 1.6038-3(g)(4) is proposed to apply to taxable years of a foreign partnership beginning on or after May 4, 2019. *See* § 7805(b)(1)(B).

E. FDII Comments.

1. TEI Comments.

- (a) TEI submitted comments on the proposed regulations on the deduction for foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI) under § 250. TEI stated that the FDII documentation requirements are burdensome, present significant compliance difficulties and require unreasonable customer requests. In addition, TEI noted some of the documentation requires information customers could not reliably provide, or represent as accurate, (e.g., a statement that the property is “not subject to a domestic use within three years of the date of delivery”).
- (b) TEI stated that tracing the use of *all* the property in order to determine that “[t]he property is not subject to a domestic use within three years of the date of delivery....” places an intolerable burden on recipients, especially unrelated recipients, to predict the future use of property.
- (c) According to TEI, the foreign use documentation requirements be replaced with rules that allow sellers to treat property as for a foreign use if the “seller’s shipping address for the recipient is outside the United States.” Potential abuse could be policed by the “know or have reason to know that the recipient is not a foreign person or that the property will not be for a foreign use” standard.
- (d) If such a change is not acceptable, TEI recommends that a de minimis (or safe harbor) exception if the recipient or related party of the recipient provides a written statement that not more than 5% of the foreign use property (in the case of a related party) and not more than ten percent of the foreign use property (in the case of an unrelated third party) would be used in the U.S.
- (e) Prop. Treas. Reg. § 1.250(b)-3(d)(3) provides that documentation is only reliable if the “documentation is obtained no earlier than one year before the date of the sale or service.” TEI states that this requirement is impractical for long-term supply contracts or successive short-term contracts with the same supplier, which typically do not necessitate a review of basic documentation each year or for each successive contract. For such long-term and successive contracts, in TEI’s view documentation should be considered reliable as long as the documentation is obtained at the inception of the first contract and the seller or renderer meets the requirements of Prop. Treas. Reg. § 1.250(b)-3(d)(i) regarding

knowing or having reason to know that the documentation is unreliable “as of the FDII filing date.”

- (f) In terms of the service providers documentation requirements, TEI states that the proposed regulations require service providers to gather information which will be difficult or impossible to obtain. U.S. service providers generally cannot reasonably determine where their customer’s operations are located or allocate the benefit of the U.S. providers’ services among those operations. Taxpayers cannot do this independently and, in TEI’s view, customers will not provide this information. Absent a change to these requirements in the final regulations, U.S. taxpayers will often fail to qualify for FDII benefits for services, eliminating the parity between FDII and GILTI.
- (g) Customers have no incentive to provide the information required by these regulatory provisions. Customers often have not determined, or even considered, where the benefits of a particular service should be allocated among their operations. Even if customers have made such a determination, TEI states that the resulting analysis would be considered proprietary business information that cannot or will not be shared with a potential competitor or with a vendor who might use it for price negotiation or other competitive purposes. TEI noted that even if a customer did share this sensitive data, the U.S. taxpayer would then possess proprietary business information on its systems, information that would be subject to significant liability risk in data breaches. For these reasons, TEI states that the documentation requirements of the business service provisions are impractical.
- (h) In TEI’s view permitting taxpayers to rely on publicly available information is not a workable solution. Most businesses are privately held, and therefore are not subject to shareholder disclosure rules. Further, even publicly-traded corporations often do not break out financial and other information between the U.S. and the rest of the world.
- (i) As constructed, TEI states the regulations push U.S. taxpayers towards earning intangible income through their CFCs, because the resulting GILTI will qualify for a lower U.S. effective tax rate without imposing documentation burdens, which is contrary to the FDII/GILTI parity policy.
- (j) TEI recommends that final regulations permit taxpayers to determine the FDII status of service income based on information already collected by U.S. service providers in the ordinary course of business – namely, a customer’s billing address, tax ID number,

primary contact name and address, or the location of a credit card issuer or bank.

- (k) The proposed applicability date of the regulations is far too soon. TEI recommends delaying that applicability date to taxable years beginning on or after one year from the date the final regulations are published.
- (l) TEI also recommends that taxpayers have the elective ability to create an imputed cost of goods sold deduction based upon its gross profit percentage for that particular product or service. Such an election is needed because recognition of an advance payment as income without associated cost of goods sold might be required under § 451 based upon certain facts and circumstances.
- (m) The final regulations should support the intent of Congress by reestablishing the principles under Treas. Reg. § 1.861-17(b) for purposes of apportioning R&D to gross DEI and FDDEI. Additionally, the final regulations should provide that the provisions of Treas. Reg. § 1.861-17(c)(3) that require sales to third parties by controlled foreign affiliates to be included should not be required as it artificially apportions more R&D expense against FDDEI.
- (n) TEI states that supply chain IP is consumed to the benefit the manufacturer – not the end user – and should be traced to the manufacturing location. TEI recommends that the final regulations provide that the exploitation of manufacturing and supply chain IP is a foreign used service, consumed at the place of manufacture, if it meets the physical transformation and proximity requirements.
- (o) The property service rule in Prop. Treas. Reg. § 1.250(b)-5(g) effectively requires most, if not all, of the actual servicing of the property to take place outside the U.S. Section 250(b)(4)(B) defines FDDEI, with respect to services, as “services provided by the taxpayer which the taxpayer establishes to the satisfaction of the Secretary are not provided to any person, or with respect to property, not located within the U.S.” For the service to be eligible under these criteria, only one test need be met using the “or” conjunction. Treasury removes the “or” test established by Congress. TEI recommends that instead of using the location of the serviced property, it would be better to base the rule on the ownership of the serviced property.
- (p) Neither § 163(j) nor § 250 provide an ordering rule with respect to the other provision, and TEI recommends that § 250(a)(2) be

determined after all the corporation's other deductions are taken into account.

- (q) Finally, TEI recommends that the regulations should be explicit that if any cost-sharing charge outs are required should the Ninth Circuit rule against *Altera* should be reimbursements by the U.S. controlled participant to the non-U.S. participant and not allocated against FDDEI generated during the year that the reimbursements are made.

2. NYSBA Comments.

- (a) The NYSBA also submitted comments on the proposed § 250 regulations on the deduction for FDII.
- (b) The NYSBA recommends that the final regulations confirm that the adjustments to foreign branch income in Prop. Treas. Reg. § 1.904-4(f)(2)(vi) apply when calculating branch income for the purposes of determining a corporation's deduction-eligible income (DEI). Under Prop. Treas. Reg. § 1.904-4(f)(2)(vi), foreign branch income would be adjusted to reflect certain transactions between a foreign branch and its foreign owner, as well as transactions between or among foreign branches that involve payments that would be deductible or capitalized if the payments were regarded for U.S. tax purposes.
- (c) Treasury should consider whether the rule that applies to tangible property subject to modification outside the U.S. should be adopted for intangible property. The rule could distinguish between "production" intangibles, such as know-how, patents and other intangibles that inherently contribute to the manufacturing process, and "marketing" intangibles, such as trademarks, that do not contribute directly to the manufacturing process. Production intangibles that are used in the development or manufacture of a product outside the U.S. could be considered to be for foreign use, irrespective of the location of the end-users of the product.
- (d) In terms of sales of tangible property, the NYSBA recommends that final regulations provide that foreign retailers that sell primarily through physical locations outside of the U.S. should be presumed to be for a foreign use absent actual knowledge on the part of the U.S. seller to the contrary. The definition of "foreign use" and the documentation requirements seek to prevent the "round-tripping" of exported products back into the U.S. from qualifying for the reduced FDII tax rate. The NYSBA states that the mere fact that general property sold to certain types of unrelated foreign parties is eventually used in the U.S. should not

necessarily disqualify the initial sale from the FDII regime absent some involvement by the U.S. seller in causing that outcome.

- (e) For purposes of determining whether a product is properly considered a “competent” of a second product, the NYSBA recommends that (i) a product is considered a component of a second product if the value of the first product is less than 50% of the value of the finished product and (ii) formally separate components each of which is added to a subsequent product should not be aggregated for these purposes, unless the U.S. seller has actual knowledge that separate components will in fact be combined or the inherent nature of the components compels them to be sold together.
- (f) The NYSBA, like TEI, recommends revising the documentation rules for foreign-derived income from services to provide greater flexibility using any reasonable method, or to provide simple forms that do not require the recipient to provide confidential, proprietary or unduly burdensome information that can be used to satisfy the requirements.
- (g) For sales to related parties where the unrelated party sale occurs in a subsequent tax year, the NYSBA recommends alternatives to requiring a taxpayer to amend its tax return for the year of the related party sale.
- (h) In terms of partnership rules, the NYSBA states that Treasury should not adopt an approach that treats partnerships as a pure entity or a pure aggregate, due to its administrative complexities. The pure entity approach can lead to incongruous results because a partnership’s place of organization may be chosen for non-tax reasons. The advantages of the pure entity approach are certainty, and ease of administration—it leads to a definite result, and requires the least amount of analysis to determine that result. A pure aggregate approach may be difficult to apply because the seller or provider would need to rely on information provided to it by the acquirer of goods relating to its direct or indirect owners. The NYSBA recommends that the FDII deduction not be taken into account in determining a partnership’s § 163(j) adjusted taxable income
- (i) Similar to TEI, the NYSBA recommends revising the applicability date so that the proposed documentation rules apply. The NYSBA recommends that they apply as of the second anniversary of the date the regulations are finalized.

IV. BEAT.

A. The § 59A base erosion and anti-abuse minimum tax (“BEAT”) provisions require an applicable taxpayer to pay a tax equal to the base erosion minimum tax amount for the tax year. The BEAT amount is the excess of 10% (5% for 2018) of the taxpayer’s modified taxable income (“MTI”) for the tax year over an amount equal to its regular tax liability for that year reduced by certain credits. MTI is the taxpayer’s taxable income increased by its base erosion payments (“BEPs”).

1. A BEP is any amount paid or accrued by the taxpayer to a foreign person that is a related party of the taxpayer for which a deduction is allowable. “Related person” is defined quite broadly to include any 25% owner of the taxpayer, any person who is related (within the meaning of § 267(b) or 707(b)(1)) to the taxpayer or any 25% owner of the taxpayer, and any other person who is related (within the meaning of § 482) to the taxpayer. BEPs include deductions arising from depreciable or amortizable assets acquired from such a related foreign person (note the issue regarding inbound IP).
2. BEPs do not include U.S.-source payments subject to gross-basis withholding and with respect to which the full 30% amount of tax has been withheld under §§ 1441 and 1442. A pro ration rule applies to the extent the rate of withholding tax is reduced pursuant to a treaty.
3. Exceptions apply for service payments charged at cost with no markup that are eligible for the services cost method under the § 482 transfer pricing regulations (determined without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure) and for payments with respect to qualified derivatives. Certain other rules apply which we will not discuss here (for example, the BEAT rules apply to taxpayers that have annual gross receipts of at least \$500 million for the preceding three years and a “base erosion percentage” of 3% or higher; special rules apply to expatriated entities; and special NOL rules apply).

B. Comments.

1. We have six general observations about these rules. **First**, the BEAT rules would seem more likely to apply to thin-margin taxpayers. For example, assume a U.S. company with \$100 of gross income, \$95 of deductions, and \$5 of taxable income. This will result in a tax of \$1 (using a 20% corporate tax rate for simplicity). If \$5 of the taxpayer’s deductions are BEPs, the taxpayer will have \$90 of deductions for calculating its MTI. Its MTI will be \$10. Assuming the full 10% tax rate, the taxpayer’s BEAT amount is zero (\$1 tentative minimum tax minus \$1 regular tax equals zero). While the taxpayer will not owe a minimum tax, it will be

right on the threshold of owing this tax. Stated differently, in a simple example such as this one, the taxpayer can't have BEPs that will reduce its taxable income by more than 50%. It's pretty close in this example even with only a small amount of BEPs.

2. Now assume the taxpayer that has the same \$100 of gross income, but that it has \$50 of deductions and \$50 taxable income. Its regular tax liability is \$10 (assuming again for simplicity a 20% regular tax rate). If this taxpayer has \$5 of deductions that constitute BEPs, its deductions for minimum tax purposes are \$45. It will have \$55 of MTI and at 10%, no minimum tax (\$5.5 is less than \$10). This taxpayer is not subject to the base erosion minimum tax, and is not even close to the threshold. Again, stated differently, this taxpayer also cannot afford to have BEPs that will reduce its taxable income by more than 50%, but here the taxpayer is not even close to having a minimum tax liability. It has a very small amount of BEPs relative to its regular taxable income.
3. Our **second** observation: BEPs are amounts paid or accrued by the taxpayer to a foreign person which is a related party and with respect to which a deduction is allowable. Problem payments, or those which must be considered, will likely primarily include payments for interest, royalties and services. If the taxpayer purchases goods from a foreign related party and resells those goods to customers, that transaction will generally not implicate the BEAT rules.
4. Income characterization might be important, however. Suppose in the previous example that the goods bear a trademark. Could an IRS examining agent assert that a portion of the amount paid to the foreign entity constitutes income properly characterized as a royalty? It would seem not. Rev. Rul. 75-254, 1975-1 C.B. 243, provides that the purchase of the goods bearing a trademark includes the right to resell the goods without having to pay a separate royalty. This assumes, of course, that the parties do not have a separate trademark agreement providing for a royalty. The same should be true regarding patented products.
5. The § 482 regulations are similar. They address imbedded-value transactions so that the value of the imbedded intangible can be considered, but they generally do not bifurcate the transaction. Further, the § 482 regulations also provide that the parties' written contracts should not be changed, modified, or ignored if the transactions satisfy the economic substance rules of Treas. Reg. §§ 1.482-1(d)(3)(ii)(B) and (iii)(B).
6. The income characterization rules in Treas. Reg. § 1.861-18 also could be important. Under those regulations, a software transaction might be characterized as the provision of services, a sale, or a license. This

characterization could have significant consequences under BEAT provisions.

7. Sales commissions could be an issue. Assume a U.S. company pays selling commissions to foreign related parties, instead of selling the products to them and having them resell the products. The commissions would be a payment for services. *See*, for example, Rev. Rul. 60-55, 1960-1 C.B. 270. If the product were sold to the foreign related parties for resale, the U.S. company's transactions would be treated as sales transactions with no payment for services to the foreign party.
8. Another issue involves a U.S. company acting as a shared service provider for the worldwide group. For example, suppose that an Indian affiliate performs R&D services for a variety of entities in the corporate group, including foreign affiliates. For purposes of administrative convenience, the Indian affiliate has a single services agreement—with the U.S. parent. The U.S. parent then subcontracts the Indian affiliate's services throughout the worldwide group. The U.S. essentially acts as a mere conduit, but its payments to the Indian service provider in respect of services rendered to other foreign affiliates could raise BEAT issues. Risk here could be mitigated through amendments to the legal relationships governing the shared services arrangement without upending the entire structure. VAT issues also might need to be considered.
9. Finally, there might be questions about what is properly subject to treatment as cost of goods sold. In the sales of goods/royalty example above but where a separate royalty is actually paid, perhaps the royalty could be charged to cost of goods sold instead of being claimed as a deduction.
10. Our **third** observation has to do with interest expense. This rule can produce surprises. Assume the U.S. taxpayer has \$100 of income for §163(j) purposes and has \$20 of interest expense owed to each of an unrelated bank and a foreign related person. The taxpayer's interest expense deduction is limited to \$30, thus \$10 is disallowed.
11. For BEAT purposes the \$10 of disallowed interest expense is taken from the \$20 of third-party (bank) interest expense. Thus, the full \$20 of related party interest expense is deductible and thus subject to the BEAT calculations.
12. **Fourth**, BEAT, of course, operates as a minimum tax. The amount is equal to 10% (5% in the case of taxable years beginning in calendar 2018) of the taxpayer's modified taxable income over the amount equal to the regular tax liability of that taxpayer. Thus, in principle, a taxpayer could have no Base Erosion Payments ("BEPs") subject to BEAT (but see below regarding BEAT's "off and on" switch) and still suffer the BEAT

minimum tax if its regular tax liability, for example, were reduced by foreign tax credits. In this sense, BEAT has nothing to do with BEPs but rather operates as a true minimum tax. This certainly can sneak up on poorly advised taxpayers.

13. A **fifth** observation, which perhaps is particularly appropriate for taxpayers who are caught by the pure minimum-tax effect described above: BEAT has an “off and on” switch. It only applies to “applicable taxpayers,” those that have average annual gross receipts for a three-year period exceeding a certain amount and that also have a base erosion percentage of at least 3% for the taxable year (2% for banks or registered securities dealers).
14. The BEAT switch thus is turned “on,” and thus the BEAT rules apply, if the taxpayer has the tainted base erosion percentage or higher. If the taxpayer can keep its base erosion percentage below that amount, the BEAT rules are turned “off.” Base erosion percentage is determined by dividing the taxpayer’s BEPs by the amount of deductions allowable to the taxpayer for that taxable year.
15. Our **sixth** observation relates to the exception for amounts paid for certain services. Under § 59A(d)(5), *amounts* paid for certain services are not treated as BEPs. To qualify, (1) the *services* must meet the requirements for eligibility for use of the services cost method under § 482 (determined without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure) and (2) the *amount* must constitute the total services cost *with no markup component*.
16. An issue has arisen that, to some, involves a colloquy on the Senate floor. The question is, does BEAT apply to just the markup component of a marked-up service or to both the markup and the cost component of the payment? Assume that a U.S. taxpayer pays \$120 for services that include the cost to the provider of \$100 and a \$20 mark-up. Is \$120 or \$20 subject to BEAT? Assume that the services qualify under the services cost method, as modified for BEAT purposes, but that a markup was either required under those rules (Treas. Reg. § 1.482-9) or was added anyway.
17. One view is reflected in comments by Martin Sullivan. A conflicting view was expressed by Maral Corwin, Ron Dabrowski, Danielle Rolfes, Michael Plowgian, and Thomas Wessel of KPMG. A report by Ryan Finley at 2018 WTD 33-3 quotes Michael McDonald of EY as stating that despite disagreement on whether a markup disqualifies the entire charge for the BEAT services exception, the exception clearly covers the cost portion for qualifying services. A report by Alexander Lewis at 2018 WTD 33-2, quotes Mark Prater, Deputy Staff Director and Chief Tax Counsel for the Senate Finance Committee as stating that when you have a

markup, there is a discussion and the legislation deals with no markup services. He states that this is clear. He also states there is a colloquy that was done on the Senate floor. He states that people should realize it is just a colloquy that discusses the issue but adds that if you look in the conference report language “I think it is pretty clear that it is the services with no markup that we’re talking about.”

18. While regulations will need to resolve the issue, we believe the matter is appropriately resolved without resort to the colloquy. In fact, the colloquy is irrelevant in our view. We think that the statute is clear: the § 59A(d)(5) exception applies to the *amount* that is without the “markup component” even if a markup amount also is billed.
19. We reach this conclusion based simply on general rules of statutory construction. The statutory exception is for an *amount*. It is an amount “with respect to” certain services. The “good services” are those that meet the requirements for eligibility for use of the services cost method under § 482 (but determined without regard to the requirement that the service does not contribute significantly to fundamental risks of business success or failure).
20. Under Treas. Reg. § 1.482-9, a markup would be required if the unmodified definition (as it appears in that regulation) required a markup. But § 59A still treats the cost amount of those services as an excepted amount. Section 59A has a different, modified definition. Section 59A(d)(5) also is pretty clear in stating that the excepted *amount* must constitute the total services cost with no markup *component*.
21. Thus, we don’t think we need the colloquy to reach an answer. We think the statute is clear.
22. There is a lot of law on statutory interpretation but this issue seems like a pretty simple matter to resolve. Those who have expressed the view that the total amount of \$120 is disqualified from constituting an excepted service amount, and thus is a BEP, would render portions of the statute meaningless. They would render use of the words “amount” and “amounts” meaningless. The words “amount” or “amounts” appear in three places in § 59A(d)(5). Under basic rules of statutory construction, all words need to be given meaning.
23. Those who would subject the full \$120 to BEAT (as a BEP) also would render the parenthetical in § 59A(d)(5) meaningless since that parenthetical says those services are “good” services even though Treas. Reg. § 1.482-9 would always require a markup.
24. Section 59A(d)(5) also uses the word “component.” One dictionary defines this term as “constituting a part or element of a larger whole;

constituent.” Thus, the statute pretty clearly contemplates a service charge with components, i.e., a cost amount and a markup component. The word “component” also cannot be ignored under basic rules of statutory construction.

25. Basic rules of statutory construction require a reading that does not nullify a portion of the statute. The statute intends to allow the exception for services that qualify for the services cost method *determined without* regard to one of the § 482 regulation’s requirements. The statute says these are good services. They result in excepted amounts even if the § 482 regulations definition requires a markup. That is, the nature of the services exempts them.
26. Thus, we think that undue focus on the colloquy is misplaced and that a simple statutory analysis is all that is necessary. In the example above, the amount of \$100 should qualify for the exclusion from treatment as a BEP and only the \$20 should be treated as a BEP subject to the BEAT rules.
27. Those persons who would disagree with this conclusion would necessarily have to assume that the parenthetical was drafted by persons who didn’t realize that it was irrelevant and had no meaning or effect. Statutory draftspersons deserve more credit than that. When the parenthetical applies, a markup indeed is required. These doubters would have to say that Congress passed a law that, as to § 59A(d)(5)’s parenthetical clause, self-destructed in all cases. A markup is always required under Treas. Reg. § 1.482-9 in these cases. That’s pretty simple.
28. The intent, and the clear statutory language, is to treat the *cost amount* of that “good” service as excepted from BEP treatment for BEAT purposes.

C. BEAT Regulations. Treasury and the IRS proposed regulations under § 59A regarding the new minimum tax related to base erosion payments (the “BEAT”). They are proposed to be effective for tax years beginning after December 31, 2017.

1. Applicable Taxpayer. The BEAT applies to “applicable taxpayers.” Under Prop. Treas. Reg. § 1.59A-2 an applicable taxpayer is a corporation (other than (1) a regulated investment company (“RIC”), (2) a real estate investment trust (“REIT”), or (3) an S corporation) that satisfies the gross receipts test and the base erosion percentage (“BEP”) test. Section 59A and the proposed regulations provide that the taxpayer and certain related corporations are treated as one person (the “aggregate group”) for purposes of determining whether the taxpayer satisfies these tests. Prop. Treas. Reg. § 1.59A-2(b).

2. Determining the Aggregate Group for Purposes of Applying the Gross Receipts Test and the Base Erosion Percentage Test.

- (a) Section 59A(e)(3) aggregates corporations on the basis of persons treated as a single employer under § 52(a), which treats members of the “same controlled group of corporations” (as defined in § 1563(a) with certain modifications) as one person. Foreign corporations are included in the aggregate group only if they have, and only to the extent they have, effectively connected income (“ECI”).
- (b) Payments between members of the aggregate group are not included in the group’s gross receipts. Similarly, payments between members of the aggregate group are also not taken into account for purposes of the numerator or the denominator in the BEP calculation. Prop. Treas. Reg. § 1.59A-2(b).
- (c) Payments between the aggregate group and a foreign corporation that is not within the aggregate group regarding the payment are taken into account in applying both the gross receipts test and the BEP test. A foreign corporation is included in the aggregate group to the extent it is subject to net income tax in the U.S. Thus, payments to a foreign corporation from within the aggregate group that are subject to net income tax in the U.S. are eliminated and not taken into account in applying the gross receipts test and the BEP test.
- (d) As a result, one payment by a domestic corporation to a foreign corporation might not be taken into account in determining applicable taxpayer status because the payee is subject to net income tax in the U.S. on that payment, while another payment by the same domestic corporation to the same foreign corporation is taken into account in determining applicable taxpayer status because the payee is not subject to net income tax in the U.S. regarding that payment.

3. Gross Receipts Test.

- (a) A taxpayer satisfies the gross receipts test if the taxpayer, or the aggregate group of which the taxpayer is a member, has \$500 million or more of average annual gross receipts during the three prior taxable years. In the case of a foreign corporation, the gross receipts test considers only those gross receipts that are taken into account in determining income that is subject to a U.S. net income tax. Prop. Treas. Reg. § 1.59A-2(d).

- (b) The proposed regulations address how a taxpayer computes gross receipts, including providing rules for corporations that have been in existence for fewer than three years or have short years. They are generally consistent with rules set forth in § 448(c). *See* § 59A(e)(2)(B). They also address how gross receipts are determined if members of the aggregate group that have different taxable years. Prop. Treas. Reg. § 1.59A-2(d)(2).
- (c) If a member of an aggregate group owns an interest in a partnership, the group includes its share of the gross receipts of the partnership in its gross receipts computation. Prop. Treas. Reg. § 1.59A-7(b)(5)(ii). The aggregate group's share of the gross receipts of the partnership is proportionate to its distributive share of items of gross income from the partnership.

4. BEP Test.

- (a) The BEP test is satisfied if the taxpayer (or if the taxpayer is a member of an aggregate group, the aggregate group) has a BEP of 3% or more. We called this the “BEAT off-on switch” above.
- (b) A lower threshold of 2% applies if the taxpayer, or a member of the taxpayer's aggregate group, is a member of an affiliated group (as defined in § 1504(a)(1)) that includes a domestic bank or registered securities dealer. Prop. Treas. Reg. § 1.59A-2(e)(2)(iii). The lower 2% threshold does not apply, however, in the case of an aggregate group or consolidated group that has de minimis bank or registered securities dealer activities.
- (c) The BEP for a taxable year is computed by dividing (1) the aggregate amount of base erosion tax benefits (the “numerator”) by (2) the sum of the aggregate amount of deductions plus certain other base erosion tax benefits (the “denominator”). Prop. Treas. Reg. § 1.59A-2(e)(3). In the case of a taxpayer that is a member of an aggregate group, the BEP is measured by reference to the deductions or certain reductions in gross income of the taxpayer and members of the taxpayer's aggregate group as of the end of the taxpayer's taxable year. “Base erosion tax benefits” are generally the deductions or reductions in gross income that result from base erosion payments. Prop. Treas. Reg. § 1.59A-3(c)(1).
- (d) As discussed below, the numerator of the BEP excludes deductions for (i) amounts paid or accrued to foreign related parties for services qualifying for the exception in Prop. Treas. Reg. § 1.59A-3(b)(3)(i) (the “services cost method (“SCM”) exception”), (ii) payments covered by the qualified derivatives payments (“QDP”) exception in Prop. Treas. Reg. § 1.59A-3(b)(3)(ii), and

(iii) amounts excluded pursuant to the total loss-absorbing capacity (“TLAC”) exception in Prop. Treas. Reg. § 1.59A-3(b)(3)(v). These deductions are also excluded from the denominator of the BEP. Prop. Treas. Reg. § 1.59A-2(e)(3)(ii).

- (e) An exception to this rule applies if an applicable taxpayer makes a payment to a foreign related party that is not a member of the aggregate group, if, for example, the recipient of the payment is a 25% owner as described in Prop. Treas. Reg. § 1.59A-1(b)(17) (related persons) that does not own more than 50% of the applicable taxpayer, and that payment qualifies for the ECI exception described in Prop. Treas. Reg. § 1.59A-3(b)(3)(iii). If so, and if that payment also qualifies for either the SCM exception described in Prop. Treas. Reg. § 1.59A-3(b)(3)(i), the QDP exception described in Prop. Treas. Reg. § 1.59A-3(b)(3)(ii), or the TLAC exception described in Prop. Treas. Reg. § 1.59A-3(b)(3)(v), the payment will be included in the denominator for purposes of the base erosion percentage.
- (f) For example, if an applicable taxpayer makes a deductible payment to a foreign related person who is a 25% owner and the payment is both a QDP and subject to federal income taxation as income that is, or is treated as, effectively connected with the conduct of a trade or business in the U.S., the payment is included in the denominator of the BEP. However, if the applicable taxpayer makes a deductible payment to a foreign related person and the payment is a QDP, but not otherwise subject to federal income taxation, the payment is excluded from the denominator of the BEP.
- (g) The proposed regulations also exclude any § 988 losses from the numerator and the denominator in determining the BEP. Prop. Treas. Reg. §§ 1.59A-2(e)(3)(ii) and -3(b)(3)(iv).
- (h) The numerator of the BEP only takes into account base erosion tax benefits, which generally are base erosion payments for which a deduction is allowed under the Code for a taxable year. Prop. Treas. Reg. §§ 1.59A-2(e)(3) and 1.59A-3(c)(i). The proposed regulations ensure that the denominator of the BEP only takes into account deductions allowed under the Code by providing that the denominator of the BEP does not include deductions that are not allowed in determining taxable income for the taxable year.
- (i) A deduction allowed under § 965(c) to a United States shareholder of a deferred foreign income corporation is not one of the categories of deductions specifically excluded from the denominator under § 59A(c)(4)(B). Thus, that deduction is included in the denominator. Preamble p. 13.

- (j) If tax is imposed by § 871 or § 881 and that tax has been deducted and withheld under § 1441 or § 1442 on a base erosion payment, it is not treated as a base erosion tax benefit for purposes of calculating a taxpayer's modified taxable income. Prop. Treas. Reg. § 1.59A-3(c)(2). However, if an income tax treaty reduces the amount of withholding imposed on the base erosion payment, it is treated as a base erosion tax benefit to the extent of the reduction in withholding under rules similar to those in § 163(j)(5)(B) as in effect before the TCJA. Prop. Treas. Reg. § 1.59A-2(e)(iii).
- (k) The same rule applies concerning withholding taxes for purposes of the BEP computation. Accordingly, a base erosion tax benefit is not included in the numerator when the payment was subject to tax under § 871 or § 881 and that tax has been deducted and withheld under § 1441 or § 1442. In the case of a base erosion payment subject to a reduced rate of withholding tax under an income tax treaty, the associated amount of base erosion tax benefits eliminated from the numerator of the BEP calculation is determined using rules similar to those in § 163(j)(5)(B) as in effect before the TCJA.
- (l) The BEP also takes into account the two categories of base erosion tax benefits that result from reductions in gross income rather than deductions allowed under the Code; specifically, (1) certain premiums or other consideration paid to a foreign related party for reinsurance, and (2) amounts paid or accrued by the taxpayer to certain surrogate foreign corporations that result in a reduction in gross receipts to the taxpayer. Prop. Treas. Reg. § 1.59A-3(b)(i). Section 59A(c)(4)(A)(ii)(II) provides that those base erosion tax benefits that result from reductions in gross income are included in the both the numerator and the denominator in the same amount. Other payments that reduce gross income but that are not base erosion payments are not included in the denominator of the BEP.

5. Taxpayers in an Aggregate Group with Different Taxable Years.

- (a) Section 59A determines the status of a corporation as an applicable taxpayer on the basis of the aggregate group rules by taking into account the gross receipts and base erosion payments of each member of the aggregate group. However, each member must compute the aggregate group amount of gross receipts and base erosion payments based on its own taxable year and based on those corporations that are members of the aggregate group at the end of that taxable year. Therefore, members with different taxable years may have different BEPs.

- (b) However, each corporation that is an applicable taxpayer computes its modified taxable income and base erosion minimum tax amount (“BEMTA”) on a separate taxpayer basis. In the case of a group of affiliated corporations filing a consolidated tax return, the consolidated group is treated as a single taxpayer for purposes of § 59A, and its modified taxable income and BEMTA are determined on a consolidated group basis.
- (c) The proposed regulations provide rules for determining whether the gross receipts test and BEP test are satisfied with respect to a specific taxpayer when other members of its aggregate group have different taxable years. *See* Prop. Treas. Reg. § 1.59A-2(e)(3)(vii). In general, the proposed regulations provide that each taxpayer determines its gross receipts and BEP by reference to its own taxable year, taking into account the results of other members of its aggregate group during that taxable year.
- (d) Thus, for purposes of determining the gross receipts, base erosion tax benefits, and deductions of the aggregate group, the taxpayer must include those amounts that occur during the course of the taxpayer’s own taxable year, not another member of the aggregate group’s taxable year, if different. The proposed regulations adopt this approach to provide certainty for taxpayers and avoid the complexity of a rule that identifies a single taxable year for an aggregate group for purposes of § 59A that may differ from a particular member of the aggregate group’s taxable year.
- (e) Prop. Treas. Reg. § 1.59A-2(f)(2) Example 2 provides:

(2) Example 2: Determining gross receipts test and base erosion percentage when aggregate group members have different taxable years. (i) Facts. Foreign Parent (FP) is a foreign corporation that owns all of the stock of a domestic corporation that uses a calendar year (DC1) and a domestic corporation that uses a fiscal year ending on January 31 (DC2). FP does not have income effectively connected with the conduct of a trade or business within the U.S. DC2 is a member of DC1’s aggregate group, and DC1 is a member of DC2’s aggregate group.

(ii) Analysis. (A) For DC1’s tax return filed for the calendar year ending December 31, 2026, DC1 determines its gross receipts based on gross receipts of DC1 and DC2 for the calendar years ending December 31, 2023, December 31, 2024, and December 31, 2025. Further, DC1 determines its base erosion percentage for the calendar year ending December 31, 2026, on the basis of transactions of DC1 and DC2 for the calendar year ending December 31, 2026.

(B) For DC2’s tax return filed for the fiscal year ending January 31, 2027, DC2 determines its gross receipts based on gross

receipts of DC2 and DC1 for the fiscal years ending January 31, 2024, January 31, 2025, and January 31, 2026. Further, DC2 determines its base erosion percentage for the fiscal year ending January 31, 2027, on the basis of transactions of DC2 and DC1 for the fiscal year ending January 31, 2027.

- (f) As a result of this rule, two related taxpayers with different taxable years will compute their applicable gross receipts and BEP by reference to different periods, even though in each case the calculations are done on an aggregate group basis that takes into account other members of the controlled group. Taxpayers may use a reasonable method to determine the gross receipts and BEP information for the time period of the member of the aggregate group with a different taxable year.
- (g) The proposed regulations also provide that when determining the BEP for a taxpayer that is a member of an aggregate group with other members that have a different taxable year, the effective date of § 59A, as it applies to the taxpayer making the return, controls whether that taxpayer takes into account transactions of other members of its aggregate group. Section 59A applies only to base erosion payments paid or accrued in taxable years beginning after December 31, 2017.
- (h) Thus, if one corporation (US1) that has a calendar year is a member of an aggregate group with another corporation (US2) that has a taxable year ending November 30, when US1 computes its BEP for its calendar year ending December 31, 2018, the base erosion payments made by US2 during the period from January 1, 2018, through December 31, 2018, are taken into account with respect to US1 for its computations even though US2's base erosion payments in its taxable year ending November 30, 2018, are not base erosion payments with respect to US2 because of § 59A's effective date.
- (i) Correspondingly, US2's taxable year beginning December 1, 2017, and ending November 30, 2018, is not subject to § 59A because US2's base erosion payments occur in a year beginning before January 1, 2018, and base erosion payments made by US1 during the period from December 1, 2017 through November 30, 2018, do not change that result.

6. Mark-to-Market Deductions.

- (a) The taxpayer (or in the case of a taxpayer that is a member of an aggregate group, the aggregate group) must determine the amount of base erosion tax benefits in the numerator and the total amount of certain deductions, including base erosion tax benefits, in the

denominator to determine the BEP for the year. Prop. Treas. Reg. § 1.59A-2(e)(3)(vi) provides rules for determining the amount of base erosion tax benefits in the case of transactions that are marked to market. They also apply for determining the total amount of the deductions that are included in the denominator of the BEP computation.

- (b) To ensure that only a single deduction is claimed with respect to each transaction, the proposed regulations combine all income, deduction, gain, or loss on each transaction for the year to determine the amount of the deduction that is used for purposes of the BEP test. This rule does not modify the net amount allowed as a deduction pursuant to the Code and regulations. This rule is intended to prevent distortions in deductions from being included in the denominator of the BEP, including as a result of the use of an accounting method that values a position more frequently than annually.

7. Base Erosion Payments. A base erosion payment is defined as a payment or accrual by the taxpayer to a foreign related party (as defined in Prop. Treas. Reg. § 1.59A-1(b)(12)) that is described in one of four categories: (1) a payment with respect to which a deduction is allowable; (2) a payment made in connection with the acquisition of depreciable or amortizable property; (3) premiums or other consideration paid or accrued for reinsurance that is taken into account under § 803(a)(1)(B) or § 832(b)(4)(A); or (4) a payment resulting in a reduction of the gross receipts of the taxpayer that is with respect to certain surrogate foreign corporations or related foreign persons.
8. A payment or accrual that is not within one of the categories may be a base erosion payment described in one of the other categories. For example, a deductible payment related to reinsurance that does not meet the requirements for the third category of base erosion payments may still be a base erosion payment under the first category because the payment is deductible. Nonetheless, to the extent all or a portion of a payment or accrual is described in more than one of these categories, the amount is only taken into account once as a base erosion payment.
9. Unless an exception applies, the determination of whether a payment or accrual by the taxpayer to a foreign related party is described in one of these four categories is made under general U.S. federal income tax law. For example, the proposed regulations do not explicitly address whether a royalty payment is classified as deductible under § 162 or as a cost includible in inventory under §§ 471 and 263A resulting in a reduction in gross income under § 61.

10. In general, the treatment of a payment as deductible, or as other than deductible, such as an amount that reduces gross income or is excluded from gross income because it is beneficially owned by another person, generally will have federal income tax consequences that will affect the application of § 59A and will also have consequences for other provisions of the Code.
11. In light of existing tax law dealing with identifying who is the beneficial owner of income, who owns an asset, and the related tax consequences (including under principal-agent principles, case law conduit principles, assignment of income or other principles of generally applicable tax law), the proposed regulations do not establish any specific rules for purposes of § 59A for determining whether a payment is treated as a deductible payment or, when viewed as part of a series of transactions, should be characterized in a different manner.
12. As we discussed above, income characterization could be important under the BEAT rules. This is not the subject of specific rules in the BEAT regulations and is left to general tax law concepts and rules.
13. Nonetheless, note that Prop. Treas. Reg. § 1.59A-9 does contain anti-abuse rules dealing with conduits, intermediaries, and so forth.
14. Certain Specific Types of Base Erosion Payments. The proposed regulations contain operating rules for determining whether there is a payment or accrual that can give rise to a base erosion payment. They discuss proposed rules coordinating the definition of base erosion payment with rules that allocate deductions for purposes of determining a foreign corporation's ECI.
 - (a) Payments or Accruals That Consist of Non-Cash Consideration.
 - i. The proposed regulations provide that a payment or accrual by a taxpayer to a foreign related party may be a base erosion payment regardless of whether the payment is in cash or in any form of non-cash consideration. *See* Prop. Treas. Reg. § 1.59A-3(b)(2)(i). There may be situations where a taxpayer incurs a non-cash payment or accrual to a foreign related party in a transaction that meets one of the definitions of a base erosion payment, and that transaction may also qualify under certain nonrecognition provisions of the Code. Examples of these transactions include a domestic corporation's acquisition of depreciable assets from a foreign related party in an exchange described in

§ 351, a liquidation described in § 332, and a reorganization described in § 368.⁴

- ii. The proposed regulations do not include any specific exceptions for these types of transactions even though (a) the transferor of the assets acquired by the domestic corporation may not recognize gain or loss, (b) the acquiring domestic corporation may take a carryover basis in the depreciable or amortizable assets, and (c) the importation of depreciable or amortizable assets into the U.S. in these transactions may increase the regular income tax base as compared to the non-importation of those assets.
- iii. Treasury and the IRS believe that neither the nonrecognition of gain or loss to the transferor nor the absence of a step-up in basis to the transferee establishes a basis to create a separate exclusion from the definition of a base erosion payment. The statutory definition of this type of base erosion payment that results from the acquisition of depreciable or amortizable assets in exchange for a payment or accrual to a foreign related party is based on the amount of imported basis in the asset. That amount of basis is imported regardless of whether the transaction is a recognition transaction or a transaction subject to rules in Subchapter C or elsewhere in the Code.
- iv. In contrast, for transactions in which a taxpayer that owns stock in a foreign related party receives depreciable property from the foreign related party as an in-kind distribution subject to § 301, there is no base erosion payment because there is no consideration provided by the taxpayer to the foreign related party in exchange for the property. Thus, there is no payment or accrual.
- v. In addition, because § 59A(d)(1) defines the first category of base erosion payment as “any amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer and with respect to which a deduction is allowable under this chapter,” a base erosion payment also includes a payment to a foreign related party resulting in a recognized loss; for example, a loss recognized on the transfer of property to a foreign related party.

⁴ This is questionable and ought to be deleted. Consider the acquisition of a foreign target company followed by a § 338 election and a check-the-box election? Why should this result in a base erosion payment?

(b) Interest Expense Allocable to a Foreign Corporation's ECI.

- i. Section 59A applies to foreign corporations that have income that is subject to net income taxation as effectively connected with the conduct of a trade or business in the United States, taking into account any applicable income tax treaty of the United States. The proposed regulations generally provide that a foreign corporation that has interest expense allocable under § 882(c) to income that is effectively connected with the conduct of a trade or business within the U.S. will have a base erosion payment to the extent the interest expense results from a payment or accrual to a foreign related party. The amount of interest that will be treated as a base erosion payment depends on the method used under Treas. Reg. § 1.882-5. Prop. Treas. Reg. § 1.59A-3(b)(4).
- ii. If a foreign corporation uses the method described in Treas. Reg. § 1.882-5(b) through (d), interest on direct allocations and on U.S.-booked liabilities that is paid or accrued to a foreign related party will be a base erosion payment. If U.S.-booked liabilities exceed U.S.-connected liabilities, a foreign corporation computing its interest expense under this method must apply the scaling ratio to all of its interest expense on a pro-rata basis to determine the amount that is a base erosion payment. Interest on excess U.S.-connected liabilities also may be a base erosion payment if the foreign corporation has liabilities with a foreign related party.
- iii. If a foreign corporation determines its interest expense under the separate currency pools method described in Treas. Reg. § 1.882-5(e), the amount of interest expense that is a base erosion payment is equal to the sum of (1) the interest expense on direct allocations paid or accrued to a foreign related party and (2) the interest expense in each currency pool multiplied by the ratio of average foreign related party liabilities over average total liabilities for that pool. The base erosion payment exceptions may lower the amount of interest expense that is a base erosion payment.
- iv. Treasury and the IRS state that Treas. Reg. § 1.882-5 provides certain simplifying elections for determining the interest deduction of a foreign corporation. In particular, Treas. Reg. § 1.882-5(c) generally provides that the amount of U.S.-connected liabilities equals the total value of U.S. assets multiplied by the taxpayer's worldwide leverage ratio. However, Treas. Reg. § 1.882-5(c)(4) allows a

taxpayer to elect to use a fixed ratio instead of its actual worldwide leverage ratio. Similarly, Treas. Reg. § 1.882-5(d)(5)(ii)(A) provides a general rule that the deduction for interest on excess U.S.-connected liabilities is determined by reference to the average rate of interest on U.S.-dollar liabilities that are not U.S.-booked liabilities. However, Treas. Reg. § 1.882-5(d)(5)(ii)(B) allows certain taxpayers to elect to determine the deduction by reference to the 30-day London Interbank Offering Rate.

(c) Other Deductions Allowed with Respect to ECI.

- i. Like excess interest expense, the proposed regulations provide that the amount of a foreign corporation's other deductions properly allocated and apportioned to effectively connected gross income under Treas. Reg. § 1.882-4 are base erosion payments to the extent that those deductions are paid or accrued to a foreign related party. Prop. Treas. Reg. § 1.59A-3(b)(4)(ii). Treas. Reg. § 1.882-4(a)(1) generally provides that a foreign corporation engaged in a trade or business within the U.S. is allowed the deductions which are properly allocated and apportioned to the foreign corporation's gross income which is effectively connected its conduct of a trade or business within the U.S. The proposed regulations follow the approach under Treas. Reg. § 1.882-4. Accordingly, the regulations identify base erosion payments by tracing each item of deduction, and determining whether the deduction arises from a payment to a foreign related party.
- ii. If a foreign corporation engaged in a trade or business within the U.S. acquires property of a character subject to the allowance for depreciation (or amortization in lieu of depreciation) from a foreign related party, the amount paid or accrued by the taxpayer to the foreign related party is a base erosion payment to the extent the property is used, or held for use, in the conduct of a trade or business within the U.S. Prop. Treas. Reg. § 1.59A-3(b)(4)(iii).

(d) Income Tax Treaties.

- i. The use of a treaty-based expense allocation or attribution method does not, in and of itself, create legal obligations between the U.S. permanent establishment and the rest of the enterprise. The proposed regulations recognize that as a result of a treaty-based expense allocation or attribution method, amounts equivalent to deductible payments may be

allowed in computing the business profits of an enterprise with respect to transactions between the permanent establishment and the home office or other branches of the foreign corporation (“internal dealings”). Prop. Treas. Reg. § 1.59A-3(b)(4)(v).

- ii. The deductions from internal dealings would not be allowed under the Code and regulations, which generally allow deductions only for allocable and apportioned costs incurred by the enterprise as a whole. The proposed regulations require that these deductions from internal dealings allowed in computing the business profits of the permanent establishment be treated in a manner consistent with their treatment under the treaty-based position and be included as base erosion payments.
- iii. The proposed regulations include rules to recognize the distinction between the allocations of expenses addressed above, and internal dealings. In the first instance, the allocation and apportionment of expenses of the enterprise to the branch or permanent establishment is not itself a base erosion payment because the allocation represents a division of the expenses of the enterprise, rather than a payment between the branch or permanent establishment and the rest of the enterprise. In the second instance, internal dealings are not mere divisions of enterprise expenses, but rather are priced on the basis of assets used, risks assumed, and functions performed by the permanent establishment in a manner consistent with the arm’s length principle.
- iv. Treasury and the IRS believe that the approach in the proposed regulations creates parity between deductions for actual regarded payments between two separate corporations (which are subject to § 482), and internal dealings (which are generally priced in a manner consistent with the applicable treaty and, if applicable, the OECD Transfer Pricing Guidelines).
- v. The rules in the proposed regulations applicable to foreign corporations using this approach apply only to deductions attributable to internal dealings, and not to payments to entities outside of the enterprise, which are subject to the general base erosion payment rules as provided in Prop. Treas. Reg. § 1.59A-3(b)(4)(v)(A).

- (e) Certain Payments to Domestic Passthrough Entities with Foreign Owners or to Another Aggregate Group Member. The proposed regulations also provide rules for certain payments to a domestic trust, REIT or RIC, and for certain payments to a related domestic corporation that is not part of a consolidated group. Prop. Treas. Reg. § 1.59A-3(b)(2)(v) provides a rule that applies when a domestic trust, REIT or RIC receives a payment that otherwise would be a base erosion payment. Prop. Treas. Reg. § 1.59A-3(b)(2)(vi) applies when a taxpayer transfers certain property to a member of an aggregate group that includes the taxpayer, to ensure that any deduction for depreciation (or amortization in lieu of depreciation) by the transferee taxpayer remains a base erosion tax benefit to the same extent as the amount that would have been a base erosion tax benefit in the hands of the transferor.

15. Exceptions from the Base Erosion Payment Definition.

- (a) Exception for Certain Amounts with Respect to Services.
 - i. The Services Cost Method (“SCM”) exception described in § 59A(d)(5) provides that § 59A(d)(1) (which sets forth the general definition of a base erosion payment) does not apply to any amount paid or accrued by a taxpayer for services if (A) the services are eligible for the services cost method under § 482 (determined without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure) and (B) the amount constitutes the total services cost with no markup component.
 - ii. Treasury and the IRS interpret “services cost method” to refer to the services cost method described in Treas. Reg. § 1.482-9(b), interpret the requirement regarding “fundamental risks of business success or failure” to refer to the test in Treas. Reg. § 1.482-9(b)(5), commonly called the business judgment rule, and interpret “total services cost” to refer to the definition of “total services costs” in Treas. Reg. § 1.482-9(j).
 - iii. They believe that § 59A(d)(5) is ambiguous as to whether the SCM exception applies when an amount paid or accrued for services exceeds the total services cost, but the payment otherwise meets the other requirements for the SCM exception set forth in § 59A(d)(5). Under one interpretation of § 59A(d)(5), the SCM exception does not apply to any portion of a payment that includes any mark-up component. Under another interpretation of

§ 59A(d)(5), the SCM exception is available if there is a markup, but only to the extent of the total services costs.

- iv. Under the first interpretation, any amount of markup would disqualify a payment, in some cases resulting in dramatically different tax effects based on a small difference in charged costs. In addition, if any markup were required, for example because of a foreign tax law or non-tax reason, a payment would not qualify for the SCM exception.
- v. Under the second approach, the services cost would continue to qualify for the SCM exception provided the other requirements of the SCM exception are met. The latter approach to the SCM exception is more expansive because it does not limit qualification to payments made exactly at cost.
- vi. Significantly, in Prop. Treas. Reg. § 1.59A-3(b)(3), the proposed regulations provide that the SCM exception is available if there is a markup (and if other requirements are satisfied), but that the portion of any payment that exceeds the total cost of services is not eligible for the SCM exception and is a base erosion payment.
- vii. Treasury and the IRS believe this interpretation is more consistent with the text of § 59A(d)(5). Rather than require an all-or-nothing approach to service payments, § 59A(d)(5) provides an exception for “any amount” that meets the specified test. This language suggests that a service payment may be disaggregated into its component amounts, just as the general definition of base erosion payment applies to the deductible amount of a foreign related party payment even if the entire payment is not deductible. *See* § 59A(d)(1).
- viii. They state that the most logical interpretation is that a payment for a service that satisfies subparagraph (A) is excepted up to the qualifying amount under subparagraph (B), but amounts that do not qualify (i.e., the markup component) are not excepted. This interpretation is reinforced by the fact that § 59A(d)(5)(A) makes the SCM exception available to taxpayers that cannot apply the services cost method described in Treas. Reg. § 1.482-9(b) (which permits pricing a services transaction at cost for § 482 purposes) because the taxpayer cannot satisfy the business judgment rule in Treas. Reg. § 1.482-9(b)(5).

- ix. We addressed this above and reached the very same conclusion. We believe it is the correct approach under the statutory language.
- x. Because a taxpayer in that situation cannot ordinarily charge cost, without a mark-up, for transfer pricing purposes, failing to adopt this approach would render the parenthetical reference in § 59A(d)(5)(A) a nullity. The interpretation the proposed regulations adopt gives effect to the reference to the business judgment rule in § 59A(d)(5).
- xi. To be eligible for the SCM exception, the proposed regulations require that all of the requirements of Treas. Reg. § 1.482-9(b) must be satisfied, except as modified by the proposed regulations. Therefore, a taxpayer's determination that a service qualifies for the SCM exception is subject to review under the requirements of Treas. Reg. § 1.482-9(b)(3) and (b)(4), and its determination of the amount of total services cost and allocation and apportionment of costs to a particular service is subject to review under the rules of Treas. Reg. §§ 1.482-9(j) and 1.482-9(k), respectively.
- xii. The proposed regulations do not require a taxpayer to maintain separate accounts to bifurcate the cost and markup components of its services charges to qualify for the SCM exception. They do require, however, that taxpayers maintain books and records adequate to permit verification of, among other things, the amount paid for services, the total services cost incurred by the renderer, and the allocation and apportionment of costs to services in accordance with Treas. Reg. § 1.482-9(k).
- xiii. Because payments for certain services that are not eligible for the SCM due to the business judgment rule or for which taxpayers select another transfer pricing method may still be eligible for the SCM exception to the extent of total services cost, the record-keeping requirements in the proposed regulations differ from the requirements in Treas. Reg. § 1.482-9(b)(6). *See* Prop. Treas. Reg. § 1.59A-3(b)(3)(i)(B)(2).
- xiv. Unlike Treas. Reg. § 1.482-9(b)(6), the proposed regulations do not require that taxpayers "include a statement evidencing [their] intention to apply the services cost method to evaluate the arm's length charge for such services," but the proposed regulations do require that

taxpayers include a calculation of the amount of profit mark-up (if any) paid for the services. For purposes of qualifying for the SCM exception under § 59A(d)(5), taxpayers are required to comply with the books and records requirements under the proposed § 59A regulations but not Treas. Reg. § 1.482-9(b)(6).

- xv. The proposed regulations also clarify that the parenthetical reference in § 59A(d)(5) to the business judgment rule prerequisite for applicability of the services cost method -- “(determined without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure)” -- disregards the entire requirement set forth in Treas. Reg. § 1.482-9(b)(5) solely for purposes of § 59A(d)(5).

(b) Qualified Derivative Payments.

- i. Section 59A(h) provides that a qualified derivative payment (“QDP”) is not a base erosion payment. Prop. Treas. Reg. § 1.59A-6 defines a QDP as any payment made by a taxpayer to a foreign related party pursuant to a derivative for which the taxpayer recognizes gain or loss on the derivative on a mark-to-market basis (treats the derivative as sold on the last business day of the taxable year), the gain or loss is ordinary, and any gain, loss, income or deduction on a payment made pursuant to the derivative is also treated as ordinary.
- ii. The QDP exception applies only if the taxpayer satisfies reporting requirements in Prop. Treas. Reg. § 1.6038A-2(b)(7)(ix). If a taxpayer satisfies the reporting requirements for some QDPs, but not all, then only the payments for which the taxpayer fails to satisfy the reporting requirements will be ineligible for the QDP exception. Prop. Treas. Reg. § 1.6038A-2(b)(7)(ix) will first apply to taxable years beginning after final regulations are published, which provides taxpayers additional time to meet those reporting requirements. The proposed regulations provide that before final regulations are published, taxpayers satisfy the reporting requirements for QDPs by reporting the aggregate amount of QDPs for the taxable year on Form 8991, Tax on Base Erosion Payments of Taxpayers With Substantial Gross Receipts.
- iii. Section 59A(h)(3) provides two exceptions to the QDP exception. The QDP exception does not apply (1) to a

payment that would be treated as a base erosion payment if it were not made pursuant to a derivative or (2) with respect to a contract that has derivative and nonderivative components, to a payment that is properly allocable to the nonderivative component.

- iv. The proposed regulations do not specifically address or modify these statutory provisions. For the avoidance of doubt, Treasury and the IRS state that these rules in § 59A(h)(3) are self-executing; thus, taxpayers must apply these two rules to determine whether any of their payments pursuant to derivatives fail to qualify for the QDP exception.
- v. Prop. Treas. Reg. § 1.59A-6(d) defines a derivative as any contract, the value of which, or any payment with respect to which, is determined by reference to any stock, evidence of indebtedness, actively traded commodity, currency, or any rate, price, amount, index, formula or algorithm. However, direct ownership of any of these items is not ownership of a derivative. The proposed regulations provide that for purposes of § 59A(h)(4), a derivative does not include an insurance contract, a securities lending transaction, a sale-repurchase transaction, or any substantially similar transaction.
- vi. For federal tax purposes, a sale-repurchase transaction satisfying certain conditions is treated as a secured loan. Sections 59A(h)(3) and 59A(h)(4) explicitly exclude from qualified derivatives payment status any payment that would be treated as a base erosion payment if it were not made pursuant to a derivative, such as a payment of interest on a debt instrument.
- vii. Accordingly, for purposes of § 59A(h), the proposed regulations provide that sale-repurchase transactions are not treated as derivatives. Because sale-repurchase transactions and securities lending transactions are economically similar to each other, Treasury and the IRS have determined that these transactions should be treated similarly for purposes of § 59A(h)(4), and therefore payments on those transactions are not treated as QDPs.

(c) Exception to Base Erosion Payment Status for Payments the Recipient of which is Subject to U.S. Tax.

- i. In general, for a payment or accrual to be treated as a base erosion payment, the recipient must be a foreign person (within the meaning of § 6038A(c)(3)) that is a related party with respect to the taxpayer, and a deduction must be allowable with respect to the payment or accrual. *See* § 59A(f). Section 6038A(c)(3) defines “foreign person” as any person that is not a U.S. person within the meaning of section 7701(a)(30), but for this purpose the term “United States person” does not include any individual who is a citizen of any U.S. territory (but not otherwise a citizen of the U.S.) and who is not a resident of the United States. Prop. Treas. Reg. § 1.59A-1(b)(10).
- ii. Treasury and the IRS believe that it is appropriate in defining a base erosion payment to consider the U.S. tax treatment of the foreign recipient. In particular, they have determined that a payment to a foreign person should not be taxed as a base erosion payment to the extent that payments to the foreign related party are effectively connected income. Those amounts are subject to tax under §§ 871(b) and 882(a) on a net basis in substantially the same manner as amounts paid to a United States citizen or resident or a domestic corporation.
- iii. Accordingly, the proposed regulations include an exception from the definition of base erosion payment for amounts that are subject to tax as income effectively connected with the conduct of a U.S. trade or business. In the case of a foreign recipient that determines its net taxable income under an applicable income tax treaty, the exception from the definition of base erosion payment applies to payments taken into account in determining net taxable income under the treaty.

(d) Exchange Loss from a § 988 Transaction.

- i. Prop. Treas. Reg. § 1.59A-3(b)(3)(iv) provides that exchange losses from § 988 transactions described in Treas. Reg. § 1.988-1(a)(1) are not base erosion payments. These losses do not present the same base erosion concerns as other types of losses that arise in connection with payments to a foreign related party. Accordingly, under the proposed regulations, § 988 losses are excluded from the numerator.

- ii. The proposed regulations also provide that § 988 losses are excluded from the denominator of the base erosion percentage. Specifically, Prop. Treas. Reg. § 1.59A-2(e)(3)(ii)(D) provides that an exchange loss from a § 988 transaction (including with respect to persons other than foreign related parties) is not included in the denominator when calculating the base erosion percentage. Exchange gain from a § 988 transaction, however, is included as a gross receipt for purposes of the gross receipts test under Prop. Treas. Reg. § 1.59A-2(d).
- (e) Exception for Interest on Certain Instruments Issued by Globally Systemically Important Banking Organizations.
- i. The Federal Reserve requires that certain global systemically important banking organizations (“GSIBs”) issue TLAC securities as part of a global framework for bank capital that has sought to minimize the risk of insolvency. The Board of Governors of the Federal Reserve (the Board) has issued regulations that prescribe the amount and form of external TLAC securities that domestic GSIBs must issue and internal TLAC securities that certain foreign GSIBs must issue. In the case of internal TLAC securities, the Board regulations require the domestic intermediate holding company of a foreign GSIB to issue a specified minimum amount of TLAC to its foreign parent.
 - ii. Section 59A(i) provides that Treasury shall prescribe such regulations or other guidance as may be necessary or appropriate to carry out the provisions of § 59A, including regulations addressing specifically enumerated situations. Treasury and the IRS believe that because of the special status of TLAC as part of a global system to address bank solvency and the precise limits that Board regulations place on the terms of TLAC securities and structure of intragroup TLAC funding, it is necessary and appropriate to include an exception to base erosion payment status for interest paid or accrued on TLAC securities required by the Federal Reserve.
 - iii. Thus, the proposed regulations include a TLAC exception that applies only to the extent of the amount of TLAC securities required by the Federal Reserve. The exception is scaled back if the adjusted issue price of the average amount of TLAC securities issued and outstanding exceeds the average amount of TLAC long-term debt required by

the Federal Reserve for the taxable year. Prop. Treas. Reg. § 1.59A-3(b)(3)(v).

- iv. The TLAC exception applies only to securities required by the Federal Reserve, and as a result generally does not apply to securities issued by a foreign corporation engaged in a U.S. trade or business because the applicable Federal Reserve requirement applies only to domestic institutions. However, Treasury and the IRS acknowledge that foreign regulators may impose similar requirements on the financial institutions they regulate.

16. Base Erosion Payments Occurring Before the Effective Date and Pre-2018 Disallowed Business Interest.

- (a) Section 59A applies only to base erosion payments paid or accrued in taxable years beginning after December 31, 2017. The statutory definition of a base erosion tax benefit is based upon the definition of a base erosion payment. Accordingly, the proposed regulations confirm the exclusion of a deduction described in § 59A(c)(2)(A)(i) (deduction allowed under Chapter 1 for the taxable year with respect to any base erosion payment) or § 59A(c)(2)(A)(ii) (deduction allowed under Chapter 1 for the taxable year for depreciation or amortization with respect to any property acquired with such payment) that is allowed in a taxable year beginning after December 31, 2017, if it relates to a base erosion payment that occurred in a taxable year beginning before January 1, 2018. Prop. Treas. Reg. §§ 1.59A-3(b)(3)(vi) and (vii).
- (b) For example, if in 2015, a calendar year taxpayer makes a payment or accrual to a foreign related party to acquire depreciable property, the 2015 payment is excluded from the definition of a base erosion payment because of § 59A's effective date. As a result, the taxpayer's depreciation deduction allowed in 2018 regarding this property is not a base erosion tax benefit.
- (c) Similarly, if in 2016, a taxpayer with a calendar year had paid or accrued interest on an obligation to a foreign related party, but the interest was not deductible in 2016 due to the application of § 267(a), the 2016 accrual of the interest amount is excluded from the definition of a base erosion payment because of § 59A's effective date. As a result, if the interest amount becomes deductible in 2018, the taxpayer's deduction allowed in 2018 with respect to this item is not a base erosion tax benefit.
- (d) In the case of business interest expense that is not allowed as a deduction under § 163(j)(1), the proposed regulations provide a

rule that clarifies that the effective date rules apply in a similar manner as with other base erosion payments that initially arose before § 59A's effective date. Section 163(j), as modified by the TCJA, provides that the deduction for business interest expense is limited to the sum of business interest income, 30% of adjusted taxable income ("ATI"), and the amount of any floor plan financing interest. Section 163(j)(2) further provides that any disallowed business interest is carried forward to the succeeding year, and that the carryforward amount is treated as "paid or accrued" in the succeeding taxable year.

- (e) Notice 2018-28 stated that business interest carried forward from a taxable year beginning before January 1, 2018, will be treated in the same manner as interest paid or accrued in a taxable year beginning after December 31, 2017, for purposes of § 59A. Under this approach, business interest expense that was initially paid or accrued in a taxable year beginning before January 1, 2018, could nonetheless be a base erosion payment in a taxable year beginning after December 31, 2017, because § 163(j)(2) deems a recurring "payment or accrual" for such item in each carryforward year.
- (f) Treasury and the IRS believe that the approach described in Notice 2018-28 is not consistent with § 59A's effective date because the language in § 163(j)(2) deeming a recurring "payment or accrual" is primarily to implement the carryforward mechanism in § 163(j), rather than to treat interest that is carried forward to a subsequent taxable year as paid or accrued for all tax purposes in that subsequent taxable year.
- (g) Accordingly, the proposed regulations do not follow the approach described in Notice 2018-28. Instead, the proposed regulations provide that any disallowed disqualified interest under § 163(j) that resulted from a payment or accrual to a foreign related party and that is carried forward from a taxable year beginning before January 1, 2018, is not a base erosion payment.
- (h) The proposed regulations also clarify that any disallowed business interest carryforward under new § 163(j) that resulted from a payment or accrual to a foreign related party is treated as a base erosion payment in the year that the interest was paid or accrued even though the interest may be deemed to be paid or accrued again in the year in which it is actually deducted. Prop. Treas. Reg. § 1.59A-3(b)(4)(vi). The rule in the proposed regulations generally is consistent with excluding interest paid or accrued before January 1, 2018 from treatment as a base erosion payment.

17. Base Erosion Tax Benefits. The amount of base erosion tax benefits is an input in (i) the computation of the BEP test and (ii) the determination of modified taxable income. Generally, a base erosion tax benefit is the amount of any deduction relating to a base erosion payment that is allowed under the Code for the taxable year. Base erosion tax benefits are defined in Prop. Treas. Reg. § 1.59A-3(c).
18. Withholding Tax on Payments. If tax is imposed by § 871 or 881 and the tax is deducted and withheld under section 1441 or 1442 without reduction by an applicable income tax treaty on a base erosion payment, the base erosion payment is treated as having a base erosion tax benefit of zero for purposes of calculating a taxpayer's modified taxable income. If an income tax treaty reduces the amount of withholding imposed on the base erosion payment, the base erosion payment is treated as a base erosion tax benefit to the extent of the reduction in withholding under rules similar to those in § 163(j)(5)(B) as in effect before the TCJA.
19. Rules for Classifying Interest for which a Deduction is Allowed when § 163(j) Limits Deductions.
 - (a) Section 59A(c)(3) provides a stacking rule in cases in which § 163(j) applies to a taxpayer, under which the reduction in the amount of deductible interest is treated as allocable first to interest paid or accrued to persons who are not related parties with respect to the taxpayer and then to related parties. The statute does not provide a rule for determining which portion of the interest treated as paid to related parties (and thus potentially treated as a base erosion payment) is treated as paid to a foreign related person as opposed to a domestic related person.
 - (b) Prop. Treas. Reg. § 1.59A-3(c)(4) provides rules coordinating § 163(j) with the determination of the amount of base erosion tax benefits. This rule provides, consistent with § 59A(c)(3), that where § 163(j) applies to limit the amount of a taxpayer's business interest expense that is deductible in the taxable year, a taxpayer is required to treat all disallowed business interest first as interest paid or accrued to persons who are not related parties, and then as interest paid or accrued to related parties for purposes of § 59A.
 - (c) More specifically, the proposed regulations provide that when a corporation has business interest expense paid or accrued to both unrelated parties and related parties, the amount of allowed business interest expense is treated first as the business interest expense paid to related parties, proportionately between foreign and domestic related parties, and then as business interest expense paid to unrelated parties. Conversely, the amount of a disallowed business interest expense carryforward is treated first as business

interest expense paid to unrelated parties, and then as business interest expense paid to related parties, proportionately between foreign and domestic related party business interest expense.

- (d) Section 163(j) and the proposed regulations thereunder provide an ordering rule that allocates business interest expense deductions first to business interest expense incurred in the current year and then to business interest expense carryforwards from prior years (starting with the earliest year). Thus, to separately track the attributes on a year-by-year layered approach for Subchapter C purposes, the proposed regulations follow that convention.
- (e) Accordingly, the proposed regulations also follow a year-by-year convention in the allocation of business interest expense and carryovers among the related and unrelated party classifications. The proposed regulations adopt a similar approach for business interest expense and excess business interest of a partnership that is allocated to a corporate partner by separately tracking and ordering items allocated from a partnership.
- (f) Prop. Treas. Reg. § 1.59A-3(d) Example 3 provides:

(3) Example 3: Interaction with § 163(j). (i) Facts. Foreign Parent (FP) is a foreign corporation that owns all of the stock of DC, a domestic corporation that is an applicable taxpayer. In Year 1, DC has adjusted taxable income, as defined in § 163(j)(8), of \$1000x and pays the following amounts of business interest expense: \$420x that is paid to unrelated Bank, and \$360x that is paid to FP. DC does not earn any business interest income or incur any floor plan financing interest expense in Year 1. None of the exceptions in paragraph (b)(3) of this section apply, and the interest is not subject to withholding.

(ii) Analysis—(A) Classification of business interest. In Year 1, DC is only permitted to deduct \$300x of business interest expense under section 163(j)(1) (\$1000x x 30%). Paragraph (c)(4)(ii)(B) of this section provides that for purposes of paragraph (c)(1) of this section the deduction is treated first as foreign related business interest expense and domestic related business interest expense (here, only FP); and second as unrelated business interest expense (Bank). As a result, the \$300x of business interest expense that is permitted under section 163(j)(1) is treated entirely as the business interest paid to the related foreign party, FP. All of DC's \$300x deductible interest is treated as an add-back to modified taxable income in the Year 1 taxable year for purposes of Prop. Treas. Reg. § 1.59A-4(b)(2)(i).

(B) Ordering rules for business interest expense carryforward. Under § 163(j)(2), the \$480x of disallowed business interest (\$420x + \$360x - \$300x) is carried forward to the subsequent year. Under

paragraph (c)(4)(ii)(B)(1) and (2) of this section, the interest carryforward is correspondingly treated first as unrelated business interest expense, and second pro-rata as foreign related business interest expense and domestic related business interest expense. As a result, \$420x of the \$480x business interest expense carryforward is treated first as business interest expense paid to Bank and the remaining \$60x of the \$480x business interest expense carryforward is treated as interest paid to FP and as an add-back to modified taxable income.

20. Modified Taxable Income. Section 59A imposes a tax on each applicable taxpayer equal to the base erosion minimum tax amount for a particular year. Section 59A(b)(1) provides that the base erosion minimum tax amount is determined based on an applicable taxpayer's modified taxable income for the taxable year. *See* Prop. Treas. Reg. § 1.59A-4.
21. Method of Computation.
 - (a) Section 59A(c)(1) provides that the term modified taxable income means the taxable income of the taxpayer computed under Chapter 1 for the taxable year, determined without regard to base erosion tax benefits and the base erosion percentage of any net operating loss ("NOL") deduction under § 172 for the taxable year.
 - (b) The proposed regulations provide that the computation of modified taxable income and the computation of the base erosion minimum tax amount are made on a taxpayer-by-taxpayer basis. That is, under the proposed regulations, the aggregate group concept is used solely for determining whether a taxpayer is an applicable taxpayer and the BEP of any NOL deduction. This approach is consistent with § 59A(a)'s imposition of a tax equal to the base erosion minimum tax amount ("BEMTA"), which is in addition to the regular tax liability of a taxpayer.
 - (c) The proposed regulations also provide that the computation of modified taxable income is done on an add-back basis. The computation starts with taxable income (or taxable loss) of the taxpayer as computed for regular tax purposes, and adds to that amount (a) the gross amount of base erosion tax benefits for the taxable year and (b) the BEP of any NOL deduction under § 172 for the taxable year.
 - (d) The proposed regulations do not provide for the recomputation of income under an approach similar to the alternative minimum tax, which the TCJA repealed for corporations. Under a recomputation approach, attributes that are limited based on taxable income would be subject to different annual limitations, and those attributes would have to be re-computed for purposes of § 59A.

- (e) Applying this approach in a manner that reflects the results of the BEAT-basis recomputation to subsequent years would lead to parallel attributes that are maintained separately in a manner similar to the pre-Act corporate alternative minimum tax. For example, the amount of the net operating loss used to reduce modified taxable income would differ from the amount used in computing regular tax liability, and the carryforward of unused net operating loss that is used to compute regular tax liability would not reflect the net operating loss amount used to reduce modified taxable income (absent a separate BEAT-basis carryover).
- (f) The annual limitation under § 163(j)(1), which generally limits a corporation's annual deduction for business interest expense, would present similar issues under a recomputation approach. Consequently, the add-back approach also provides simplification relative to the recomputation approach because the add-back approach eliminates the need to engage in the more complex tracking of separate attributes on a BEAT basis in a manner similar to the repealed corporate AMT.

22. Conventions for Computing Modified Taxable Income – Current Year Losses and Excess Net Operating Loss Carryovers.

- (a) If a taxpayer has an excess of deductions allowed by Chapter 1 over gross income, computed without regard to the NOL deduction, the taxpayer has negative taxable income for the taxable year. Generally, the proposed regulations provide that a negative amount is the starting point for computing modified taxable income when there is no NOL deduction from net operating loss carryovers and carrybacks.
- (b) They further provide a rule applicable to situations in which there is a NOL deduction from a net operating loss carryover or carryback to the taxable year and that NOL deduction exceeds the amount of positive taxable income before that deduction (because, for example, the loss arose in a year beginning before January 1, 2018). The proposed regulations provide that the excess amount of NOL deduction does not reduce taxable income below zero for determining the starting point for computing modified taxable income.
- (c) Treasury and the IRS believe that this rule is necessary because § 172(a) could be read to provide that, for example, if a taxpayer has a net operating loss of \$100x that arose in a taxable year beginning before January 1, 2018, that is carried forward, and in a subsequent year the taxpayer has taxable income of \$5x before taking into account the \$100x net operating loss carryover

deduction, the taxpayer may nonetheless have a \$100x NOL deduction in that year or a \$95x taxable loss (even though \$95x of the net operating loss would remain as a carryforward to future years, as well).

- (d) The proposed regulations recognize the notion of a taxable loss when deductions other than the NOL deduction exceed gross income. Thus, this rule clarifies that the taxpayer's starting point for computing modified taxable income in this situation is zero, rather than negative \$95x.
- (e) The proposed regulations further clarify that the NOL deduction taken into account for purposes of adding the BEP of the NOL deduction to taxable income under § 59A(c)(1)(B) is determined in the same manner.
- (f) Accordingly, in the example above, the BEP of the NOL deduction added to taxable income is computed based on the \$5x NOL deduction that reduces regular taxable income to zero, rather than the entire \$100x of net operating loss carryforward, \$95x of which is not absorbed in the current taxable year.
- (g) Finally, the proposed regulations provide that an applicable taxpayer's taxable income is determined according to § 63(a) without regard to the rule in § 860E(a)(1). That rule generally provides that a holder of a residual interest in a real estate mortgage investment conduit ("REMIC") may not have taxable income less than its excess inclusion amount. As a result of § 860E(a)(1), a holder of a REMIC residual interest may have taxable income for purposes of computing its regular tax liability even though it has a current year loss.
- (h) The proposed regulations provide that the limitation in § 860E(a)(1) is disregarded for purposes of calculating modified taxable income under § 59A. This rule is relevant, for example, in situations when the taxpayer would have negative taxable income attributable to a current year loss, or no taxable income as a result of a net operating loss. Section 860E(a)(1) ensures that the excess inclusion is subject to tax under § 11. Thus, Treasury and the IRS believe that it is not appropriate to apply the rule in § 860E(a)(1) for the purpose of calculating modified taxable income under § 59A.

23. Conventions for Computing Modified Taxable Income – Determining the BEP of NOL Deductions.

- (a) Section 59A(c)(1)(B) provides that modified taxable income includes the BEP of any NOL deduction allowed under § 172 for the taxable year. In this context, the relevant BEP could be either the BEP in the year that the net operating loss arose, or alternatively, the BEP in the year in which the taxpayer takes the NOL deduction.
- (b) Prop. Treas. Reg. § 1.59A-4(b)(2)(ii) applies the BEP of the year in which the loss arose, or vintage year, because the BEP of the vintage year reflects the portion of base eroding payments that are reflected in the net operating loss carryover. In addition, because the vintage-year BEP is a fixed percentage, taxpayers will have greater certainty as to the amount of the future add-back to modified taxable income (as compared to using the utilization-year base erosion percentage).
- (c) Based on this approach, the proposed regulations also provide that in the case of net operating losses that arose in taxable years beginning before January 1, 2018, and that are deducted as carryovers in taxable years beginning after December 31, 2017, the BEP is zero because § 59A applies only to base erosion payments that are paid or accrued in taxable years beginning after December 31, 2017. As a result, there is no add-back to modified taxable income for the use of those net operating loss carryovers.
- (d) The proposed regulations also clarify that in computing the add-back for NOL deductions for purposes of the modified taxable income calculation, the relevant BEP is the BEP for the aggregate group that is used to determine whether the taxpayer is an applicable taxpayer, rather than a separate computation of BEP computed solely by reference to the single taxpayer.
- (e) Prop. Treas. Reg. § 1.59A-4(c) Examples 1 and 2 provide:
 - (1) Example 1: Current year loss. (i) Facts. A domestic corporation (DC) is an applicable taxpayer that has a calendar taxable year. In 2020, DC has gross income of \$100x, a deduction of \$80x that is not a base erosion tax benefit, and a deduction of \$70x that is a base erosion tax benefit. In addition, DC has a net operating loss carryforward to 2020 of \$400x that arose in 2016.
 - (ii) Analysis. DC's starting point for computing modified taxable income is \$(50x), computed as gross income of \$100x, less a deduction of \$80x (non-base erosion tax benefit) and a deduction of \$70x (base erosion tax benefit). Under paragraph (b)(2)(ii) of this

section, DC's starting point for computing modified taxable income does not take into account the \$400x net operating loss carryforward because the allowable deductions for 2020, not counting the NOL deduction, exceed the gross income for 2020. DC's modified taxable income for 2020 is \$20x, computed as $$(50x) + $70x$ base erosion tax benefit.

(2) Example 2: Net operating loss deduction. (i) Facts. The facts are the same as in Example 1, except that DC's gross income in 2020 is \$500x.

(ii) Analysis. DC's starting point for computing modified taxable income is \$0x, computed as gross income of \$500x, less: a deduction of \$80x (non-base erosion tax benefit), a deduction of \$70x (base erosion tax benefit), and a net operating loss deduction of \$350x (which is the amount of taxable income before taking into account the net operating loss deduction, as provided in paragraph (b)(2)(ii) of this section ($$500x - $150x$)). DC's modified taxable income for 2020 is \$70x, computed as $$0x + $70x$ base erosion tax benefit. DC's modified taxable income is not increased as a result of the \$350x net operating loss deduction in 2020 because the base erosion percentage of the net operating loss that arose in 2016 is zero under paragraph (b)(2)(ii) of this section.

24. Base Erosion Minimum Tax Amount. An applicable taxpayer computes its BEMTA for the taxable year to determine its liability under § 59A(a). Prop. Treas. Reg. § 1.59A-5 describes the calculation of the BEMTA. Generally, the taxpayer's BEMTA equals the excess of (1) the applicable tax rate for the taxable year ("BEAT rate") multiplied by the taxpayer's modified taxable income for the taxable year over (2) the taxpayer's adjusted regular tax liability for that year.
25. In determining the taxpayer's adjusted regular tax liability for the taxable year, credits (including the foreign tax credit) are generally subtracted from the regular tax liability amount. To prevent an inappropriate understatement of a taxpayer's adjusted regular tax liability, the proposed regulations provide that credits for overpayment of taxes and for taxes withheld at source are not subtracted from the taxpayer's regular tax liability because these credits relate to federal income tax paid for the current or previous year.
26. For taxable years beginning before January 1, 2026, under § 59A(b)(1)(B), the credits allowed against regular tax liability (which reduce the amount of regular tax liability for purposes of calculating BEMTA) are not reduced by the research credit determined under § 41(a) or by a portion of applicable § 38 credits. For taxable years beginning after December 31, 2025, this special treatment of the research credit and applicable § 38 credits no longer applies. As a result, an applicable taxpayer may have a

greater BEMTA than would be the case in taxable years beginning before January 1, 2026.

27. In general, foreign tax credits are taken into account in computing a taxpayer's regular tax liability before other credits. *See* § 26(a). As a result, a taxpayer with foreign tax credits that reduce its regular tax liability to, or close to, zero may not use its § 41(a) credits or its applicable § 38 credits in computing its regular tax liability.
28. In these situations, those credits will not be taken into account in computing the taxpayer's BEMTA even in a pre-2026 year. Instead, those credits will reduce (or, put differently, will prevent an increase in) the BEMTA in the year when those credits are used for regular tax purposes (provided that the taxable year begins before January 1, 2026).
29. Application of Section 59A To Partnerships.
 - (a) A partnership is not an "applicable taxpayer" as defined in § 59A; only corporations can be applicable taxpayers. Partners are liable for income tax only in their separate capacities. Each taxpayer that is a partner in a partnership takes into account separately the partner's distributive share of the partner's income or loss in determining its taxable income.
 - (b) The proposed regulations generally apply an aggregate approach in conjunction with the gross receipts test for evaluating whether a corporation is an applicable taxpayer and in addressing the treatment of payments made by a partnership or received by a partnership for purposes of § 59A. *See* Prop. Treas. Reg. § 1.59A-7.
 - (c) They generally provide that partnerships are treated as an aggregate of the partners in determining whether payments to or payments from a partnership are base erosion payments consistent with the approach described in Subchapter K as well as the authority provided in § 59A(i)(1) to prescribe such regulations that are necessary or appropriate to carry out the provisions of § 59A, including through the use of intermediaries or by characterizing payments otherwise subject to § 59A as payments not subject to § 59A.
 - (d) Thus, when determining whether a corporate partner that is an applicable taxpayer has made a base erosion payment, amounts paid or accrued by a partnership are treated as paid by each partner to the extent an item of expense is allocated to the partner under § 704. Similarly, any amounts received by or accrued to a partnership are treated as received by each partner to the extent the

item of income or gain is allocated to each partner under § 704. The rules and exceptions for base erosion payments and base erosion tax benefits then apply accordingly on an aggregate basis.

- (e) Treasury and the IRS believe that a rule that applies the aggregate principle consistently is necessary to align the treatment of economically similar transactions. The proposed rule prevents an applicable taxpayer from (a) paying a domestic partnership that is owned by foreign related parties, rather than paying those foreign partners directly, to circumvent the BEAT and (b) causing a partnership in which an applicable taxpayer is a partner to make a payment to a foreign related party, rather than paying that foreign related party directly. The rule applies consistently when a payment is to a foreign partnership that is owned, for example, by domestic corporations.
- (f) This rule also addresses situations in which a partnership with an applicable taxpayer partner makes a payment to a foreign related party. Partners with certain small ownership interests are excluded from this aggregate approach for purposes of determining base erosion tax benefits from the partnership. This small ownership interests exclusion generally applies to partnership interests that represent less than ten percent of the capital and profits of the partnership and less than 10% of each item of income, gain, loss, deduction, and credit; and that have a fair market value of less than \$25 million. *See* Prop. Treas. Reg. § 1.59A-7(b)(4).
- (g) The proposed regulations do not provide for special treatment of base erosion tax benefits attributable to a partnership or to partnership nonrecognition transactions. Instead, the aggregate principle generally applies to these situations. For example, if a partnership acquires property from a foreign related party of a taxpayer that is a partner in the partnership, deductions for depreciation of the property allocated to the taxpayer generally are base erosion tax benefits.
- (h) Similarly, if a foreign related party and a taxpayer form a partnership, and the foreign related party contributes depreciable property, deductions for depreciation of the property generally are base erosion tax benefits, in part, because the partnership is treated as acquiring the property in exchange for an interest in the partnership under § 721. This approach is consistent with the approach taken with respect to Subchapter C transactions.
- (i) The proposed regulations provide that with respect to any person that owns an interest in a partnership, the related party determination under § 59A(g) applies at the partner level.

30. Rules Relating to Banks And Dealers for Purposes of Computing the BEP and Determining the Beat Rate for Computing BEMTA.

- (a) Section 59A modifies two general rules in the case of certain banks or registered securities dealers. First, § 59A(e)(1)(C) lowers the BEP threshold for certain banks and registered securities dealers from 3% or more to 2% or more. Second, § 59A(b)(3) provides that the BEAT rate is one percentage point higher for those banks or registered securities dealers.
- (b) The proposed regulations do not modify the statutory definition of the term “bank” for these purposes from its reference to § 581, which defines a bank by reference to a bank or trust company incorporated and doing business under the laws of United States (including laws related to the District of Columbia) or of any state. Thus, a foreign corporation licensed to conduct a banking business in the United States and subject to taxation with respect to income that is, or is treated as, effectively connected with the conduct of a trade or business in the United States is not included in this definition.
- (c) The proposed regulations clarify that the term “registered securities dealer” is limited to a dealer as defined in § 3(a)(5) of the Securities Exchange Act of 1934 that is registered, or required to be registered, under § 15 of the Securities Exchange Act of 1934.
- (d) The proposed regulations also confirm that the operative rules that lower the BEP threshold and that increase the BEAT rate apply only to a taxpayer that is a member of an affiliated group as defined in § 1504(a)(1), and thus do not apply, for example, if the taxpayer is not affiliated with another includible corporation (within the meaning of § 1504(b)(1)), or if the taxpayer is not itself an includible corporation (for example, a foreign corporation that is an applicable taxpayer).
- (e) For purposes of applying the lower BEP threshold to banks and registered securities dealers, the proposed regulations clarify that because the BEP is determined on an aggregate group basis, the lower threshold applies if any member of the aggregate group is a member of an affiliated group that includes a bank or registered securities dealer.
- (f) The proposed regulations provide a limited exception for members of an affiliated group that includes a bank or registered securities dealer where the bank or registered securities dealer activities are de minimis. This de minimis rule provides that a consolidated group, or a member of the aggregate group of which the taxpayer

is a member, is not subject to the lower base erosion percentage threshold if its gross receipts attributable to the bank or the registered securities dealer are less than 2% of the aggregate group's total gross revenue.

- (g) This de minimis rule uses the same threshold measurement for exclusion from the special rule for banks and registered securities dealers (2%) that is used as the base erosion percentage threshold for banks or registered securities dealers to determine whether such taxpayers are applicable taxpayers that are subject to the BEAT, with the latter test functioning in a manner similar to a de minimis threshold for the application of the BEAT.

31. Rules Relating to Insurance Companies.

- (a) The definition of a base erosion payment in § 59A(d) includes any premiums or other consideration paid or accrued by a taxpayer to a foreign related party for any reinsurance payments taken into account under § 803(a)(1)(B) or 832(b)(4)(A). Generally, § 803(a)(1) defines gross income for a life insurance company to include the gross amount of premiums and other consideration on insurance and annuity contracts less return premiums and premiums and other consideration arising out of indemnity reinsurance.
- (b) For an insurance company other than a life insurance company, under § 832(b), gross income generally includes underwriting income, which is comprised of premiums earned during the taxable year less losses incurred and expenses incurred. Section 832(b)(4)(A) provides that the amount of premiums earned on insurance contracts is the amount of gross premiums written on insurance contracts during the taxable year less return premiums and premiums paid for reinsurance.
- (c) Treasury and the IRS believe that certain reinsurance agreements provide that amounts paid to and from a reinsurer are settled on a net basis or netted under the terms of the agreement. Other commercial agreements with reciprocal payments may be settled on a net basis or netted under the terms of those agreements.
- (d) The proposed regulations do not provide a rule permitting netting in any of these circumstances because the BEAT statutory framework is based on including the gross amount of deductible and certain other payments (base erosion payments) in the BEAT's expanded modified taxable income base without regard to reciprocal obligations or payments that are taken into account in

the regular income tax base, but not the BEAT's modified taxable income base.

- (e) Generally, the amounts of income and deduction are determined on a gross basis under the Code. However, if there are situations where an application of otherwise generally applicable tax law would provide that a deduction is computed on a net basis (because an item received reduces the item of deduction rather than increasing gross income), the proposed regulations do not change that result.
- (f) The proposed regulations also do not provide any specific rules for payments by a domestic reinsurance company to a foreign related insurance company. In the case of a domestic reinsurance company, claims payments for losses incurred and other payments are deductible and are thus potentially within the scope of § 59A(d)(1). *See* §§ 803(c) and 832(c). In the case of an insurance company other than a life insurance company (non-life insurance company) that reinsures foreign risk, certain of these payments may also be treated as reductions in gross income under § 832(b)(3), which are not deductions and also not the type of reductions in gross income described in § 59A(d)(3).
- (g) The proposed regulations do not address a foreign insurance company that has in effect an election to be treated as a domestic corporation for purposes of the Code. Amounts paid or accrued to such a company are not base erosion payments because the corporation is treated as a domestic corporation for purposes of the Code.

32. Anti-Abuse and Recharacterization Rules. Prop. Treas. Reg. § 1.59A-9(b) provides that certain transactions that have a principal purpose of avoiding § 59A will be disregarded or deemed to result in a base erosion payment. This proposed anti-abuse rule addresses the following types of transactions: (a) transactions involving intermediaries acting as a conduit to avoid a base erosion payment; (b) transactions entered into to increase the deductions taken into account in the denominator of the base erosion percentage; and (c) transactions among related parties entered into to avoid the application of rules applicable to banks and registered securities dealers (for example, causing a bank or registered securities dealer to disaffiliate from an affiliated group so as to avoid the requirement that it be a member of such a group).

33. Consolidated Groups as Taxpayers.

- (a) Affiliated groups of domestic corporations that elect to file a consolidated income tax return generally compute their income tax

liability on a “single-entity” basis. The regular tax liability is computed on a single entity basis. Thus, the additional tax imposed by § 59A must also be imposed on the same basis (because it is an addition to that regular tax liability). Accordingly, the proposed regulations provide that for affiliated corporations electing to file a consolidated income tax return, the tax under § 59A is determined at the consolidated group level, rather than determined separately for each member of the group.

- (b) The BEAT is an addition to the regular corporate income tax under § 11, and the regular corporate income tax is applied to a consolidated group on a consolidated basis. Further, application of the BEAT on a group level eliminates the differences in the aggregate amount of taxation to a consolidated group that would otherwise occur, based on the location of deductions, including, for example, the location of related party interest payments within the group.
- (c) Accordingly, the BEAT is also applied on a consolidated basis. This single taxpayer treatment for members of a consolidated group applies separately from the aggregate group concept in Prop. Treas. Reg. § 1.59A-2(c), which also treats all members of the aggregate group as a single entity, but in that case, only for purposes of applying the gross receipts test and base erosion percentage test for determining whether a particular taxpayer is an applicable taxpayer.
- (d) To properly reflect the taxable income of the group, consolidated return regulations generally determine the tax treatment of items resulting from intercompany transactions (as defined in Treas. Reg. § 1.1502-13(b)(1)(i)) by treating members of the consolidated group as divisions of a single corporation (single entity treatment). In general, the existence of an intercompany transaction should not change the consolidated taxable income or consolidated tax liability of a consolidated group.
- (e) Consistent with single entity treatment, items from intercompany transactions are not taken into account for purposes of making the computations under § 59A. For example, any increase in depreciation deductions resulting from intercompany sales of property are disregarded for purposes of determining the taxpayer’s base erosion percentage. Similarly, interest payments on intercompany obligations (as defined in Treas. Reg. § 1.1502-13(g)(2)(ii)) are not taken into account in making the computations under § 59A.

34. Coordinating Consolidated Group Rules for Sections 59A(c)(3) and 163(j).

- (a) Section 59A(c)(3) and Prop. Treas. Reg. § 1.59A-3(c)(4) coordinate the application of § 163(j) with the determination of the amount of base erosion tax benefits when a taxpayer has business interest expense paid to both unrelated parties and related parties. Those rules provide that, where § 163(j) applies to limit the amount of a taxpayer's business interest that is deductible in a taxable year, the taxpayer is required to treat all disallowed business interest as allocable first to interest paid or accrued to persons who are not related parties, and then to related parties.
- (b) Prop. Treas. Reg. § 1.1502-59A provides rules regarding application of § 59A(c)(3) to consolidated groups. These rules are required for the allocation of the BEMTA among members of the group under § 1552. In addition, apportionment of the domestic related party status and foreign related party status of § 163(j) carryforwards among members of the group is necessary when a member deconsolidates from the group.
- (c) The proposed regulations implement the classification approach of Prop. Treas. Reg. § 1.59A-3(c)(4) on a consolidated basis (the "classification rule"), to identify which interest deductions are allocable to domestic related party payments, foreign related party payments, and unrelated party payments. Slightly different rules apply to the deduction of current year business interest expense than to the deduction of section 163(j) carryforwards.
- (d) A consolidated group applies these rules to the amount of business interest expense (either from current year business interest expense or from carryforward amounts) that is actually deducted pursuant to § 163(j) and Prop. Treas. Reg. §§ 1.163(j)-4(d) and 1.163(j)-5(b)(3). If the group deducts business interest expense paid or accrued in different taxable years (for example, both current year business interest expense and § 163(j) carryforwards), the classification rule applies separately to business interest expense incurred in each taxable year.
- (e) For purposes of the proposed regulations, a member's current year business interest expense is the member's business interest expense that would be deductible in the current taxable year without regard to § 163(j) and that is not a disallowed business interest expense carryforward from a prior taxable year.
- (f) The classification rule applies on a single-entity basis to deductions of current year business interest expense. The

consolidated group classifies its aggregate business interest deduction from current year business interest expense based on the aggregate current year business interest expense of all types (related or unrelated) paid by members of the group to nonmembers. Business interest deductions are treated as from payments or accruals to related parties first, and then from payments or accruals to unrelated parties. If there are payments to both foreign related parties and domestic related parties, the deductions are classified as to the related parties on a pro-rata basis.

- (g) The proposed regulations provide that, if the group has aggregate business interest deductions classified as payments or accruals to a domestic related party (domestic related party status) or foreign related party (foreign related party status), the status of such payments or accruals is spread among members of the group (the allocation rule). Specifically, the domestic related party status and foreign related party status of the deduction is allocated among members of the group in proportion to the amount of each member's deduction of its current year business interest expense.
- (h) Similarly, if any part of a § 163(j) carryforward is from a payment or accrual to a domestic related party or a foreign related party, the related party status of the § 163(j) carryforwards for the year will be allocated among members of the group. The allocation is in proportion to the relative amount of each member's § 163(j) carryforward from that year. Members' additional § 163(j) carryforward amounts are treated as payments or accruals to unrelated parties. The allocation rule applies separately to each carryforward year.
- (i) With regard to the deduction of any member's § 163(j) carryforward, the classification rule applies on an entity-by-entity basis. As discussed, before a member's § 163(j) carryforward moves forward into subsequent years, it is allocated a domestic related party status, foreign related party status, or unrelated party status. This allocation ensures that business interest deductions drawn from any carryforward originating in the same consolidated return year bear the same ratio of domestic related, foreign related, and unrelated statuses.
- (j) When a member deducts any portion of its § 163(j) carryforward, the member applies § 59A(c)(3) and Prop. Treas. Reg. § 1.59A-3(c)(4) to determine the status of the deducted carryforward, based on the status previously allocated to the member's § 163(j) carryforward for the relevant tax year. The tax liability imposed under § 59A on the consolidated group is allocated among the

members of the consolidated group pursuant to the consolidated group's tax allocation method, taking into account these allocations. *See* § 1552.

- (k) If a member that is allocated a foreign related party status or domestic related party status to its § 163(j) carryforward deconsolidates from the group, the departing member's carryforward retains the allocated status. The departing member (and not the original consolidated group) takes into account the status of that carryforward for purposes of computing the BEAT in future years.
- (l) In Treas. Reg. § 1.1502-2, a reference is added to the base erosion anti-abuse tax as a tax included in the computation of consolidated tax liability.

35. Sections 382 and 383.

- (a) Treas. Reg. § 1.383-1 provides that only otherwise currently allowable pre-change losses and pre-change credits will result in the absorption of the § 382 limitation and the § 383 credit limitation. The limitations under §§ 382 and 383 are applied after the application of all other limitations contained in subtitle A of the Code. If the pre-change losses or pre-change credits cannot be deducted or otherwise used, they are carried forward to the next taxable year.
- (b) The BEAT is not a modification to the normal computation of income tax under Subtitle A of the Code but an addition to that income tax. Therefore, these proposed regulations clarify that additions to tax under § 59A do not affect whether a loss, deduction, or credit is absorbed under § 382 or § 383.

36. Reporting and Recordkeeping Requirements Pursuant to § 6038A.

- (a) Section 6038A imposes reporting and recordkeeping requirements on domestic corporations that are 25% foreign-owned. Section 6038C imposes the same reporting and recordkeeping requirements on certain foreign corporations engaged in a U.S. trade or business. These corporations are collectively known as "reporting corporations."
- (b) Reporting corporations are required to file an annual return on Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Under Sections 6038A and 6038C of the Internal Revenue Code)*, with respect to each related party with which the reporting corporation has had any "reportable transactions." *See*

Treas. Reg. § 1.6038A-2. Reporting corporations are also subject to specific requirements under §§ 6038A and 6038C to maintain and make available the permanent books of account or records as required by § 6001 that are sufficient to establish the accuracy of the federal income tax return of the corporation, including information, documents, or records to the extent they may be relevant to determine the correct U.S. tax treatment of transactions with related parties. *See* Treas. Reg. § 1.6038A-3.

- (c) The TCJA amended § 6038A by adding paragraph (b)(2), which authorizes regulations requiring information from a reporting corporation that is also a § 59A “applicable taxpayer” for purposes of administering § 59A. Section 6038A(b)(2) applies to taxable years beginning after December 31, 2017. These proposed regulations identify certain types of information that will be required to be reported on Form 5472 and Form 8991, *Tax on Base Erosion Payments of Taxpayers With Substantial Gross Receipts*, and also provide the time and manner for reporting. While an applicable taxpayer that is not a reporting corporation would not be subject to monetary penalties and collateral provisions specific to §§ 6038A and 6038C, the taxpayer remains subject to BEAT-related reporting obligations, including Form 8991, and applicable consequences for noncompliance.
- (d) Under § 59A(d)(4), the status of a foreign shareholder as a surrogate foreign corporation as defined in § 7874(a)(2)(B) or as a member of the same expanded affiliated group, as defined in § 7874(c)(1), as the surrogate foreign corporation can affect the treatment of payments from a taxpayer to that corporation under § 59A(d).
- (e) If the reporting corporation is an expatriated entity as defined in § 7874(a)(2), the taxation of certain transactions between it and its foreign related persons as defined in § 7874(d)(3) may be affected. Consequently, the proposed regulations require all reporting corporations to state whether a foreign shareholder required to be listed on Form 5472 is a surrogate foreign corporation. The form may provide for reporting of whether the shareholder is a member of an expanded affiliated group including the surrogate foreign corporation.
- (f) In addition, to facilitate screening for important tax compliance concerns under § 59A as well as other provisions at the return filing stage, these proposed regulations clarify that the IRS may require by form or by form instructions the following information: (1) reporting of particular details of the reporting corporation’s relationships with related parties in regard to which it is required to

file a Form 5472, (2) reporting of transactions within certain categories on a more detailed basis, (3) reporting of the manner (such as type of transfer pricing method used) in which the reporting corporation determined the amount of particular reportable transactions and items, and (4) summarization of a reporting corporation's reportable transactions and items with all foreign related parties on a schedule to its annual Form 5472 filing.

37. Proposed Applicability Date.

- (a) Consistent with the applicability date of § 59A, the proposed regulations (other than the proposed reporting requirements for QDPs in Prop. Treas. Reg. § 1.6038A-2(b)(7)) are proposed to apply to taxable years beginning after December 31, 2017. Until finalization, a taxpayer may rely on the proposed regulations for taxable years beginning after December 31, 2017, provided the taxpayer and all related parties of the taxpayer (as defined in Prop. Treas. Reg. § 1.59A-1(b)(17)) consistently apply the proposed regulations for all those taxable years that end before the finalization date.
- (b) With respect to the reporting requirements for QDPs, Prop. Treas. Reg. § 1.6038A-2(b)(7)(ix) applies to taxable years beginning one year after final regulations are published in the Federal Register, although simplified QDP reporting requirements provided in Treas. Reg. § 1.6038A-2(g) are also proposed to apply to taxable years beginning after December 31, 2017.
- (c) If any provision is finalized after June 22, 2019, Treasury and the IRS expect that such a provision will apply only to taxable years ending on or after the date the final regulation is filed in the Federal Register.

V. SALE OF A PARTNERSHIP INTEREST.

A. Sale of Partnership Interest.

- 1. The Tax Reform Act (2017 Act) overturned *Grecian Magnesite v. Commissioner* (below), which held that the sale by a foreign person of its interest in a partnership engaged in a U.S. trade or business was not subject to U.S. tax. The 2017 Act added new § 864(c)(8), providing that if a non-resident alien individual or foreign corporation owns, directly or indirectly, an interest in a partnership that is engaged in any trade or business within the United States, gain or loss on the sale or exchange of all (or any portion of) such interest shall be treated as income that is effectively connected with the conduct of a U.S. trade or business (ECI).

This is the end result that the IRS advocated in Rev. Rul. 91-32. The IRS lost in court, but the result the IRS wanted is now codified.

2. The amount of gain or loss that is ECI is (i) the portion of the partner's distributive share of the amount of gain or loss that would have been ECI, if the partnership had sold all of its assets at their fair market value as of the date of the sale or exchange of such interest or (ii) zero, if no gain or loss on such deemed sale would have been ECI.
3. The status of the partnership as U.S. or foreign does not matter; the relevant point is whether the partnership is engaged in a U.S. trade or business.
4. A partner's distributive share of gain or loss on the deemed sale is determined in the same manner as such partner's distributive share of the non-separately stated taxable income or loss of such partnership.
5. New § 1446(f)(1) provides that if any portion of the gain on any disposition of an interest in a partnership would be treated under new § 864(c)(8) as effectively connected with the conduct of a trade or business within the U.S. ("effectively connected gain"), then the transferee must withhold a tax equal to 10 percent of the amount realized on the disposition. Future guidance will be issued on how to withhold, deposit, and report the tax withheld.
6. Presumably these new withholding rules will use the FIRPTA rules as a precedent, in which the purchaser of a U.S. real property interest from a non-resident seller must withhold 10 percent of the purchase price. The FIRPTA rules contain an exemption to the extent the seller can demonstrate the withholding of 10 percent of the purchase price would exceed the seller's tax on the disposition.
7. Absent rules under section 1446, as a matter of prudence presumably buyers will withhold whenever there is a foreign seller of a partnership interest.
8. Further, the partnership will need to exercise caution that is not treated as a "backup" withholding agent. § 1446(f)(4).
9. While a seller can provide a "non-foreign affidavit" to certify that he is not a foreign person (and thus avoid withholding), § 1446(f), the statute does not provide for a certification that the partnership does not have a U.S. trade or business. Hopefully, regulations will authorize such an exception from withholding.
10. In addition, commentators expressed concern that in the case of a disposition of a publicly traded partnership interest, applying new § 1446(f) presents significant practical problems. In response, Treasury

and the IRS determined that withholding under § 1446(f) is not required for any disposition of an interest in a publicly traded partnership until regulations or other guidance has been issued (see below). The temporary suspension is limited to dispositions of interest that are publicly traded and does not extend to non-publicly traded interests.

B. Notice 2018-29: Non-publicly traded partnerships.

1. There's no need to withhold if:
 - (a) The transferor certifies that for each of the past three years the transferor was a partner for the full year and that the transferor's ECI was less than 25% of the transferor's total income for the partnership (this only applies to sales, not distributions), or
 - (b) The partnership certifies that its ECI (including FIRPTA gain) under § 964(c)(8) would be less than 25% of the total gain on the deemed sale of all its assets. The certification must be issued no earlier than 30 days before the transaction.
2. Withholding also is not required if:
 - (a) The transferor certifies that the disposition will not result in gain (for example, it had a loss), or
 - (b) The transferor has no recognized gain (*i.e.*, in a nonrecognition transaction), at least until further study by Treasury and the IRS.
3. The transferor may rely on a transferor's most recently issued K-1 for determining liabilities in addressing the transferor's gain, or, alternatively, a certification from the partnership.
4. In the case of a distribution by the partnership, the partnership is permitted to rely on its books and records, or on a certification from the distributee partner, to determine whether a distribution exceeds the partner's basis.
5. The total amount of withholding is generally limited to the amount of cash and property to be transferred (other than in related-party transactions and partnership distributions).
6. Forms and procedures applicable under § 1445 (FIRPTA) apply for depositing the withheld funds. The transferor's non-foreign affidavit also is as provided under the § 1445 regulations.
7. The § 1446(f)(4) rules that can make a partnership liable for tax not withheld by the transferee are suspended until regulations or other guidance is issued.

8. Tiered partnership issues will be addressed in future regulations on a look-through basis.

C. Determining the Taxable Amount.

1. New § 864(c)(8) applies when foreign person sells, exchanges or otherwise disposes of a partnership interest in a partnership that is engaged in a U.S. trade or business.
2. The partnership is deemed to have sold all of its assets under § 864(c)(8)(B) and the hypothetical gain on that sale must be analyzed to determine what portion of that gain, if any, would have been effectively connected with the conduct of a trade or business in the U.S. (ECI).
3. Section 865 needs to be considered in determining the source of the hypothetical gain. Under § 865(i)(5), the § 865 source rules are applied at the partner level. In this case the partner will be a foreign person.
4. Section 865(d) applies to intangibles, the gain on the deemed sale of which likely initially will be foreign source income (with a special rule for goodwill which looks to where the goodwill was “generated”).
5. Section 865(e)(2) can cause the gain, initially treated as foreign source gain in the case of non-goodwill intangibles, to be characterized as U.S. source income if it is “attributable” to a U.S. office of the foreign person under the principles of § 864(c)(5). § 865(e)(3).
6. This was an issue addressed in *Grecian Magnesite Mining* (below), although in the context of the sale of a partnership interest whereas under § 864(c)(8) it would need to be addressed in the context of the hypothetical sale by the partnership of all of its assets.
7. Section 865(h) also provides a treaty election to characterize the gain on the sale of an intangible (including goodwill) that otherwise would be U.S. source income as foreign source income if a treaty would apply to treat it as foreign source income. Perhaps any such treaty should override the Code without the need for the election if the treaty post-dates the enactment of § 865 (1986).
8. To the extent the gain on the hypothetical sale of the partnership’s assets constitutes foreign source income, it would seem not to constitute ECI. *See* § 864(c)(4). The flush language in § 864(c)(4)(B), however, should be considered (although if applicable, § 865(e)(2) presumably would have made the income U.S. source income).
9. If the hypothetical gain is U.S. source income from the sale of a capital asset, § 864(c)(2) provides rules to determine whether the gain is ECI. Other U.S. source gain likely is ECI under § 864(c)(3).

10. Real property is subject to FIRPTA. § 864(c)(8)(C).
11. The gain on the sale of the partner's partnership interest is ECI to the extent it does not exceed the partner's distributive share of the deemed-sale ECI amount.
12. These rules might be helpful regarding the partnership certification discussed above concerning less than 25% of the deemed-sale gain constituting ECI.

D. Grecian Magnesite Affirmed.

1. The D.C. Circuit Court of Appeals upheld the taxpayer victory in *Grecian Magnesite Mining, Industrial & Shipping Co. SA v. Commissioner*, _____ F.3d _____ (D.C. Cir. 2019), and affirmed the Tax Court's decision holding that the gain from redeeming a U.S. partnership interest is not U.S.-source income. The decision could have significant consequences going forward as we will discuss.
2. The government raised two arguments. The first argument was that the partnership interest distribution should be treated like a sale of the underlying assets. The second alternative government argument was that the disputed gain was attributable to Grecian's U.S. office under the U.S. office rule and therefore was U.S.-source income because all activities leading to the appreciation of the partnership share occurred in the United States. The government did not challenge the Tax Court's holding on the first argument.
3. After the Tax Court's decision, Congress, in the TCJA, enacted § 864(c)(8) establishing that the aggregate theory (rather than the entity theory) governs the disposition of a partnership interest.
4. The appellate court noted that the longstanding position of the IRS, set out in Revenue Ruling 91-32, is that "[i]ncome from the disposition of a [U.S.] partnership interest by [a] foreign partner will be attributable to the foreign partner's fixed place of business in the United States. However, the court stated that it would not defer to the ruling and proceed to "consider the question afresh." The "dispute hinges in large part on what conduct must be 'attributable to such [i.e., the U.S.] office.'" The court states that the statute frames the rule as applying to sales rather than income-generating activity.
5. The court noted that the regulations interpreting § 864(c)(5) confirm that the provision does not mandate considering income production in each and every sense in any given case.
6. The court held that "[i]n sum, the U.S. office rule's focus, as indicated by its text, structure, regulations, and legislative history, is directed to the

transaction rather than the appreciation of the asset.” The question was whether the redemption transaction was within the ordinary course of business for the U.S. office. The court held that the U.S. office was engaged in the business of magnesite mining, extraction, and processing, not in the business of redemption. Therefore, the Court held the gain is not attributable to Grecian’s U.S. office.

7. Perhaps the most important point regarding the decision will be its effect going forward under new § 864(c)(8), the TCJA provision intended to overrule *Grecian*. Section 864(c)(8) and Prop. Treas. Reg. § 1.864(c)(8)-1 require a calculation regarding a hypothetical sale of the partnership’s assets which is slightly different from *Grecian*, but which ultimately will involve the same issue.
8. Attribution of the income to the partnership’s U.S. office will be a key determinant regarding the source of that hypothetical income.
9. It obviously is a factual issue, as a matter of law. Nonetheless, Treasury and the IRS included in the proposed regulations a provision that deems the income from the hypothetical sale to be attributable to an office or fixed place of business in the U.S. maintained by the partnership. Prop. Treas. Reg. § 1.864(c)(8)-1(c)(2)(i). This will make the hypothetical income U.S. source income.
10. This is not correct as a matter of law and if adopted in the final regulations simply will lead to more litigation, not less. Since it likely will involve a foreign partner claiming a refund of the withheld tax, any such litigation could ultimately find its way to the very court that decided *Grecian*.

E. Publicly-Traded Partnership Interests.

1. In Notice 2018-8, Treasury and the IRS temporarily suspended withholding obligations under new § 446(f) for dispositions of some publicly-traded partnership interests.
2. The Notice was issued in response to newly enacted §§ 864(c)(8) and 1446(f). New § 864(c)(8) provides that a nonresident alien individual’s or foreign corporation’s gain or loss from the sale, exchange, or other disposition of a partnership interest is effectively connected with the conduct of a trade or business in the U.S. to the extent that the person would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value.
3. New § 1446(f)(1) provides that if any portion of the gain on any disposition of an interest in a partnership would be treated under new § 864(c)(8) as effectively connected with the conduct of a trade or business within the U.S. (“effectively connected gain”), then the transferee must withhold a tax equal to 10 percent of the amount realized on the

disposition. Future guidance will be issued on how to withhold, deposit, and report the tax withheld.

4. Commentators expressed concern that in the case of a disposition of a publicly traded partnership interest, applying new § 1446(f) presents significant practical problems. In response, Treasury and the IRS determined that withholding under § 1446(f) is not required for any disposition of an interest in a publicly traded partnership until regulations or other guidance has been issued. The temporary suspension is limited to dispositions of interest that are publicly traded and does not extend to non-publicly traded interests.
5. Comments were requested on the application of § 1446(f) to interests in publicly traded partnerships, rules for determining the amount realized taking into account § 752(d), procedures for requesting a reduced amount required to be withheld, whether a temporary suspension of § 1446(f) for partnership interests that are not publicly traded partnership interests is needed, and what additional guidance, or forms and instructions, may be needed to help taxpayers apply §§ 864(c)(8) and 1446(f).

F. § 1.864(c)(8) Regulations.

1. Section 864(c)(8), which was added to the Code by the TCJA, generally overturns the result in *Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3 (2017), appeal argued, No. 17-1268 (D.C. Cir. Oct. 9, 2018), by providing that gain or loss of a nonresident alien individual or foreign corporation (a “foreign transferor”) from the sale, exchange, or other disposition (“transfer”) of a partnership interest is treated as effectively connected with the conduct of a trade or business within the U.S. to the extent that the transferor would have had effectively connected gain or loss if the partnership had sold all of its assets at fair market value as of the date of the sale or exchange (the “deemed sale”). Section 864(c)(8) is effective for sales, exchanges, and dispositions on or after November 27, 2017.
2. New § 1446(f) was also added to the Code by the TCJA. Section 1446(f)(1) requires that the transferee of a partnership interest withhold 10 percent of the amount realized on the transferor’s disposition of the partnership interest (if any portion of the gain would be treated as effectively connected gain) unless the transferor certifies that the transferor is not a foreign person. Section 1446(f) is effective for sales, exchanges, and dispositions after December 31, 2017.
3. Notice 2018-08 (the “PTP Notice”) temporarily suspended the requirement to withhold on amounts realized in connection with the sale, exchange, or disposition of certain interests in publicly traded partnerships (“PTPs”).

4. Notice 2018-29 provided important temporary guidance under §§ 864(c)(8) and 1446(f) in a non-publicly traded context. The proposed regulations do not provide guidance under § 1446(f), and the § 1446(f) guidance in those notices presumably remains outstanding until further guidance is issued.
5. Gain or Loss on the Transfer of a Partnership Interest.
 - (a) Section 864(c)(8)(A) provides that gain or loss of a foreign transferor from the transfer of an interest, owned directly or indirectly, in a partnership that is engaged in any trade or business within the U.S. is treated as effectively connected gain or loss to the extent the gain or loss does not exceed the amount determined under § 864(c)(8)(B).
 - (b) Section 864(c)(8)(B) limits the amount of effectively connected gain or loss to the portion of the foreign transferor's distributive share of gain or loss that would have been effectively connected gain or loss if the partnership had sold all of its assets at fair market value.
 - (c) The new proposed regulations set forth rules for determining gain or loss described in § 864(c)(8)(A) and the limitation described in § 864(c)(8)(B).
6. Determination of gain or loss described in § 864(c)(8)(A). The proposed regulations require that a foreign transferor must first determine its gain or loss on the transfer of a partnership interest. They provide that outside gain or loss is determined under all relevant provisions of the Code and the regulations thereunder. A foreign transferor may recognize capital gain or loss and ordinary gain or loss on the transfer of its partnership interest and must separately apply § 864(c)(8) with respect to its capital gain or loss and its ordinary gain or loss.
7. Interaction with §§ 741 and 751.
 - (a) Section 864(c)(8) provides rules regarding the treatment of gain or loss on the transfer of a partnership interest as effectively connected gain or loss, but it does not address the computation of the amount of gain or loss to a partner as a result of the transfer. Rather, applicable tax law, including subchapter K, determines the amount and character of outside gain or loss on the transfer of a partnership interest. For example, the reduction in a transferor's share of partnership liabilities is treated as an amount realized on the transfer of the partnership interest under § 1001 and the regulations thereunder. Treas. Reg. §§ 752(d) and 1.752-1(h).

- (b) Section 741 provides that on a sale or exchange of an interest in a partnership, gain or loss recognized by the transferor will be considered capital gain or loss except as otherwise provided in § 751. Under 751, an amount received by a transferor of a partnership interest that is attributable to unrealized receivables or inventory items of the partnership (“§ 751 property”) is considered ordinary income or loss. As a result of §§ 741 and 751 and the regulations thereunder, gain or loss on a sale or exchange of a partnership interest can comprise capital gain, capital loss, ordinary income, or ordinary loss (or a combination thereof).
- (c) Prop. Treas. Reg. § 1.864(c)(8)-1(b) provides that a foreign transferor must separately determine the portions of its capital gain or loss and its ordinary income or loss to characterize them as effectively connected gain or loss under § 864(c)(8).
- (d) Section 864(c)(8)(A) provides that a foreign partner’s effectively connected gain or loss will not exceed its outside gain or loss on the sale of its partnership interest as determined under §§ 741 and 751. Thus, the amount of a foreign partner’s gain or loss determined under § 741 (before application of § 751) is not itself a limitation on the amount of gain or loss characterized as effectively connected with the conduct of a trade or business within the U.S.

8. Nonrecognition Transactions.

- (a) The gain or loss on the transfer of a partnership interest that is subject to tax as effectively connected gain or loss is limited to gain or loss otherwise recognized under the Code. Prop. Treas. Reg. § 1.864(c)(8)-1(b)(2)(ii). When a nonrecognition provision results in a foreign transferor recognizing only a portion of its gain or loss on the transfer of an interest in a partnership, § 864(c)(8) may apply with respect to the portion of the gain or loss recognized. The proposed regulations, however, do not contain special rules applicable to nonrecognition transactions.
- (b) The preamble states that certain nonrecognition transactions may have the effect of reducing gain or loss that would be taken into account for U.S. federal income tax purposes. For example, if a partnership that conducts a trade or business within the U.S. owns property that is not subject to tax under § 871(b) or § 882(a) in the hands of a foreign partner, the partnership may distribute that property to the foreign partner rather than a U.S. partner.
- (c) Treasury and the IRS request comments regarding whether other Code provisions adequately address transactions that rely on § 731 distributions to reduce the scope of assets subject to U.S. federal

income taxation, and may propose rules addressing these types of transactions.

9. Determination of Deemed Sale Gain or Loss.

- (a) After outside gain and loss are determined under Prop. Treas. Reg. § 1.864(c)(8)-1(b), the proposed regulations set forth three amounts that a foreign transferor must determine to derive the limitation in § 864(c)(8)(B) against which the outside gain or loss is compared:
 - i. with respect to each asset held by the partnership, the amount of gain or loss that the partnership would recognize in connection with a deemed sale to an unrelated party in a fully taxable transaction for cash equal to the asset's fair market value immediately before the partner's transfer of its partnership interest;
 - ii. the amount of that gain or loss that would be treated as effectively connected gain or loss; and
 - iii. the foreign transferor's distributive share of the ordinary and capital components of any deemed sale effectively connected gain and loss.
- (b) The proposed regulations refer to the separate sums of the foreign transferor's distributive shares of the ordinary and capital components of deemed sale effectively connected gain and loss items for all assets, determined at the level of the foreign transferor.
- (c) After each of these aggregate amounts is determined, the proposed regulations implement the limitation described in § 864(c)(8)(B), generally, by comparing the foreign transferor's outside gain or loss amounts with the relevant aggregate deemed sale effectively connected gain or loss. This determination is made separately regarding capital gain or loss and ordinary income or loss. Thus, for example, a foreign transferor would compare its outside capital gain to its aggregate deemed sale effectively connected capital gain, treating its outside capital gain as effectively connected gain only to the extent it does not exceed the effectively connected capital gain. Prop. Treas. Reg. § 1.864(c)(8)-1(b)(3).

10. Treatment of Deemed Sale Gain or Loss as Effectively Connected Gain or Loss.

- (a) A foreign transferor must determine the amount of gain or loss that would arise in a deemed asset sale that would be treated as

effectively connected gain or loss. In general, gain or loss on the sale of personal property is effectively connected with the conduct of a trade or business within the U.S. if the gain is from sources within the U.S. and it satisfies the requirements of § 864(c) and the regulations thereunder. Thus, Prop. Treas. Reg. § 1.864(c)(8)-1(c)(2)(i) provides that § 864 and the regulations thereunder apply for purposes of determining whether gain or loss that would arise in a deemed asset sale would be treated as effectively connected gain or loss.

- (b) The determination as to whether gain or loss from a deemed asset sale by the partnership would be from sources within or without the U.S., and whether that income would be treated as effectively connected gain or loss, is based on certain factual determinations, including whether the gain or loss results from a sale that is attributable to an office or other fixed place of business in the U.S. We discussed this issue in our June 4, 2018 column p. 1143 at 1144.
- (c) In a surprising provision, for purposes of determining whether gain or loss recognized in connection with a deemed asset sale by the partnership would be from sources within or without the U.S., and thus whether that income would be treated as effectively connected gain or loss, the deemed asset sale is treated as attributable to an office or fixed place of business in the United States maintained by the partnership. Prop. Treas. Reg. § 1.864(c)(8)-1(c)(2)(i).
- (d) This deemed attribution of the asset sale to a U.S. office ignores the statute. It's a factual issue under the statute, not a matter of law. It also is one of the key issues on appeal in *Grecian Magnesite*. But win or lose in *Grecian*, it's still a factual issue, and the proposed regulation is contrary to the statute.
- (e) As a result of the deemed attribution of the sale to a U.S. office of the partnership, the deemed sale gain or loss generally would be treated as from sources within the U.S. Preamble at p. 10.
- (f) To prevent this rule from potentially converting gain or loss from assets with no connection to the partnership's trade or business within the U.S. into effectively connected gain or loss, Prop. Treas. Reg. § 1.864(c)(8)-1(c)(2)(ii) provides that gain or loss from the deemed sale of a partnership asset is not treated as effectively connected gain or loss if:
 - i. no income or gain previously produced by the asset was taxable as effectively connected with the conduct of a trade or business within the U.S. by the partnership (or a

predecessor of the partnership) during the ten-year period ending on the date of the transfer, and

- ii. the asset was not used, or held for use, in the conduct of a trade or business within the U.S. by the partnership (or a predecessor of the partnership) during the ten-year period ending on the date of transfer.

11. Determining Distributive Share of Deemed Sale Effectively Connected Gain and Loss.

- (a) Section 864(c)(8)(B) provides that a transferor partner's distributive share of gain or loss on the deemed sale is determined in the same manner as the transferor partner's distributive share of the non-separately stated taxable income or loss of the partnership. The term "non-separately stated taxable income or loss of the partnership" is not defined in the Code or regulations. The proposed regulations provide that a partner's distributive share of gain or loss from the deemed sale is determined under all applicable Code sections (including § 704), taking into account allocations of tax items applying the principles of § 704(c), including any remedial allocations under Treas. Reg. § 1.704-3(d), and any § 743 basis adjustment pursuant to Treas. Reg. § 1.743-1(j)(3).
- (b) Treasury and IRS believe this approach applying § 704 more closely ties the results of the deemed sale with regard to the selling foreign partner to the economic results of an actual sale, as compared (for example) to an approach that did not consider special allocations or considered only a partner's share of ordinary business income, which would distort the economic agreement among the partners. Prop. Treas. Reg. § 1.864(c)(8)-1(c)(3)(i).
- (c) They are considering whether § 704 and the regulations thereunder adequately prevent the avoidance of the purposes of § 864(c)(8) through allocations of effectively connected gain or loss to specific partners. For example, suppose that immediately before a foreign transferor sells its interest in a partnership, adjustments are made to partnership allocations that result in the foreign transferor recognizing less effectively connected gain from the deemed sale by the partnership. While statutory and regulatory provisions, as well as judicial doctrines, may limit the extent to which inappropriate results may be obtained in that transaction or similar transactions, Treasury and the IRS believe additional guidance may be necessary to prevent this type of abuse.

12. Source. Neither § 864(c)(8) nor the proposed regulations address the source of gain or loss from the transfer of a partnership interest. Section 864(c)(4) provides that, except as enumerated in §§ 864(c)(4)(B) and (C), no income, gain, or loss from sources without the U.S. is treated as effectively connected gain or loss. Section 864(c)(8)(A) and the proposed regulations, however, apply “[n]otwithstanding any other provision of [subtitle A of the Code],” so that gain or loss recognized on the transfer of an interest in a partnership that is engaged in a trade or business within the U.S. may be treated as effectively connected gain or loss even if it is from sources without the U.S.
13. Provision is Non-Exclusive.
- (a) The proposed regulations do not apply to prevent any portion of gain or loss recognized on the transfer of a partnership interest from being treated as effectively connected gain or loss under other provisions of the Code (subject to a special rule coordinating the application of § 864(c)(8) and § 897).
 - (b) Thus, if a foreign transferor maintains an office or fixed place of business in the U.S., and sells a partnership interest in a transaction that generates gain or loss attributable to that office, gain or loss recognized in connection with that transfer may be U.S. source income under § 865(e)(2), and may be treated as effectively connected income under § 864(c)(2).
 - (c) If the amount of gain or loss recognized that would be treated as effectively connected gain or loss under § 864(c)(2) exceeds the amount of gain that would be treated as effectively connected gain under § 864(c)(8), then the larger amount would be treated as effectively connected gain. Prop. Treas. Reg. § 1.864(c)(8)-1(b)(1).
14. Coordination with § 897.
- (a) Section 897(g) generally provides that the amount realized by a nonresident alien individual or foreign corporation in exchange for all or part of its interest in a partnership is, to the extent attributable to U.S. real property interests (as defined in § 897(c)), considered as an amount received from the sale or exchange in the U.S. of that property. The preamble states that § 897(g) generally provides the same result for U.S. real property interests as Rev. Rul. 91-32 provides for property used, or held for use, in a trade or business in the United States.
 - (b) Section 864(c)(8)(C) provides that if a partnership described in § 864(c)(8)(A) holds a U.S. real property interest at the time of the

transfer by the foreign partner of its partnership interest, then the gain or loss treated as effectively connected gain or loss under § 864(c)(8)(A) is reduced by the amount treated as effectively connected gain or loss regarding that U.S. real property interest under § 897.

- (c) Under the proposed regulations, the limitation on effectively connected gain or loss in § 864(c)(8)(B) is based on a deemed sale by the partnership of all of its assets, including all U.S. real property interests held by the partnership, which are treated as effectively connected assets under § 897. *See* Prop. Treas. Reg. § 1.864(c)(8)-1(c)(2)(i).
- (d) To coordinate the taxation of U.S. real property interests under §§ 897(g) and 864(c)(8), Prop. Treas. Reg. § 1.864(c)(8)-1(d) provides that when a partnership holds U.S. real property interests and is also subject to § 864(c)(8) because it is engaged in the conduct of a trade or business within the U.S. without regard to § 897, the amount of the foreign transferor's effectively connected gain or loss will be determined under § 864(c)(8) and not under § 897(g). Therefore, the reduction called for by § 864(c)(8)(C) is not necessary.

15. Tiered Partnerships.

- (a) Section 864(c)(8) applies to a foreign nonresident alien individual or foreign corporation that owns an interest in a partnership directly or indirectly. Consistent with Notice 2018-29, the proposed regulations provide that if a foreign transferor transfers an interest in an upper-tier partnership that owns, directly or indirectly, an interest in one or more lower-tier partnerships that are engaged in the conduct of a trade or business within the U.S., then the deemed sale gain or loss must be computed with respect to each lower-tier partnership.
- (b) The amount of effectively connected gain or loss that would be allocated to the upper-tier partnership must be determined, and the amount of gain or loss recognized by a foreign transferor that is treated as effectively connected gain or loss under Prop. Treas. Reg. § 1.864(c)(8)-1(c) must be determined by reference to the transferor's distributive share of effectively connected gain or loss arising from each lower-tier partnership. Prop. Treas. Reg. § 1.864(c)(8)-1(e)(1).
- (c) The proposed regulations also provide that when a foreign transferor is a partner in an upper-tier partnership and the upper-tier partnership transfers an interest in a lower-tier partnership that

is engaged in the conduct of a trade or business within the U.S., the upper-tier partnership must determine its effectively connected gain or loss by applying the principles of the proposed regulations, including the tiered partnership rules described in Prop. Treas. Reg. § 1.864(c)(8)-1(e)(1).

16. Treaties.

- (a) The business profits articles of many U.S. income tax treaties limit the taxation of income that is otherwise treated as effectively connected with the conduct of a trade or business within the U.S. under the Code to income and gain attributable to a permanent establishment in the U.S. The applicable gains articles of many U.S. income tax treaties allow the country in which a permanent establishment is located to tax gains from the alienation of movable property forming part of the business property of a permanent establishment, including gains from the alienation of a permanent establishment, alone or with the whole enterprise of which it is a part. In general, the permanent establishment of a partnership in the U.S. is considered a permanent establishment of the partners of the partnership.
- (b) The proposed regulations provide that the disposition of a foreign partner's interest in a partnership, in whole or in part, is a disposition of all or part of a partner's permanent establishment. Thus, to the extent the partnership's assets form part of a foreign partner's permanent establishment in the U.S., the permanent establishment paragraph of the gains article would generally preserve the U.S.' taxing jurisdiction over the gain on the transfer of a partnership interest that is subject to tax under § 864(c)(8). In addition, if an income tax treaty has a gains article that permits the United States to apply its domestic laws to tax gains or does not have a gains article, the treaty does not prevent the application of § 864(c)(8).
- (c) Treaties' gains articles also often have special provisions covering certain assets, regardless of whether the assets form part of a permanent establishment, such as gains from dispositions of U.S. real property interests and ships and aircraft used in international traffic. If a gains article of an income tax treaty prohibits taxation of the gain from the disposition of any asset, such as ships or aircraft used in international traffic, the gains and losses from those assets will not be considered assets that form part of the permanent establishment, nor will they be taken into account in determining deemed sale effectively connected gain or loss, for purposes of computing the § 864(c)(8)(B) limitation.

- (d) If the gains article of an income tax treaty allows the taxation of gain from the disposition of a U.S. real property interest, the transfer of an interest in a partnership that holds a U.S. real property interest remains subject to § 897(g) even if the transfer is not subject to § 864(c)(8) (because the partnership's assets are not treated as forming part of a permanent establishment in the United States). Prop. Treas. Reg. § 1.864(c)(8)-1(d).
17. Anti-Stuffing Rule. The proposed regulations include an anti-stuffing rule applicable to both these regulations and § 897. This rule is included to prevent inappropriate reductions in amounts characterized as effectively connected with the conduct of a trade or business within the United States under § 864(c)(8) or § 897.
18. Section 1446(f) Guidance. The proposed regulations do not provide guidance under § 1446(f). Treasury and the IRS intend to issue guidance under § 1446(f) expeditiously.
19. Applicability Dates. The proposed regulations apply to transfers occurring on or after November 27, 2017, the effective date of § 864(c)(8). If any provision is finalized after June 22, 2019, Treasury and the IRS expect that the provision will apply only to transfers occurring on or after the date the final regulation is published in the Federal Register.
20. Examples.
- (a) Proposed Treas. Reg. § 1.864(c)(8)(i) contains examples that illustrate these rules. Examples 1 and 3 are below. In each, FP is a foreign corporation. USP is a domestic corporation, when FP and USP each contributed \$100x in cash. FP's adjusted basis in its interest in PRS is \$100x. X is a foreign corporation that is unrelated to FP, USP, or PRS. Upon the formation of PRS, FP and USP entered into an agreement providing that all income, gain, loss, and deduction of PRS will be allocated equally between FP and USP.
- (b) PRS is engaged in the conduct of a trade or business within the U.S. (the U.S. Business) and an unrelated business in Country A (the Country A Business). In a deemed sale described in paragraph (c)(1) of the proposed regulations, gain or loss on assets of the U.S. Business would be treated as effectively connected gain or effectively connected loss, and gain or loss on assets of the Country A Business would not be so treated. PRS has no liabilities. FP does not qualify for the benefits of an income tax treaty between the United States and another country.

(1) Example 1. Deemed sale limitation--(i) Facts. On January 1, 2019, FP sells its entire interest in PRS to X for \$105x. Immediately before the sale, PRS's balance sheet appears as follows:

	<u>Adjusted Basis</u>	<u>Fair Market Value</u>
U.S. Business capital asset	\$100x	\$104x
Country A Business capital asset	<u>100x</u>	<u>106x</u>
Total	<u>\$200x</u>	<u>\$210x</u>

(ii) Analysis--(A) Outside gain or loss. FP is a foreign transferor and transfers its interest in PRS to X. FP recognizes a \$5x capital gain under § 741, which is an outside capital gain. FP's \$5x capital gain is treated as effectively connected gain to the extent that it does not exceed the limitation, which is FP's aggregate deemed sale effectively connected capital gain.

(B) Deemed sale. FP's aggregate deemed sale effectively connected capital gain is determined according to the three-step process set forth in paragraph (c) of the proposed regulations. First, the amount of gain or loss that PRS would recognize regarding each of its assets upon a deemed sale described in paragraph (c)(1) is a \$4x gain regarding the U.S. Business capital asset and a \$6x gain regarding the Country A Business capital asset.

Second, under paragraph (c)(2), PRS's deemed sale effectively connected gain is \$4x. PRS recognizes no deemed sale effectively connected gain or loss with respect to the Country A Business capital asset under § 864.

Third, under paragraph (c)(3)(ii)(B), FP's aggregate deemed sale effectively connected capital gain is \$2x (that is, the aggregate of its distributive share of deemed sale effectively connected gain attributable to the deemed sale of assets that are not § 751(a) property, which is 50% of \$4x).

(C) Limitation. The \$5x outside capital gain recognized by FP is treated as effectively connected gain to the extent that it does not exceed FP's \$2x aggregate deemed sale effectively connected capital gain. Accordingly, FP recognizes \$2x of capital gain that is treated as effectively connected gain.

(2) Example 3. Interaction with § 751(a)--(i) Facts. On January 1, 2019, FP sells its entire interest in PRS to X for \$95x. Through both its U.S. Business and its Country A Business, PRS holds inventory items that are § 751 property. Immediately before the sale, PRS's balance sheet appears as follows:

	<u>Adjusted Basis</u>	<u>Fair Market Value</u>
U.S. Business capital asset	\$20x	\$50x
U.S. Business inventory	30x	50x
Country A Business capital asset	100x	80x
Country A business inventory	<u>50x</u>	<u>10x</u>
Total	<u>\$200x</u>	<u>\$190x</u>

(ii) Analysis--(A) Outside gain or loss. FP is a foreign transferor and transfers its interest in PRS to X. Under §§ 741 and 751, FP recognizes a \$10x ordinary loss and a \$5x capital gain. FP has outside ordinary loss equal to \$10x and outside capital gain equal to \$5x. FP's outside ordinary loss and outside capital gain are treated as effectively connected loss and effectively connected gain to the extent that each does not exceed the applicable limitation.

In the case of FP's outside ordinary loss, the applicable limitation is FP's aggregate deemed sale effectively connected ordinary loss. In the case of FP's outside capital gain, the applicable limitation is FP's aggregate deemed sale effectively connected capital gain.

(B) Deemed sale. FP's aggregate deemed sale effectively connected ordinary loss and aggregate deemed sale effectively connected capital gain are determined according to the three-step process set forth in paragraph (c) of the proposed regulations.

(1) Step 1. The amount of gain or loss that PRS would recognize regarding each of its assets upon a deemed sale described in paragraph (c)(1) is as follows:

<u>Asset</u>	<u>Gain/(Loss)</u>
U.S. Business capital asset	\$30x
U.S. Business inventory	20x
Country A Business capital asset	(20x)
Country A Business inventory	(40x)

(2) Step 2. Under paragraph (c)(2) of this section, PRS's deemed sale effectively connected gain and deemed sale effectively connected loss must be determined regarding each asset. The amounts determined under paragraph (c)(2) are as follows:

<u>Asset</u>	<u>Deemed Sale Effectively Connected Gain/(Loss)</u>
U.S. Business capital asset	\$30x
U.S. Business inventory	20x
Country A Business capital asset	0
Country A Business inventory	0

(3) Step 3. Under paragraph (c)(3) of this section, FP's aggregate deemed sale effectively connected capital gain is \$15x (that is, the aggregate of its distributive share of deemed sale effectively connected gain that is attributable to the deemed sale of assets that are not § 751(a) property, which is 50% of \$30x). FP's aggregate deemed sale effectively connected ordinary loss is \$0 (that is, the aggregate of its distributive share of deemed sale effectively connected loss that is attributable to the deemed sale of assets that are § 751(a) property).

(C) Limitation--(i) Capital gain. The \$5x outside capital gain recognized by FP is treated as effectively connected gain to the extent that it does not exceed FP's \$15x aggregate deemed sale effectively connected capital gain. Accordingly, the amount of FP's capital gain that is treated as effectively connected gain is \$5x.

(ii) Ordinary loss. The \$10x outside ordinary loss recognized by FP is treated as effectively connected loss to the extent that it does not exceed FP's \$0 aggregate deemed sale effectively connected ordinary loss. Accordingly, the amount of FP's ordinary loss that is treated as effectively connected loss is \$0.

G. § 1.1446(f) Regulations.

1. Sale of Interests in Partnerships: Withholding Tax. Treasury and the IRS proposed regulations implementing the TCJA provisions regarding the

withholding of tax and information reporting concerning certain dispositions of interests in partnerships engaged in the conduct of a U.S. trade or business.

2. § 1446(f).

- (a) Section 1446(f) provides rules for withholding on the transfer of a partnership interest described in § 864(c)(8). Under § 1446(f)(1), the transferee is required to deduct and withhold a tax equal to 10% of the amount realized on the disposition if a portion of the gain (if any) on any disposition of an interest in a partnership would be treated under § 864(c)(8) as effectively connected with the conduct of a trade or business within the U.S.
- (b) Section 1446(f)(2)(A) provides an exception to the general withholding requirement described in § 1446(f)(1) if the transferor furnishes an affidavit to the transferee stating, under penalties of perjury, the transferor's U.S. taxpayer identification number and that the transferor is not a foreign person. Section 1446(f)(2)(B)(i) provides that the exception to withholding described in § 1446(f)(2)(A) will not apply if the transferee has actual knowledge that the affidavit furnished is false, or if the transferee receives a notice from a transferor's agent or transferee's agent that the affidavit is false.
- (c) Section 1446(f)(3) provides that, at the request of the transferor or transferee, the IRS may prescribe a reduced amount to be withheld under this section if the IRS determines that reducing the amount to be withheld will not jeopardize the collection of tax on gain treated under § 864(c)(8) as effectively connected with the conduct of a U.S. trade or business.
- (d) Section 1446(f)(4) provides that if a transferee fails to withhold any amount required to be withheld under § 1446(f)(1) then the partnership must deduct and withhold from distributions to the transferee a tax in an amount equal to the amount the transferee failed to withhold, plus interest.
- (e) Section 1446(f)(6) generally provides that Treasury and the IRS shall prescribe such regulations as may be necessary to carry out the purposes of § 1446(f), including regulations providing for exceptions from the provisions of § 1446(f). Section 1446(f) is effective for sales, exchanges, and other dispositions after December 31, 2017.
- (f) On December 29, 2017, the Treasury and the IRS released Notice 2018-08, 2018-7 I.R.B. 352, which temporarily suspended the

requirement to withhold on amounts realized in connection with the sale, exchange, or disposition of certain interests in a publicly traded partnership not treated as a corporation under § 7704 and the regulations thereunder.

- (g) On April 2, 2018, Treasury and the IRS released Notice 2018-29, 2018-16 I.R.B. 495, which provided temporary guidance and announced an intent to issue proposed regulations under § 1446(f) regarding the sale, exchange, or disposition of certain interests in non-publicly traded partnerships. Notice 2018-29, and § 1446(f)(1) generally, rely on the principles contained within the § 1445 withholding regime, which deals with FIRPTA withholding. Under § 1445, if a foreign person disposes of a U.S. real property interest (“U.S. real property interest”), as defined in § 897(c), a withholding obligation is imposed on the transferee of the interest.
- (h) On December 27, 2018, Treasury and the IRS published a notice of proposed rulemaking under § 864(c)(8) (the “proposed § 864(c)(8) regulations”). The proposed § 864(c)(8) regulations provide rules for determining the amount of gain or loss treated as effectively connected with the conduct of a trade or business within the U.S. (“effectively connected gain” or “effectively connected loss”) described in § 864(c)(8), including rules coordinating § 864(c)(8) with §§ 741 and 751 (relating to the character of gain or loss realized in connection with the sale or exchange of an interest in a partnership). They also provide rules for coordination of § 864(c)(8) with § 897 (relating to amounts treated as effectively connected gain or loss with respect to U.S. real property interests), tiered partnerships, and U.S. income tax treaties.

3. Publicly Traded Partnerships: § 1446(a) Regarding Distributions,

- (a) Generally, withholding under § 1446(a) is required by a partnership when effectively connected taxable income (“ECTI”) is allocable to a foreign person. *See* Treas. Reg. §§ 1.1446-2 and 1.1446-3. However, withholding on ECTI earned by a publicly traded partnership is required when the ECTI is distributed to the foreign person. *See* Treas. Reg. § 1.1446-4. Often, an interest in the publicly traded partnership is held by a nominee, such as a domestic financial institution that holds the publicly traded partnership interest as a custodian for a foreign partner.
- (b) When a publicly traded partnership provides a qualified notice (within the meaning of Treas. Reg. § 1.1446-4(b)(4)), a nominee, which must be a domestic person, may be treated as a withholding

agent with respect to a distribution. *See* Treas. Reg. §§ 1.1446-4(b)(4) and 1.1446-4(d).

- (c) The qualified notice must be given in accordance with notice requirements with respect to dividends under regulations under the Securities Exchange Act of 1934. Treas. Reg. § 1.1445-8(f) provides similar qualified notice rules that apply to certain distributions subject to withholding when attributable to the disposition of a U.S. real property interest.
- (d) Treas. Reg. § 1.1446-4(f)(3) provides an ordering rule for situations in which the distribution is attributable to multiple types of income (such as amounts attributable to income described in § 1441 or § 1442 or amounts subject to withholding under § 1446). However, no rule is provided for situations in which a qualified notice does not provide information regarding the types of income being distributed.

4. The Newly Proposed Regulations.

- (a) The newly proposed regulations provide rules for withholding, reporting, and paying tax under § 1446(f) upon the sale, exchange, or other disposition of an interest in a partnership described in § 864(c)(8) and Prop. Treas. Reg. § 1.864(c)(8)-1. The proposed regulations would, when finalized, adopt many of the rules that were described in Notice 2018-29, with certain modifications provided, in part, in response to comments. In fact, Treasury and the IRS responded quite favorably to many taxpayer comments and suggestions in an effort to help make these rules as workable as possible, although commentators undoubtedly will have additional comments and suggestions now that the proposed regulations have been issued.
- (b) The proposed regulations also provide reporting rules relating to § 864(c)(8) and rules implementing withholding under § 1446(f)(4). They also contain rules clarifying the reporting rules applicable to transfers of partnership interests subject to § 6050K.
- (c) Further, the proposed regulations provide rules implementing withholding by brokers on transfers of certain interests in publicly traded partnerships subject to § 1446(f)(1), and make related changes to the reporting rules and procedures for adjusting withholding under §§ 1461, 1463, and 1464.
- (d) They also make changes to the rules regarding withholding on distributions by publicly traded partnerships under Treas. Reg. § 1.1446-4, including the rules that apply to qualified notices and

nominees. Finally, the proposed regulations provide rules coordinating withholding under § 1446(f) with other withholding regimes to prevent over withholding of tax.

5. Reporting Requirements.

- (a) A partnership that is engaged in the conduct of a U.S. trade or business is required to file an annual information return, Form 1065, U.S. Return of Partnership Income, and also provide information to its partners on Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc., regarding each partner's distributive share of partnership items and other information. *See* Treas. Reg. § 6031 and Treas. Reg. §§ 1.6031(a)-1 and 1.6031(b)-1T. Domestic partners generally report the information from the Schedule K-1 (Form 1065) on their income tax return, typically Form 1040, U.S. Individual Income Tax Return, for an individual, or Form 1120, U.S. Corporation Income Tax Return, for a corporation. A foreign partner with a U.S. income tax return filing obligation generally files Form 1040NR, U.S. Nonresident Alien Income Tax Return, or Form 1120-F, U.S. Income Tax Return of a Foreign Corporation.
- (b) A partner (foreign or domestic) that transfers an interest in a partnership in an exchange described in § 751(a) (relating to an exchange of an interest in a partnership that holds unrealized receivables or inventory) generally has an obligation both to inform the partnership of the transfer and to include a statement regarding the exchange on the partner's income tax return under Treas. Reg. § 1.751-1(a)(3). *See* Treas. Reg. § 6050K(c) and Treas. Reg. § 1.6050K-1(d). A partnership also has an obligation to provide information regarding the exchange to the transferee and transferor under § 6050K(c) and Treas. Reg. § 1.6050K-1(c). *See also* Form 8308, Report of a Sale or Exchange of Certain Partnership Interests.
- (c) Because § 864(c)(8) requires a deemed sale at the partnership level to determine a foreign partner's effectively connected gain or loss, a foreign person that transfers its partnership interest generally will not be able to compute its income tax liability under § 864(c)(8) unless the partnership provides certain information to the foreign partner. The proposed regulations therefore provide rules to facilitate the transfer of information between a foreign partner and the partnership for purposes of § 864(c)(8).
- (d) The proposed regulations generally provide that a notifying transferor (generally, any foreign person and certain domestic partnerships that have a foreign person as a direct or indirect

partner) that transfers (within the meaning of Prop. Treas. Reg. § 1.864(c)(8)-1(g)(5)) an interest in a partnership (other than certain interests in a publicly traded partnership) in a transaction described in § 864(c)(8) must notify the partnership within 30 days of the transfer by providing a statement that includes information relevant to the partnership for making calculations under § 864(c)(8), including the date on which the notifying transferor transferred its interest, and other identifying information regarding the transferor and transferee. *See* Prop. Treas. Reg. § 1.864(c)(8)-2(a). This rule generally parallels Treas. Reg. § 1.6050K-1, including the content of the information and when it must be provided.

- (e) Prop. Treas. Reg. § 1.864(c)(8)-2(b) requires a specified partnership (generally, a partnership that is engaged in the conduct of a trade or business within the U.S. or a partnership that owns, directly or indirectly, an interest in a partnership so engaged) to furnish to a notifying transferor the information necessary for the transferor to comply with Prop. Treas. Reg. § 864(c)(8) by the due date of the Schedule K-1 (Form 1065) for the tax year of the partnership in which the transfer occurred.
- (f) Prop. Treas. Reg. § 1.864(c)(8)-2(b) applies if a specified partnership receives the notification described in Prop. Treas. Reg. § 1.864(c)(8)-2(a), or otherwise knows that a relevant transfer has occurred, and the notifying transferor would have had a distributive share of deemed sale EC gain or deemed sale EC loss (within the meaning of Prop. Treas. Reg. § 1.864(c)(8)-1(c)) at the time of the transfer.
- (g) For these purposes, a notifying transferor that is a partnership is treated as a nonresident alien. Prop. Treas. Reg. § 1.864(c)(8)-2(b) provides that, for purposes of the reporting requirements described in Prop. Treas. Reg. § 1.864(c)(8)-2, a partnership that makes a distribution to a transferor that qualifies as a transfer under § 864(c)(8) and Prop. Treas. Reg. § 1.864(c)(8)-1(b) will be treated as having actual knowledge that a transfer occurred, thereby triggering the reporting requirement of Prop. Treas. Reg. § 1.864(c)(8)-2(b) to the extent that the transferee would have had a distributive share of deemed sale EC gain or deemed sale EC loss within the meaning of Prop. Treas. Reg. § 1.864(c)(8)-1(c).
- (h) The proposed regulations also clarify that the information a partnership must provide under § 6050K upon being notified of a transfer includes the information necessary for a transferor to make the transferor's required statement under Treas. Reg. § 1.751-1(a)(3). *See* Prop. Treas. Reg. § 1.6050K-1(c)(2).

6. Definitions and General Rules.
7. Definitions. For purposes of the proposed regulations under § 1446(f), the term “transfer” means a sale, exchange, or other disposition, and includes a distribution from a partnership to a partner. *See* Prop. Treas. Reg. § 1.1446(f)-1(b)(9). A “transferee” is any person, foreign or domestic, that acquires a partnership interest through a transfer. *See* Prop. Treas. Reg. § 1.1446(f)-1(b)(10). The term “transferor” generally means any person, foreign or domestic, that transfers a partnership interest, and therefore refers to the person that directly owns the interest in the partnership. For a trust, to the extent all or a portion of the trust is treated as owned by the grantor or another person under §§ 671 through 679 (such trust, “a grantor trust”), the term “transferor” means the grantor or other person. *See* Prop. Treas. Reg. § 1.1446(f)-1(b)(11). The Preamble also cites Rev. Rul. 85-13, 1985-1 C.B. 184, in this regard.
8. Certifications and Books and Record. Similar to the approach described in Notice 2018-29, the proposed regulations provide various exceptions to withholding and procedures for determining the amount to withhold. Under these rules, the person required to withhold may generally rely on information provided in certifications that it receives or that is contained in its own books and records. The general rules of applicability provide the requirements for providing a valid certification and for retaining certifications or information in books and records. *See* Prop. Treas. Reg. § 1.1446(f)-1(c)(2). A certification includes any documents associated with the certification, such as statements from the partnership, IRS forms, withholding certificates, withholding statements, certifications, or other documentation.
9. Determination Dates.
 - (a) Notice 2018-29 required determinations to be made as of the date of transfer when applying many of its rules and exceptions. Because it may be difficult to make these determinations on the precise date of transfer, the proposed regulations generally allow the choice of one of several dates solely for purposes of making determinations under § 1446(f)(1) regarding a transfer. This date is referred to as the determination date.
 - (b) The determination date is chosen on a transfer-by-transfer basis and must be used for a transfer for all purposes of § 1446(f). The date must be one of the following: the date of the transfer, any date no more than 60 days before the transfer, or, regarding a transferor that is not a controlling partner, the later of either the first day of the partnership’s taxable year in which the transfer occurs or the date before the transfer of the most recent revaluation

described in Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5) or 1.704-1(b)(2)(iv)(s)(1). *See* Prop. Treas. Reg. § 1.1446(f)-1(c)(4).

- (c) As the determination date applies only for purposes of determining the withholding obligation under § 1446(f), the calculation of tax resulting from the application of § 864(c)(8) and the reporting requirements under Prop. Treas. Reg. § 1.864(c)(8)-2 are determined based on the date of the transfer.

10. IRS Forms and Instructions. Prop. Treas. Reg. § 1.1446(f)-1(c)(5) states that any reference in the proposed regulations to an IRS form includes its successor form and that any form must be filed in the manner provided in the instructions to the forms or in other guidance.

11. Coordination with Other Withholding Rules.

- (a) Prop. Treas. Reg. § 1.1446(f)-1(d) provides a rule coordinating § 1446(f)(1) with § 1445. Specifically, the rule provides that if a transferee is required to withhold under § 1445(e)(5) or Treas. Reg. § 1.1445-11T(d)(1) and § 1446(f)(1), then the transferee will be subject to the payment and reporting requirements of § 1445 only.
- (b) This rule clarifies that even though Prop. Treas. Reg. § 1.864(c)(8)-1(d) provides that § 897(g) does not apply to a transfer that is also subject to § 864(c)(8), the withholding regime provided in § 1445 and the regulations thereunder applies under these circumstances, rather than the rules described in § 1446(f)(1).
- (c) Thus, if a foreign transferor disposes of an interest in a partnership that is engaged in the conduct of a trade or business within the U.S. (not taking into account the application of § 897(a)) and in which 50% or more of the value of the gross assets consist of U.S. real property interests, and 90% or more of the value of the gross assets consist of U.S. real property interests plus any cash or cash equivalents, a transferee must generally withhold under § 1445(a) (at 15% of the amount realized) and not § 1446(f).
- (d) However, this rule applies only if the transferor has not applied for a withholding certificate under Treas. Reg. § 1.1445-11T(d)(1). *See* Prop. Treas. Reg. § 1.1446(f)-1(d). If the transferor has applied for a withholding certificate, then the transferee must withhold the greater of the amounts required under § 1445(e)(5) or § 1446(f)(1).
- (e) Because gain that an upper-tier partnership recognizes on the transfer of an interest in a lower-tier partnership engaged in the conduct of a trade or business within the U.S. is included when calculating the upper-tier partnership's ECTI, the proposed

regulations also provide a coordination rule that allows a partnership that is withheld upon under § 1446(f)(1) (in its capacity as a transferor) to claim a credit for the amount withheld against its withholding tax liability under § 1446(a) (if any). *See* Prop. § 1.1446-3(c)(4). *See also* Prop. Treas. Reg. § 1.1446-3(d)(2) for rules on how the partnership or its partners may claim a credit or refund for tax paid under § 1446.

12. Transfer of a Non-Publicly Traded Partnership Interest. Under § 1446(f)(1), a transferee of a partnership interest must withhold a tax equal to 10% of the amount realized on any disposition when the disposition results in gain that is treated as effectively connected with the conduct of a U.S. trade or business within the U.S. under § 864(c)(8). Prop. Treas. Reg. § 1.1446(f)-2(a) implements this rule by requiring any transferee to withhold a tax equal to 10% of the amount realized on any transfer of a partnership interest (other than certain publicly traded partnership interests) under Treas. Reg. § 1446(f)(1), unless an exception to withholding applies under Prop. Treas. Reg. § 1.1446(f)-2(b). If an exception does not apply and withholding is required, Prop. Treas. Reg. § 1.1446(f)-2(c) provides rules for determining and adjusting the amount required to be withheld under Treas. Reg. § 1446(f)(1). The exceptions and determination procedures in the proposed regulations apply solely for purposes of § 1446(f)(1) and do not affect a foreign person's filing obligation under the Code or a foreign person's tax liability resulting from the application of § 864(c)(8).
13. Exceptions to Withholding. The proposed regulations provide six exceptions to withholding by a transferee under § 1446(f)(1). These exceptions generally allow the transferee to rely on certain certifications that it receives from the transferor or partnership unless it has actual knowledge that the certifications are incorrect or unreliable. *See* Prop. Treas. Reg. § 1.1446(f)-2(b)(1). When the partnership is a transferee because it makes a distribution, it may instead rely on its books and records unless it knows, or has reason to know, that the information is incorrect or unreliable.
 - (a) Certification of Non-Foreign Status by Transferor. Consistent with section 6.01 of Notice 2018-29, Prop. Treas. Reg. § 1.1446(f)-2(b)(2) provides the requirements for a certification of non-foreign status (including the requirement that it include the transferor's TIN), and clarifies that a valid Form W-9, Request for Taxpayer Identification Number and Certification, may be used for this purpose, including a Form W-9 for the transferor that is already in the transferee's possession. The proposed regulations also clarify that a Form W-9 may be used to establish non-foreign status of a transferor for purposes of § 1445. *See* Prop. Treas. Reg. §§ 1.1445-2(b)(2)(v) and 1.1445-5(b)(3)(iv).

(b) No Realized Gain by Transferor.

- i. Section § 1446(f)(1) applies only when there is gain described in § 864(c)(8) on the transfer of a partnership interest. Consistent with section 6.02 of Notice 2018-29, the proposed regulations provide that a transferee is not required to withhold if the transferor provides the transferee with a certification stating that the transferor would not realize any gain on the transfer of the partnership interest determined as if the transfer occurred on the determination date.
- ii. Prop. Treas. Reg. § 1.1446(f)-2(b)(3)(i) provides that this certification of no realized gain must take into account any ordinary income arising from application of § 751(a) and the regulations thereunder. Therefore, a transferor may not provide the certification if § 751(a) and the regulations thereunder require the transferor to realize ordinary income, even if the transferor would realize an overall loss on the transfer.
- iii. A similar rule in Prop. Treas. Reg. § 1.1446(f)-2(b)(3)(ii) applies to partnership distributions. Section 731 generally provides that if a distribution of money to a partner exceeds the partner's adjusted basis in its interest in the partnership, then gain will be recognized to the extent of the difference between the money distributed and the partner's basis. That gain or loss is considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner. *See* § 731(a). Consistent with section 9 of Notice 2018-29, Prop. Treas. Reg. § 1.1446(f)-2(b)(3)(ii) provides that for purposes of determining whether withholding is required on a distribution, a partnership is permitted to rely on its books and records or on a certification provided by the transferor (the distributee partner) to determine if there is realized gain to the distributee partner.

(c) Effectively Connected Gain upon a Partnership's Deemed Sale.

- i. To make the determination of whether there is a transfer to which withholding applies more administrable for transferors and transferees, Prop. Treas. Reg. § 1.1446(f)-2(b)(4) provides that no withholding is required if the transferee receives a certification from the partnership stating that if the partnership sold all of its assets at fair market value, the amount of net effectively connected gain resulting from the deemed sale would be less than 10% of

the total net gain. Section 6.04 of Notice 2018-29 provided a similar rule, but at a threshold of 25%.

- ii. Prop. Treas. Reg. § 1.1446(f)-2(b)(4) lowers the percentage threshold in accordance with section 2 of Notice 2018-29, which stated that Treasury and the IRS intend to provide future guidance reducing the percentage threshold provided in section 6.04 of Notice 2018-29. The proposed regulations also allow a partnership that is a transferee because it makes a distribution to use this exception when it determines that the 10% test is satisfied from its books and records.
- iii. To make it easier for the partnership to calculate its effectively connected gain from the deemed sale, the proposed regulations allow this amount to be determined as of the determination date. Further, the proposed regulations allow a partnership to make this determination when no gain on the deemed sale would have been effectively connected with the conduct of a trade or business within the U.S. (for example, when the deemed sale would result in a loss that would have been effectively connected with the conduct of a trade or business within the U.S.). See Prop. Treas. Reg. § 1.1446(f)-2(b)(4)(i)(B).

(d) Allocable Share of ECTI.

- i. Section 6.03 of Notice 2018-29 provided an exception to withholding under § 1446(f)(1) for situations in which a transferor's distributive share of ECTI during the previous three taxable years was less than 25% of the transferor's total distributive share of income in each year (the "three-year ECTI exception"). Section 2 of Notice 2018-29 provided that Treasury and the IRS intended to lower the three-year ECTI exception's 25% threshold in proposed regulations, and that other limitations for this rule were under consideration.
- ii. The three-year ECTI exception was intended to relieve potentially significant overwithholding that could arise when a partner transfers an interest in a partnership, recognizes relatively little effectively connected gain under § 864(c)(8), but cannot obtain information from the partnership at the time of the transfer necessary to qualify for the deemed sale exception. The three-year ECTI exception uses a transferor's allocable share of ECTI as a proxy for distributive share of effectively connected gain

recognized in connection with a deemed sale described in § 864(c)(8)(B).

- iii. Treasury and the IRS are aware that the amount of a partner's recent allocable share of ECTI may not accurately indicate whether, and to what extent, the partner would recognize gain taxable under § 864(c)(8) and Prop. Treas. Reg. § 1.864(c)(8)-1. For example, a partnership may recognize relatively little effectively connected income for several years while nonetheless holding assets with significant built-in gain that would be taxable as effectively connected gain. The three-year ECTI exception may in certain cases increase compliance and collection risks if foreign partners with limited connections to the U.S. and significant tax liability under Prop. Treas. Reg. § 864(c)(8) are not withheld on under Treas. Reg. § 1446(f)(1).
- iv. The preamble states that, in the interest of striking the appropriate balance between the risk of noncompliance and the potential for overwithholding, the proposed regulations adopt the three-year ECTI exception from Notice 2018-29. It also says that Treasury and the IRS continue to study whether the three-year ECTI exception is appropriate in light of the risk of noncompliance, and request comments on the utility of the rule and modifications to the rule that would reduce that risk.
- v. Accordingly, Prop. Treas. Reg. § 1.1446(f)-2(b)(5)(i) provides that no withholding is required if a transferee receives a certification from a transferor stating that the transferor was at all times a partner in the partnership for the immediately prior taxable year and the two taxable years that precede it and that the transferor's allocable share of ECTI for each of those taxable years was less than 10% of the transferor's total distributive share of the partnership's net income for that year. *See* Prop. Treas. Reg. § 1.1446(f)-2(b)(5)(i)(A) and (C).
- vi. In addition, a transferor must certify that, in the immediately prior taxable year and the two that preceded it, the transferor's allocable share of ECTI was less than \$1 million (including ECTI allocated to certain persons related to the transferor). *See* Prop. Treas. Reg. § 1.1446(f)-2(b)(5)(i)(B).
- vii. A transferor must also certify that its distributive share of income or gain that is effectively connected with the

conduct of a trade or business within the U.S. or deductions or losses properly allocated and apportioned to that income in each of the taxable years described in Prop. Treas. Reg. § 1.1446(f)-2(b)(5)(i)(A) has been reported on a Federal income tax return (filed on or before the due date (including extensions) for filing the return (and all amounts due with respect to the return are timely paid)) for each of the three preceding taxable years, if required to be filed, before the date on which the transferor furnishes the certification. *See* Prop. Treas. Reg. § 1.1446(f)-2(b)(5)(i)(D).

- viii. For this purpose, if the transferor is a nonresident alien individual or foreign corporation, the Federal income tax return is the transferor's Form 1040NR or Form 1120-F; if the transferor is a partnership, the Federal income tax returns are the Forms 1040NR or 1120-F of the direct or indirect partners of the transferor.
- ix. For purposes of this rule, the immediately prior taxable year is the transferor's most recent taxable year with or within which a taxable year of the partnership ended and for which a Schedule K-1 (Form 1065) was due or furnished (if earlier) before the date of the transfer. *See* Prop. Treas. Reg. § 1.1446(f)-2(b)(5)(ii). Consistent with the three-year ECTI exception described in Notice 2018-29, a transferor does not satisfy this requirement if for any of the relevant years it did not receive Form 8805, Foreign Partner's Information Statement of Section 1446 Withholding Tax, unless the transferor was allocated an item of deduction or loss that is effectively connected with the conduct of a trade or business within the U.S., in which case it is treated as having an allocable share of ECTI for that year of zero. *See* Prop. Treas. Reg. § 1.1446(f)-2(b)(5)(iii).
- x. When a transferor has had neither ECTI nor a net distributive share of income allocated to it in the previous three taxable years, the composition of the income the partnership allocates to the transferor does not provide any indication of the amount of effectively connected gain realized by the transferor in connection with the transfer. Accordingly, the proposed regulations also provide that a transferor does not qualify for the exception provided in Prop. Treas. Reg. § 1.1446(f)-2(b)(5) if the transferor did not have a net distributive share of income allocated to it in

any of its previous three taxable years. *See* Prop. Treas. Reg. § 1.1446(f)-2(b)(5)(iv).

- xi. Section 6.03 of Notice 2018-29 provided that the three-year ECTI exception does not apply when a partnership is a transferee by reason of making a distribution. The Preamble states that commentators noted that, particularly in tiered partnership structures, a distributing partnership may not be able to obtain the information necessary to use the deemed sale exception described in section 6.04 of Notice 2018-29, such that the partnership would be required to withhold under § 1446(f)(1) in cases in which there was relatively limited effectively connected income earned by the partnership.
- xii. In response to the comments, the proposed regulations allow a distributing partnership to use this exception when it determines that the three-year ECTI exception is applicable based on its books and records, provided that it receives a representation from the transferor stating that income tax returns have been filed, and tax has been paid, for each of the relevant years for which the transferor was allocated effectively connected income (or loss). *See* Prop. Treas. Reg. § 1.1446(f)-2(b)(5)(v).
- xiii. Finally, Prop. Treas. Reg. § 1.1446(f)-2(b)(5)(vi) provides that a transferor may not make the certification if it has actual knowledge that the information relevant to the certification that is reported by the partnership on any Form 8805 or Schedule K-1 (Form 1065) is incorrect.

(e) Nonrecognition by Transferor.

- i. Section 864(c)(8) and Prop. Treas. Reg. § 1.864(c)(8)-1 provide that gain from the transfer of a partnership interest that is treated as effectively connected with the conduct of a U.S. trade or business is limited to gain otherwise recognized under the Code. If a nonrecognition provision of the Code applies to all of the gain realized on a transfer, withholding under § 1446(f)(1) does not apply. Accordingly, section 6.05 of Notice 2018-29 provided an exception to withholding for certain nonrecognition transactions if the transferee receives a notice from the transferor describing the application of a nonrecognition provision. This exception was based on the rules in Treas. Reg. § 1.1445-2(d)(2).

- ii. Consistent with the rule provided in Notice 2018-29, the proposed regulations generally permit a transferee to rely on a certification of nonrecognition from the transferor. *See* Prop. Treas. Reg. § 1.1446(f)-2(b)(6). The certification provided by the transferor must include a brief description of the transfer and the relevant law and facts relating to the application of the nonrecognition provision.
- iii. If only a portion of the gain realized on the transfer is subject to a nonrecognition provision, an adjustment to the amount required to be withheld may be permitted under Prop. Treas. Reg. § 1.1446(f)-2(c)(4).

(f) Claim of Treaty Benefits

- i. Notice 2018-29 did not contain specific rules addressing the application of income tax treaties, instead including them in section 6.05 by adopting a modified version of Treas. Reg. § 1.1445-2(d) (providing an exception from withholding under § 1445 when the transferor certifies that it is not required to recognize gain either under a provision of the Code or under a treaty).
- ii. The proposed regulations provide an exception to withholding under § 1446(f)(1) when a transferor certifies that it is not subject to tax on any gain from the transfer pursuant to an income tax treaty in effect between the U.S. and a foreign country. *See* Prop. Treas. Reg. § 1.1446(f)-2(b)(7)(i). This exception applies only when a transferor (as opposed to owners of an interest in the transferor, including partners in a partnership that is a transferor) qualifies for the benefits of an income tax treaty in order to reduce the burden on a transferee of reviewing documentation from multiple persons.
- iii. The certification to the transferee must include a valid Form W-8BEN, Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals), or W-8BEN-E, Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities) (as applicable), that contains the information necessary to support the claim for treaty benefits, and the transferee must mail a copy of the certification to the IRS by the 30th day after the date of the transfer in order to rely upon it. *See also* Form 8833, Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b), and the instructions to the form regarding

the requirement for the transferor to disclose a claim for treaty benefits with a return.

- iv. To ensure that these procedures are followed for claims involving treaty benefits, this exception is the sole method by which a transferor may claim an exception to withholding by reason of a claim of treaty benefits. *See* Prop. Treas. Reg. § 1.1446(f)-2(b)(7)(iii).

14. Determining the Amount to Withhold.

(a) In General.

- i. The proposed regulations provide certain procedures for determining the amount to withhold under Treas. Reg. § 1446(f)(1). The rules are intended to provide administrable procedures for transferees to determine the amount to withhold, and in some cases, provide procedures intended to better reflect the amount of the transferor's actual tax liability under § 864(c)(8).
- ii. When applicable, these procedures generally allow the transferee to rely on certifications that it receives from the transferor (or, in certain cases, from the partnership) to determine the amount to withhold unless it has actual knowledge that the certification is incorrect or unreliable. *See* Prop. Treas. Reg. § 1.1446(f)-2(c)(1).
- iii. In cases in which a partnership is the transferee because it makes a distribution, it may instead rely on its books and records unless it knows, or has reason to know, that the information is incorrect or unreliable.

(b) Amount Realized.

- i. The amount required to be withheld under § 1446(f)(1) is determined by reference to the transferor's amount realized on the transfer. *See* § 1446(f)(1). The proposed regulations provide that the amount realized for purposes of Prop. Treas. Reg. § 1.1446(f)-2 is determined under § 1001 and the regulations thereunder and § 752 and the regulations thereunder. *See* Prop. Treas. Reg. § 1.1446(f)-2(c)(2)(i); *see also* Treas. Reg. §§ 1.752-1(h) and 1.1001-2.
- ii. The proposed regulations also clarify that in the case of a distribution, the amount realized is the sum of the amount of cash distributed (or to be distributed), the fair market

value of property distributed (or to be distributed), and the reduction in the transferor's share of partnership liabilities.

(c) Procedures to Determine Share of Partnership Liabilities.

- i. Comments stated that the allocation of liabilities to a partner under § 752 is not information that normally would be available to a transferee and may be difficult for a transferor to determine as of the date of transfer. To address these issues, section 7.02 of Notice 2018-29 provided that a transferee may in certain cases rely on a certification from the transferor as to the amount of the transferor's share of partnership liabilities reported on the transferor's most recently received Schedule K-1 (Form 1065), provided that the form was for a partnership taxable year that closed no more than 10 months before the date of transfer and the transferor is not a controlling partner. Section 7.03 of Notice 2018-29 allowed a transferee to rely on a certification from the partnership that provided the transferor's share of partnership liabilities as reflected on the most recently prepared Schedule K-1 (Form 1065).
- ii. The proposed regulations provide procedures similar to §§ 7.02 and 7.03 of Notice 2018-29 that allow a transferee to rely on a certification from the transferor or the partnership. Prop. Treas. Reg. § 1.1446(f)-2(c)(2)(ii)(B) provides that a transferee may generally rely on a certification from a transferor that provides the amount of the transferor's share of partnership liabilities reported on the most recent Schedule K-1 (Form 1065) issued by the partnership.
- iii. In response to comments stating that a transferor may not possess a Schedule K-1 (Form 1065) that satisfies the 10-month requirement in Notice 2018-29 because of the timing of the extended due date for Schedule K-1 (Form 1065), the proposed regulations provide that a transferee may generally rely on a certification if the last day of the partnership taxable year for which the Schedule K-1 (Form 1065) was provided was no more than 22 months before the date of the transfer. See Prop. Treas. Reg. § 1.1446(f)-2(c)(2)(ii)(B).
- iv. Consistent with Notice 2018-29, a transferor that is a controlling partner may not provide this certification because it will generally be able to require the partnership

to provide a partnership-level certification as to the controlling partner's share of partnership liabilities.

- v. Prop. Treas. Reg. § 1.1446(f)-2(c)(2)(ii)(C) allows a transferee to rely on a certification from the partnership that provides the amount of the transferor's share of partnership liabilities. However, unlike the rule in Notice 2018-29, the partnership is required to make this determination as of the determination date rather than relying on its most recently prepared Schedule K-1 (Form 1065). The proposed regulations also provide a new procedure that allows a partnership that is a transferee because it makes a distribution to rely on its books and records to determine the transferor's share of partnership liabilities as of the determination date. *See* Prop. Treas. Reg. § 1.1446(f)-2(c)(2)(iii).
- vi. If a transferee does not use one of these determination procedures, the reduction in the transferor's share of partnership liabilities must be determined as of the date of the transfer for purposes of computing the amount realized.

(d) Modified Amount Realized for Foreign Partnerships

- i. Section 1446(f)(2) and Prop. Treas. Reg. § 1.1446(f)-2(b)(2) provide an exception to withholding when the transferor is not a foreign person. A transferor that is a foreign partnership may not rely on this exception even though it may have U.S. persons (which are not subject to tax under § 864(c)(8)) as its partners.
- ii. To avoid overwithholding when a foreign partnership transfers its interest in a partnership, Prop. Treas. Reg. § 1.1446(f)-2(c)(2)(iv) provides a procedure to limit the amount realized for withholding purposes to the portion of the amount realized that is attributable to foreign persons. For this purpose, the portion of the amount realized attributable to a direct or indirect partner is determined based on the percentage of gain allocable to that partner. Any partner that does not provide a valid certification of non-foreign status (including a Form W-9) is treated as a foreign person for this purpose.
- iii. To make the certification for a modified amount realized, the transferor must provide to the transferee a Form W-8IMY, Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States

Tax Withholding and Reporting, that includes a certification of non-foreign status for each partner that is treated as a U.S. person. It must also include a withholding statement that provides the percentage of gain allocable to each direct or indirect partner and that indicates whether that person is a U.S. person or is treated as a foreign person.

- (e) Lack of Money or Property or Lack of Knowledge Regarding Liabilities. As described in section 8 of Notice 2018-29, in some cases, a reduction in the transferor's share of partnership liabilities may cause the amount otherwise required to be withheld to exceed the cash or other property that the transferee actually pays to the transferor. In other cases, a transferee may have not received, or cannot rely upon, a certification regarding the transferor's share of partnership liabilities, and may not otherwise know the transferor's share of partnership liabilities. In these situations, the proposed regulations generally provide that the amount required to be withheld is equal to the amount realized determined without regard to the decrease in the transferor's share of partnership liabilities. *See* Prop. Treas. Reg. § 1.1446(f)-2(c)(3).
- (f) Certification of Maximum Tax Liability.
- i. To more closely align the amount to withhold with the transferor's tax liability under § 864(c)(8), the proposed regulations provide a procedure to determine the amount to withhold that is intended to estimate the amount of tax the transferor is required to pay under § 864(c)(8). *See* Prop. Treas. Reg. § 1.1446(f)-2(c)(4). This is a very important and helpful addition.
 - ii. For this procedure to apply, a transferee must receive a certification from the transferor containing certain information relating to the transferor and the transfer. *See* Prop. Treas. Reg. § 1.1446(f)-2(c)(4)(iii). One of the requirements for this certification is for the transferor to identify the amount of outside capital gain and outside ordinary gain that would be treated as effectively connected gain on the determination date. *See* Prop. Treas. Reg. § 1.1446(f)-2(c)(4)(iii)(E).
 - iii. Further, to provide this certification, the transferor must represent that it has obtained a statement from the partnership that includes, among other things, information relating to the transferor's distributive share of effectively connected gain in connection with a deemed sale described

in § 864(c)(8)(B) as of the determination date. *See* Prop. Treas. Reg. § 1.1446(f)-2(c)(4)(iii)(G).

- iv. When a transferor provides a transferee this information, Prop. Treas. Reg. § 1.1446(f)-2(c)(4)(i) allows the transferee to withhold based on the transferor's maximum tax liability on the transfer. The transferor's maximum tax liability is the amount of the transferor's effectively connected gain multiplied by the applicable percentage. *See* § 1446(b) and Treas. Reg. § 1.1446-3(a)(2). The applicable percentage applies the highest rate of tax for each particular type of income or gain allocable to a foreign person.
- v. Special rules apply for a transfer in which only a portion of the gain is subject to tax under § 864(c)(8) because a nonrecognition provision of the Code or an income tax treaty in effect between the U.S. and a foreign country applies (for example, when the partnership carries on one trade or business through a U.S. permanent establishment, and another trade or business that is not carried on through a U.S. permanent establishment). *See* Prop. Treas. Reg. § 1.1446(f)-2(c)(4)(v) and (vi).
- vi. These rules provide that the transferor must, in addition to providing the maximum tax liability certification, comply with the procedural requirements that would otherwise apply when claiming a full exception to withholding based on a nonrecognition provision or treaty benefits.

15. Reporting and Paying Withheld Amounts.

- (a) In General. A transferee required to withhold must report and pay any tax withheld by the 20th day after the date of the transfer. *See* Prop. Treas. Reg. § 1.1446(f)-2(d)(1). To report and pay the amount withheld, the proposed regulations direct the transferee to use Forms 8288, U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests, and 8288-A, Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests. The IRS will stamp a valid Form 8288-A to show receipt and mail a copy to the transferor.
- (b) Transferee's Obligation to Certify the Amount Withheld to the Partnership.
 - i. A partnership must withhold on distributions to a transferee under Treas. Reg. § 1446(f)(4) to the extent the transferee

fails to properly withhold under § 1446(f)(1) and Prop. Treas. Reg. § 1.1446(f)-2(a). See Prop. Treas. Reg. § 1.1446(f)-3. In order for the partnership to determine whether it must withhold under these rules, Prop. Treas. Reg. § 1.1446(f)-2(d)(2) requires a transferee to timely furnish certain information regarding its compliance with § 1446(f)(1) to the partnership.

- ii. Specifically, Prop. Treas. Reg. § 1.1446(f)-2(d)(2) requires a transferee (other than a partnership that is a transferee because it makes a distribution) to furnish, no later than 10 days after the transfer, a certification to the partnership that either includes a copy of the Form 8288-A that it files with the IRS, or states the amount realized on the transfer and any amount withheld by the transferee.
 - iii. The certification must also include any underlying certifications that the transferee has relied upon that claim an exception or adjustment to withholding. The partnership must conduct its own review of the certification provided by the transferee, including any underlying certifications.
 - iv. Therefore, a transferee that has relied on a certification claiming an exception or adjustment to withholding may want to ensure that the partnership has determined the certification to be correct and reliable before the due date for payment of any withheld amounts to the IRS.
16. Effect of Withholding on Transferor. Prop. Treas. Reg. § 1.1446(f)-2(e) states that a foreign person must file a U.S. tax return and pay any tax due with respect to a transfer that is subject to § 864(c)(8) regardless of whether there is withholding under § 1446(f)(1) and Prop. Treas. Reg. § 1.1446(f)-2. To claim a credit under § 33, a transferor that is an individual or corporation must attach to its return the stamped copy of Form 8288-A. See Prop. Treas. Reg. § 1.1446(f)-2(e)(2)(i). If a stamped copy of Form 8288-A has not been provided to the transferor by the IRS, Prop. Treas. Reg. § 1.1446(f)-2(e)(3) provides that a transferor may establish the amount of tax withheld by furnishing substantial evidence of the amount.
17. Partnership's Requirement to Withhold. Prop. Treas. Reg. § 1.1446(f)-3 provides rules under § 1446(f)(4) that would implement the partnership's requirement to withhold on distributions to a transferee on any amount that the transferee failed to properly withhold under § 1446(f)(1), plus any interest on this amount. The rules, when made applicable as final rules, would end the suspension of § 1446(f)(4) withholding provided in § 11 of Notice 2018-29.

18. Requirement to Withhold.

- (a) The proposed regulations provide that, if a transferee fails to withhold any amount required to be withheld under Prop. Treas. Reg. § 1.1446(f)-2 in connection with the transfer of a partnership interest, the partnership must withhold from any distributions made to the transferee in accordance with the rules in Prop. Treas. Reg. § 1.1446(f)-3.
- (b) Under the general rule, a partnership determines whether a transferee has withheld the amount required to be withheld under Prop. Treas. Reg. § 1.1446(f)-2 by relying on the certification described in Prop. Treas. Reg. § 1.1446(f)-2(d)(2) that it receives from the transferee. *See* Prop. Treas. Reg. § 1.1446(f)-3(a)(1).
- (c) The partnership may rely on this certification unless it knows, or has reason to know, that the certification is incorrect or unreliable. Therefore, the partnership must review the certification received from the transferee, which includes any underlying certifications that the transferee relied on to reduce or eliminate withholding. Because the partnership may have information that may not be available to the transferee (for example, information in its books and records), a partnership may know, or have reason to know, that an underlying certification is incorrect or unreliable even though the transferee properly relied on the certification. In this case, the partnership would be required to withhold on the transferee under § 1446(f)(4) to the extent required in Prop. Treas. Reg. § 1.1446(f)-3.
- (d) If the partnership timely receives (within 10 days from the transfer), and may rely on, a certification from the transferee stating that an exception to withholding applies or establishing that the transferee has withheld the amount required to be withheld under Prop. Treas. Reg. § 1.1446(f)-2, then the partnership is not required to withhold under the general rule in Prop. Treas. Reg. § 1.1446(f)-3(a)(1). *See* Prop. Treas. Reg. § 1.1446(f)-3(b)(1).
- (e) For this purpose, the amount required to be withheld may take into account any adjustment procedures under Treas. Reg. § 1.1446(f)-2(c) (for which any documents, including underlying certifications, are attached to the certification provided by the transferee). The proposed regulations thus reduce the burden imposed by § 1446(f)(4) by allowing transferees and partnerships to rely on the information produced under the regulations implementing § 1446(f)(1).

- (f) The proposed regulations provide an additional rule that allows the IRS, in limited circumstances, to require a partnership to withhold under Treas. Reg. § 1446(f)(4) when the IRS notifies the partnership that it has determined that the transferee has provided incorrect information on the certification described in Prop. Treas. Reg. § 1.1446(f)-2(d)(2) regarding the amount realized or the amount withheld, or that the transferee failed to pay the amounts reported as withheld to the IRS. *See* Prop. Treas. Reg. § 1.1446(f)-3(a)(2).
- (g) This rule is meant to induce the transferee to properly determine the amount realized on transfer (in accordance with the rules in Prop. Treas. Reg. § 1.1446(f)-2(c)(2)), and to correctly report to the partnership the amount of tax withheld and paid to the IRS.
- (h) Under the proposed regulations, withholding under § 1446(f)(4) does not apply when a partnership is a transferee because it makes a distribution. *See* Prop. Treas. Reg. § 1.1446(f)-3(b)(3). Section 1446(f)(4) imposes a withholding obligation on a secondary party, the partnership, when the transferee fails to withhold under § 1446(f)(1). When the partnership is the transferee because it made a distribution and failed to withhold under § 1446(f)(1) and Prop. Treas. Reg. § 1.1446(f)-2, imposing a § 1446(f)(4) withholding obligation on it does not provide an additional party to ensure the § 1446(f) liability is paid. Furthermore, the partnership remains liable for its failure to withhold in its capacity as a transferee.
- (i) A publicly traded partnership generally is also not required to withhold on distributions made to a transferee under § 1446(f)(4). *See* Prop. Treas. Reg. § 1.1446(f)-3(b)(2)(i). This preamble says it would be administratively difficult for a publicly traded partnership to determine when a transfer of its interest has occurred, and whether the correct amount has been withheld under § 1446(f)(1).
- (j) However, the proposed regulations do require a publicly traded partnership to withhold under § 1446(f)(4) in certain limited instances. Specifically, a publicly traded partnership may publish a qualified notice that states that withholding under Treas. Reg. § 1446(f)(1) does not apply regarding a distribution.
- (k) To ensure that publicly traded partnerships exercise due diligence when publishing these qualified notices, Prop. Treas. Reg. § 1.1446(f)-3(b)(2)(ii) provides that the exception from § 1446(f)(4) withholding applicable to publicly traded partnerships does not apply if a publicly traded partnership determines

(including by reason of having received notification from the IRS) that it has published a qualified notice that falsely states that an exemption applied.

- (1) When a publicly traded partnership makes this determination, it must withhold on distributions to the transferees an amount equal to the amount that any brokers failed to withhold under Prop. Treas. Reg. § 1.1446(f)-4 due to reliance on the qualified notice, plus interest.

19. Withholding Rules.

- (a) A partnership that does not receive, or cannot rely on, a timely certification from a transferee stating that an exception to withholding applies or that the proper amount has been withheld must begin to withhold under the general rule on distributions made to the transferee on the later of the date that is 30 days after the transfer or the date that is 15 days after the partnership acquires actual knowledge of the transfer. *See* Prop. Treas. Reg. § 1.1446(f)-3(c)(1)(i).
- (b) The partnership must withhold on the entire amount of each distribution made to the transferee until it may rely on a certification from the transferee that states that an exception to withholding applies or that provides the information necessary to determine the amount required to be withheld. *See* Prop. Treas. Reg. § 1.1446(f)-3(c)(1)(ii).
- (c) The partnership may rely on this certification to determine its withholding obligation regardless of whether it is provided within the time prescribed in Prop. Treas. Reg. § 1.1446(f)-2(d)(2). If the partnership has not already satisfied the amount required to be withheld, as determined from the certification from the transferee, it must continue to withhold on distributions to the transferee until it has done so. However, the partnership may stop withholding if the transferee disposes of all of its interest in the partnership, unless the partnership has actual knowledge that any successor to the transferee is related to the transferee or the transferor from which the transferee acquired the interest.
- (d) The amount required to be withheld under Prop. Treas. Reg. § 1.1446(f)-3(a)(1), as determined from the certification provided by the transferee, is a tax equal to 10% of the amount realized on the transfer, reduced by any amount already withheld by the transferee, plus any computed interest. *See* Prop. Treas. Reg. § 1.1446(f)-3(c)(2)(i).

- (e) The proposed regulations provide that a partnership that is required to withhold under Prop. Treas. Reg. § 1.1446(f)-3(a)(1) may not take into account any adjustment procedures that would otherwise affect the amount required to be withheld under Prop. Treas. Reg. § 1.1446(f)-2(c)(2)(i). *See* Prop. Treas. Reg. § 1.1446(f)-3(c)(2)(i)(A).
- (f) Thus, for example, a partnership may not reduce the amount that it is required to withhold under the procedures described in Prop. Treas. Reg. § 1.1446(f)-2(c)(4) (adjusting the amount subject to withholding based on a transferor's maximum tax liability).
- (g) Treasury and the IRS believe that it would be inappropriate to permit adjustments that may reduce the amount required to be withheld under § 1446(f)(4). Withholding on distributions to transferees under § 1446(f)(4) applies only after the transferee has either failed to properly withhold under § 1446(f)(1) or has not complied with the applicable procedural requirements in the proposed regulations. Accordingly, permitting adjustments to the amount a partnership is required to withhold under § 1446(f)(4) would reduce transferees' incentive to comply with their obligations under § 1446(f)(1) while potentially increasing the partnership's administrative burden associated with that withholding.
- (h) Prop. Treas. Reg. § 1.1446(f)-3(c)(2)(ii) provides rules for the partnership to compute interest on the amount that the transferee failed to withhold. Prop. Treas. Reg. § 1.1446(f)-3(c)(3) provides that any amount required to be withheld on a distribution under any other withholding provision in the Code is not required to be withheld under § 1446(f)(4). For example, if a partnership is required to withhold \$30 under § 1441 on a \$100 distribution, the maximum amount required to be withheld on that distribution under § 1446(f)(4) is \$70.
- (i) Prop. Treas. Reg. § 1.1446(f)-3(d) provides that a partnership required to withhold under Treas. Reg. § 1446(f)(4) must report and pay the tax withheld using Forms 8288, U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests, and 8288-C, Statement of Withholding Under Section 1446(f)(4) for Withholding on Dispositions by Foreign Persons of Partnership Interests, as provided in forms, instructions, or other guidance.

20. Effect of Withholding on the Transferor and Transferee.

- (a) The withholding of tax under § 1446(f)(4) does not relieve a nonresident alien individual or foreign corporation subject to tax under § 864(c)(8) from filing a U.S. income tax return with respect to the transfer and paying any tax due with the return. *See Prop. Treas. Reg. § 1.1446(f)-3(e)(1).* Because this tax is withheld from the transferee rather than from the transferor, the transferor is not allowed a credit under § 33. However, the proposed regulations clarify that tax will not be collected from the transferor to the extent it has already been collected from another person under these rules. Therefore, the transferor will not be required to pay tax to the extent the tax (but not any portion treated as interest) has been paid through withholding on the transferee.
- (b) A transferee remains liable under § 1446(f)(1) even when the partnership is required to withhold under § 1446(f)(4). However, the transferee is treated as satisfying this withholding tax liability under § 1446(f)(1) to the extent that it is withheld upon under § 1446(f)(4). *See Prop. Treas. Reg. § 1.1446(f)-3(e)(2).* Any amount withheld that is treated as interest is not treated as satisfying the transferee's liability under § 1446(f)(1), but that amount will instead be treated as interest paid by the transferee with respect to its § 1446(f)(1) liability.
- (c) Under the proposed regulations, if the amount of tax withheld from the transferee exceeds its liability under § 1446(f)(1), only the partnership may claim a refund on behalf of the transferee for the excess amount. This rule is meant to make the refund process more administrable by having the partnership act on behalf of each of its transferees for purposes of claiming any excess amounts withheld under § 1446(f)(4).
- (d) Treasury and the IRS anticipate that partnerships and transferees will make arrangements by contract so that the transferees may be reimbursed for amounts refunded to the partnership. They request comments on this issue.

21. Transfer of a Publicly Traded Partnership Interest. The proposed regulations provide rules for withholding and reporting on the transfer of an interest in a publicly traded partnership if the interest is publicly traded on an established securities market or is readily tradable on a secondary market or the substantial equivalent thereof (such interests, "PTP interests"). The rules, when made applicable as final rules, would end the suspension of § 1446(f)(1) withholding on the disposition of PTP interests provided in Notice 2018-08.

22. In General.

- (a) A transfer of a PTP interest raises unique issues for withholding under § 1446(f). For example, when a transfer of a PTP interest is effected through one or more brokers, the transferee will generally not know the identity of the transferor. Accordingly, the Conference Report on the TCJA acknowledged that transfers involving PTP interests could require withholding rules different from those that apply to transfers involving non-PTP interests.
- (b) Consistent with the Conference Report, Prop. Treas. Reg. § 1.1446(f)-4(a)(1) provides that if a transfer of a PTP interest is effected through one or more brokers, the transferee is not required to withhold, and the withholding obligation is instead imposed on certain brokers involved with the transfer. Generally, the proposed regulations define a broker to include any person, foreign or domestic, that in the ordinary course of a trade or business during the calendar year stands ready to effect sales made by others, and that, in connection with a transfer of a PTP interest, receives all or a portion of the amount realized on behalf of the transferor. *See* Prop. Treas. Reg. § 1.1446(f)-1(b)(1).
- (c) For example, when a transfer of a PTP interest occurs through a cash on delivery account, a delivery versus payment account, or other similar account or transaction, this definition would include a broker that receives an amount realized from the sale against delivery of the PTP interest and any other broker that receives an amount realized from that broker. Therefore, the withholding obligation under Prop. Treas. Reg. § 1.1446(f)-4 is generally limited to brokers that receive proceeds from the sale and act on behalf of the transferor.
- (d) The definition of broker also includes any clearing organization that effects a transfer of a PTP interest on behalf of the transferor. While comments have stated that clearing organizations may not have the capability to complete the withholding required under § 1446(f), Treasury and the IRS anticipate that clearing organizations will make arrangements to ensure that, when effecting the transfer of a PTP interest on behalf of foreign brokers, they act on behalf of brokers that assume withholding responsibility when clearing sales of PTP interests (such as a qualified intermediary (“QI”)).
- (e) If a transfer of a PTP interest is effected through multiple brokers, Prop. Treas. Reg. § 1.1446(f)-4(a)(2) provides rules that specify which broker or brokers have a withholding obligation. Under Prop. Treas. Reg. § 1.1446(f)-4(a)(2)(i), a broker that pays the

amount realized to a foreign broker is required to withhold unless the foreign broker is either a U.S. branch treated as a U.S. person or a QI that assumes primary withholding responsibility for the payment.

- (f) Consistent with this rule, Treasury and the IRS intend to modify the QI agreement provided in Rev. Proc. 2017-15, 2017-3 I.R.B. 437, to allow QIs to assume primary withholding responsibility on the amount realized. Prop. Treas. Reg. § 1.1446(f)-4(a)(2)(ii) provides an additional rule requiring the broker that effects a transfer for the transferor as its customer to satisfy the withholding obligation. This rule ensures that withholding will be completed on payment of the amount realized to the transferor when another broker has not already satisfied the withholding.
- (g) To avoid withholding by multiple brokers, Prop. Treas. Reg. § 1.1446(f)-4(a)(2)(iii) provides the general rule that a broker is not required to withhold when it knows that the withholding obligation has been satisfied by another broker. Prop. Treas. Reg. § 1.1446(f)-4(a)(2)(iv) provides that a broker must treat another broker as a foreign person unless it obtains documentation (including a certification of non-foreign status) establishing that the other broker is a U.S. person.
- (h) If the transfer of a PTP interest is not effected through one or more brokers, then Prop. Treas. Reg. § 1.1446(f)-4 does not apply, and the general rules of § 1446(f)(1) and Prop. Treas. Reg. § 1.1446(f)-2 apply. A transfer that is effected through a broker includes a distribution with respect to a PTP interest held through an account with a broker.

23. Exceptions to Withholding. The proposed regulations provide five exceptions to withholding that apply to the transfer of a PTP interest. The exceptions are intended to both reduce the compliance burden placed on brokers and provide rules that are administrable.

24. Certification of Non-Foreign Status.

- (a) Withholding under § 1446(f)(1) is limited to transfers by foreign partners. Accordingly, a broker is not required to withhold to the extent that it relies on a certification of non-foreign status that it receives from the transferor that claims an exception to withholding. *See* Prop. Treas. Reg. § 1.1446(f)-4(b)(2). For purposes of Prop. Treas. Reg. § 1.1446(f)-4, a certification of non-foreign status means a Form W-9, or valid substitute form, that meets the requirements of Treas. Reg. § 1.1441-1(d)(2).

- (b) A broker may rely on a valid Form W-9 that it already possesses, and in certain cases, may instead rely on a certification that it receives from another broker that states the TIN and status of the transferor when that other broker acts as an agent for the transferor and possesses the Form W-9 (for example, from an introducing broker). A broker will not qualify for the exception provided in Prop. Treas. Reg. § 1.1446(f)-4(b)(2) if it has actual knowledge that the certification is incorrect or unreliable.

25. Ten-percent Exception.

- (a) The proposed regulations include an exception to withholding that may apply if, on a deemed sale of the assets of the publicly traded partnership the interest in which is transferred, the amount of effectively connected gain would be less than 10% of the total gain. Specifically, Prop. Treas. Reg. § 1.1446(f)-4(b)(3) provides that a broker is not required to withhold under Prop. Treas. Reg. § 1.1446(f)-4 if it properly relies on a qualified notice stating that the 10-percent exception applies.
- (b) The 10% exception applies if a hypothetical sale by the publicly traded partnership of all of its assets at fair market value on a specified date would result in an amount of gain effectively connected with the conduct of a trade or business within the U.S. that is less than 10% of the total gain. The specified date must be a date designated by the publicly traded partnership that is within the 92-day period ending on the date that it posts a qualified notice. This rule requires a publicly traded partnership to designate a date for this purpose that generally occurs within the most recent calendar quarter. *See* Prop. Treas. Reg. § 1.1446(f)-2(b)(4) (permitting the deemed sale computation to occur on a determination date, which would allow the deemed sale date to be determined as of the first day of a partnership's taxable year in which the transfer occurred in certain cases).
- (c) Treasury and the IRS believe that it is appropriate to limit the availability of this exception to cases in which a publicly traded partnership has designated a deemed sale date occurring within the most recent calendar quarter because publicly traded partnerships are in a better position to determine the value of their assets, and in some cases determine the basis of their assets, on a quarterly basis. The proposed regulations limit reliance on a qualified notice depending on its date of posting. *See* Prop. Treas. Reg. § 1.1446(f)-4(b)(3)(iii).

26. Qualified Current Income Distributions.

- (a) The proposed regulations allow a transferor of a non-PTP interest to provide a certification stating that the transferor would not realize any gain on the transfer. Because it would be administratively difficult for a broker to timely obtain this type of certification from the transferor of a PTP interest, and difficult for the transferor to determine its basis in the PTP interest, the proposed regulations do not provide a similar exception for transfers of PTP interests.
- (b) Treasury and the IRS concluded, however, that it would be appropriate to eliminate withholding under § 1446(f)(1) on distributions (the full amount of which is generally treated as an amount realized under the proposed regulations) by a publicly traded partnership when it is likely that the transferor would realize no gain. In general, under § 705(a)(1), a partner's basis in its interest is increased by its distributive share of income for the taxable year, such that a distribution by the partnership not in excess of that income generally does not result in the recognition of gain under § 731(a)(1).
- (c) Accordingly, the proposed regulations provide that when a qualified notice posted by a publicly traded partnership indicates that the distribution does not exceed the net income the partnership earned since the record date of the partnership's last distribution, no withholding is required with respect to the distribution. *See* Prop. Treas. Reg. § 1.1446(f)-4(b)(4).

27. Proceeds Subject to Withholding under § 3406. A broker may also be required to withhold on gross proceeds from the transfer of a PTP interest under § 3406 when a payment is treated as being made to a non-exempt U.S. recipient. To prevent withholding twice on the same payment, Prop. Treas. Reg. § 1.1446(f)-4(b)(5) provides an exception to withholding under § 1446(f)(1) if the amount realized is subject to withholding under § 3406.

28. Claim of Treaty Benefits. The proposed regulations provide an exception when a transferor states that it is not subject to tax on any gain from the transfer pursuant to an income tax treaty in effect between the U.S. and a foreign country. *See* Prop. Treas. Reg. § 1.1446(f)-4(b)(6). The exception also requires the transferor to furnish a valid Form W-8 with the information necessary to support the claim. Unlike the exception for non-PTP interests, a broker is not required to mail the certification to the IRS because under the proposed regulations brokers are required to file a Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding, to

report a transfer of a PTP interest that includes information about the claim of treaty benefits.

29. Determining the Amount to Withhold.

(a) Amount Realized.

- i. A broker that is required to withhold under Prop. Treas. Reg. § 1.1446(f)-4(a) must withhold 10% of the amount realized on the transfer of a PTP interest. A reduction in a partner's share of partnership liabilities is treated as an amount realized under Prop. Treas. Reg. § 1.1446(f)-2(c). However, because of the difficulties involved with requiring a broker to timely determine a transferor's share of partnership liabilities, Prop. Treas. Reg. § 1.1446(f)-4(c)(2)(i) provides a special rule that treats the amount realized on the transfer of a PTP interest as the amount of gross proceeds (as defined in Treas. Reg. § 1.6045-1(d)(5)) paid or credited to the customer or another broker (as applicable). If a publicly traded partnership makes a distribution to a partner, the amount realized is the amount of cash distributed (or to be distributed) and the fair market value of property distributed (or to be distributed).
- ii. This provision is helpful and important in the PTP context: withhold 10% on the gross proceeds. This will help to make compliance much easier, and non-compliance easy to identify.
- iii. Modified Amount Realized for Foreign Partnerships. The proposed regulations include a rule that allows brokers to rely on a certification from a foreign partnership to modify the amount realized based on the extent to which the amount realized is attributable to persons who are (or are presumed to be) foreign persons. *See* Prop. Treas. Reg. § 1.1446(f)-4(c)(2)(ii).

30. Reporting and Paying Withheld Amounts.

- (a) A broker required to withhold under Prop. Treas. Reg. § 1.1446(f)-4 must pay the withheld tax pursuant to the deposit rules in Treas. Reg. § 1.6302-2, and report the withholding on Forms 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons, and 1042-S pursuant to the procedures in Treas. Reg. § 1.1461-1(b) and (c). The proposed regulations treat as a recipient for Form 1042-S reporting purposes a partner that receives an amount realized from a transfer of a PTP interest

subject to Prop. Treas. Reg. § 1.1446(f)-4. *See* Treas. Reg. § 1.1461-1(c)(1)(ii)(A)(8). This rule also clarifies that a foreign partnership is treated as a recipient for this purpose to ensure that the foreign partnership receives a Form 1042-S that it may use to claim credit for any withholding under Prop. Treas. Reg. § 1.1446(f)-4 against its tax liability under § 1446(a).

(b) To implement the reporting requirements, the proposed regulations add to the list of amounts subject to reporting on Form 1042-S an amount realized on the transfer of a PTP interest subject to Prop. Treas. Reg. § 1.1446(f)-4 (with limited exceptions). *See* Treas. Reg. § 1.1461-1(c)(2). The proposed regulations also add to this list any distributions of effectively connected income by a publicly traded partnership subject to Prop. Treas. Reg. § 1.1446-4 to clarify that these amounts are reportable on Form 1042-S.

31. Effect of Withholding on Transferor. The proposed regulations neither relieve a transferor of its substantive tax liability under § 864(c)(8), nor relieve a transferor subject to § 864(c)(8) from its filing obligation. *See* Prop. Treas. Reg. § 1.1446(f)-4(e)(1). However, a transferor is allowed a credit under § 33 for the amount withheld under § 1446(f)(1) and Prop. Treas. Reg. § 1.1446(f)-4. To claim the credit, the transferor must attach to its return a copy of the Form 1042-S that includes the transferor's TIN. For a discussion of the rules regarding a transferor that is a foreign partnership claiming a credit for withholding under § 1446(f)(1).
32. Procedures to Adjust Overwithholding. Treas. Reg. § 1.1461-2(a) allows a withholding agent that overwithheld under chapter 3 of the Code, and made a deposit of tax as provided in Treas. Reg. § 1.6302-2(a), to adjust the overwithheld amount using either a reimbursement or a set-off procedure. Because these rules are meant to allow withholding agents to adjust overwithholding for any deposited amounts that are reportable on Forms 1042 and 1042-S, the proposed regulations modify Treas. Reg. § 1.1461-2(a) to allow use of the adjustment procedures for amounts withheld by a broker pursuant to Prop. Treas. Reg. § 1.1446(f)-4.
33. Procedures to Adjust Underwithholding. In general, Treas. Reg. § 1.1461-2(b) allows a withholding agent that underwithheld on a beneficial owner under chapter 3 of the Code to withhold from future payments made to the beneficial owner, or satisfy the tax from property or additional contributions of the beneficial owner, before the earlier of the due date for filing Form 1042 or the date on which the form is actually filed. The proposed regulations amend this provision to allow the use of this procedure by brokers that underwithheld under Prop. Treas. Reg. § 1.1446(f)-4 on the transfer of a PTP interest.

34. Refunds and Credits. Treas. Reg. § 1.1464-1 generally provides that if an overpayment of tax has actually been withheld from the beneficial owner of the income, any refund or credit will be made to that beneficial owner. If, however, the tax was not withheld at source, but was instead paid by the withholding agent, the refund or credit will be made to the withholding agent. The proposed regulations clarify that these rules apply for purposes of Treas. Reg. § 1446(f). *See* Prop. Treas. Reg. § 1.1464-1(a).
35. Liability for Failure to Withhold.
- (a) In General. Prop. Treas. Reg. § 1.1446(f)-5(a) provides that every person required to deduct and withhold tax under Treas. Reg. § 1446(f), including under Prop. Treas. Reg. §§ 1.1446(f)-2 through 1.1446(f)-4, but that fails to do so is liable under § 1461. If the tax required to be withheld is paid by another person required to withhold, or by the nonresident alien individual or foreign corporation subject to tax under § 864(c)(8), § 1463 and the proposed regulations clarify that the tax will only be collected once. However, the satisfaction of this liability does not relieve a person that failed to withhold under § 1446(f) from any interest, penalties, or additions to tax that would otherwise apply. The proposed regulations also provide that a partnership that fails to withhold under Prop. Treas. Reg. § 1.1446(f)-3 is liable under § 1461 only for the amount of tax that it failed to withhold, and not any interest computed under Treas. Reg. § 1.1446(f)-3(c)(2)(ii). This rule ensures that interest will be computed and assessed only once with respect to the same underlying tax liability.
36. Liability of Agents.
- (a) Prop. Treas. Reg. § 1.1446(f)-5(b) provides rules for the liability of agents, which generally require an agent of a transferor or transferee to notify the transferee (or other person required to withhold) if it has knowledge that a certification furnished to that person is false. A person that receives notice from an agent may not rely on the certification to apply an exception to withholding or for determining the amount to withhold. Prop. Treas. Reg. § 1.1446(f)-5(b)(2) provides procedural rules regarding the timing and content of the notice, and requires the agent to furnish a copy of the notice to the IRS.
- (b) An agent that fails to provide the required notice is liable for the tax that the person that should have received the notice would have been required to withhold under § 1446(f).
- (c) However, under Prop. Treas. Reg. § 1.1446(f)-5(b)(4), this liability is limited to the amount of compensation that the agent derives

from the transaction (and any civil or criminal penalties that may apply). The proposed regulations clarify that brokers required to withhold under Treas. Reg. § 1.1446(f)-4 are not treated as agents for purposes of this rule, and are instead liable for any failure to withhold.

37. Amendments to Existing § 1446 Regulations: Publicly Traded Partnerships.

- (a) In response to comments received outside the context of § 1446(f), the proposed regulations also contain changes to the existing qualified notice rules that apply to distributions that publicly traded partnerships make to foreign partners. Treasury and the IRS are aware that in certain cases nominees receive notices of distribution from publicly traded partnerships that do not provide detailed information regarding the amounts of income comprising the distribution as specified in Treas. Reg. § 1.1446-4(f)(3) (such as amounts described in § 1441 or § 1442 or subject to withholding under § 1446).
- (b) The term “qualified notice” under Treas. Reg. § 1.1446-4(b)(4) is currently defined by reference to certain reporting requirements that do not include a requirement to report information regarding the types of income comprising the distribution. Unless a notice provides that information, however, a nominee will not have the information necessary to apply the ordering rule of Treas. Reg. § 1.1446-4(f)(3) to the distribution for purposes of determining the amount required to be withheld.
- (c) The proposed regulations make two changes to resolve this issue. First, Prop. Treas. Reg. § 1.1446-4(b)(4) revises the method for a publicly traded partnership to provide a nominee a qualified notice by requiring that the notice be posted in a readily accessible format in an area of the primary public Web site of the publicly traded partnership that is dedicated to this purpose.
- (d) Second, Prop. Treas. Reg. § 1.1446-4(d) creates a default withholding rule subjecting gross distributions to the higher of the withholding percentage required under §§ 1441 and 1442 or the applicable percentage under § 1446(b)(2), unless a qualified notice provides the nominee sufficient detail to determine the types of income distributed and the appropriate withholding rates to apply. Thus, if a publicly traded partnership is unable to determine the makeup of a distribution when it is made, the nominee must withhold at the highest applicable rate.

- (e) The proposed regulations also expand the definition of a nominee for withholding under Treas. Reg. § 1.1446-4 to include certain foreign persons that agree to assume primary withholding responsibility. Therefore, a QI or a U.S. branch treated as a U.S. person that assumes primary withholding responsibility for a distribution by a publicly traded partnership under Prop. Treas. Reg. § 1.1446-4(b)(3) can act as a nominee with respect to the distribution. Treasury and the IRS intend to modify the QI agreement provided in Rev. Proc. 2017-15 to allow QIs to assume primary withholding responsibility for distributions by publicly traded partnerships under § 1446(a).
- (f) The proposed regulations also make changes to the qualified notice rules applicable to publicly traded partnerships, publicly traded trusts, and real estate investment trusts (“REITs”) under § 1445 that conform to Prop. Treas. Reg. § 1.1446-4(b)(4) so that those rules also provide more readily available information for nominees. *See* Prop. Treas. Reg. § 1.1445-8(f).
- (g) The proposed regulations modify Treas. Reg. § 1.1461-2(a) and (b) to allow use of procedures to adjust overwithholding and underwithholding for amounts withheld by a broker pursuant to Prop. Treas. Reg. § 1.1446(f)-4. The proposed regulations also amend Treas. Reg. § 1.1461-2(a) to allow the use of reimbursement and set-off procedures with respect to amounts withheld under § 1446(a) on distributions of ECTI by publicly traded partnerships (which are reported on Forms 1042 and 1042-S, as opposed to Forms 8804, Annual Return for Partnership Withholding Tax (§ 1446), and 8805 used by non-publicly traded partnerships to report withholding on ECTI allocable to foreign partners).
- (h) They also amend Treas. Reg. § 1.1461-2(b) to clarify that the existing reference to “distributions of effectively connected income under Treas. Reg. § 1446” is meant to apply only to those distributions that are made by publicly traded partnerships.

38. Applicability Dates.

- (a) Prop. Treas. Reg. § 1.864(c)(8)-2(a) and Prop. Treas. Reg. § 1.6050K-1(d)(3) apply to transfers that occur on or after the date that these regulations are published as final regulations in the Federal Register (the “finalization date”). Prop. Treas. Reg. § 1.864(c)(8)-2(b) and (c) and Prop. Treas. Reg. § 1.6050K-1(c)(2) and (c)(3) apply to returns filed on or after the finalization date. Prop. Treas. Reg. § 1.864(c)(8)-2(d) applies beginning on the finalization date.

- (b) Prop. Treas. Reg. §§ 1.1445-2(b)(2)(v) and 1.1445-5(b)(3)(iv) apply to certifications provided on or after May 7, 2019, except that a taxpayer may apply those provisions with respect to certifications provided before that date. A taxpayer may rely on the proposed amendments to Treas. Reg. §§ 1.1445-2 and 1.1445-5 with respect to any period before the finalization date. Prop. Treas. Reg. § 1.1445-8(f)(1) applies to distributions made on or after the date that is 60 days after the finalization date.
- (c) Prop. Treas. Reg. § 1.1446-3(c)(4) applies to partnership taxable years that include transfers that occur on or after the date that is 60 days after the finalization date. Prop. Treas. Reg. § 1.1446-4(b)(2), (b)(3), (c), (d), and (f) apply to distributions made on or after the date that is 60 days after the finalization date.
- (d) Prop. Treas. Reg. §§ 1.1446(f)-1 through 1.1446(f)-5 apply to transfers that occur on or after the date that is 60 days after the finalization date. For transfers that occur before the date that is 60 days after the finalization date, taxpayers may apply the rules described in Notice 2018-08 and Notice 2018-29. Alternatively, instead of applying the rules described in Notice 2018-29, taxpayers and other affected persons may choose to apply Treas. Reg. §§ 1.1446(f)-1, 1.1446(f)-2, and 1.1446(f)-5 of the proposed regulations in their entirety to all transfers as if they were final regulations.
- (e) The proposed amendments to Treas. Reg. § 1.1461-1(a)(1), (c)(1)(i), (c)(1)(ii), (c)(2)(i) and (c)(4) apply with respect to returns for transfers occurring on or after the date that is 60 days after the finalization date. The proposed amendments to Treas. Reg. § 1.1461-2(a)(1) and (b) apply to transfers occurring on or after the date that is 60 days after the finalization date.
- (f) The proposed amendments to Treas. Reg. § 1.1461-3 apply to returns for transfers occurring on or after the date that is 60 days after the finalization date.
- (g) The proposed amendments to Treas. Reg. § 1.1463-1(a) apply to transfers that occur on or after the date that is 60 days after the finalization date.
- (h) The proposed amendments to Treas. Reg. § 1.1464-1(a) apply to transfers that occur on or after the date that is 60 days after the finalization date.

- (i) Treasury and the IRS intend to obsolete Notice 2018-08 and Notice 2018-29 effective on the date that is 60 days after the finalization date.

VI. SECTION 163(j).

A. Section 163(j) Regulations.

1. Treasury and the IRS proposed regulations under the new § 163(j) rules. We will review the rules in general but with an emphasis on the international aspects of those regulations. The regulations are proposed to be effective in 2019 (for calendar year taxpayers) but can be applied retroactively to 2018 (again, for calendar year taxpayers). Viewed solely from an international tax perspective, U.S. parent companies of a multinational group might want to make the election to apply the proposed regulations retroactively to 2018. This is further discussed below.
2. Section 163(j) generally limits the amount of business interest that can be deducted in the current year to the sum of: (1) the taxpayer's business interest income for the taxable year; (2) 30% of the taxpayer's adjusted taxable income ("ATI") for the year; and (3) the taxpayer's floor plan financing interest expense for the taxable year. The amount of any business interest not allowed as a deduction for any taxable year as a result of the limitation under § 163(j) is carried forward and treated as business interest paid or accrued in the next taxable year. Section 163(j) does not provide for the carryforward of any excess limitation. Special rules apply for business interest expense incurred at the partnership level. Generally, the limitation on the deduction for business interest is applied at the partnership level. The § 163(j) limitation does not apply to certain trades or businesses. These "excepted trades or business" are the trade or business of providing services as an employee, electing real property businesses, electing farming businesses, and certain regulated utility businesses.
3. First, let us address the international provisions that are not covered in the proposed regulations. Section 250 provides for a deduction relevant for the GILTI and FDII provisions. A separate set of proposed regulations will provide general guidance regarding § 250, including the computation of the § 250 deduction and the application of the taxable income limitation in § 250(a)(2). The proposed regulations also reserve on the interaction of the new § 163(j) provisions with the base erosion minimum tax ("BEAT") rules. This interaction will be further considered in separate guidance under § 59A. Finally, the proposed regulations do not address the allocation and apportionment of interest expense to foreign source income, or to § 904 baskets of foreign source income.

4. Prop. Treas. Reg. § 1.163(j)-7 deals with the application of § 163(j) to foreign corporations and their shareholders. Unlike the prior § 163(j) rules, the new rules apply at the controlled foreign corporation (“CFC”) level.

B. The Regulations.

1. Prop. Treas. Reg. § 1.163(j)-1 sets forth definitions. To compute ATI, taxpayers must first compute taxable income, as defined in Prop. Treas. Reg. § 1.163(j)-1(b)(37), in accordance with § 63. In computing taxable income for this purpose, taxpayers would treat all business interest expense as deductible without regard to the § 163(j) limitation. Then taxpayers must add or subtract as appropriate, certain items specified in the proposed regulations as adjustments to taxable income. Prop. Treas. Reg. § 1.163(j)-1(b)(1) includes as adjustments to taxable income items specifically referenced in § 163(j)(8)(A). These include items such as income, gain, deduction, or loss which is not properly allocable to a trade or business; business interest and business interest income; and so forth. Certain items in addition to those set forth in § 163(j)(8)(A) also are set forth as adjustments. For example, the proposed regulations would provide special rules that apply in defining the taxable income of a consolidated group, a partnership, and certain controlled foreign corporations.
2. If for a taxable year a taxpayer is allowed a deduction under § 250(a)(1), the taxpayer should take into account the deduction when computing taxable income that is used to calculate ATI, but the proposed regulations would provide that the taxable income limitation of § 250(a)(2) does not apply for this purpose. Taxpayers, however, may be required to make adjustments adding back the § 250(a)(1) deduction to the extent that some or all of the deduction is attributable to an inclusion under the GILTI rules.
3. The definition of “interest” is quite broad. The preamble states there are no generally applicable regulations or statutory provisions addressing when financial instruments are treated as debt for federal income tax purposes or when a payment is interest. As a result, the proposed regulations draw upon past guidance and caselaw that address the meaning of “interest” in the context of federal tax law. Treating amounts that are closely related to interest as interest income or expense when appropriate to achieve a statutory purpose is not new. Most of the rules treating these payments as interest in the proposed regulations were developed in Treas. Reg. §§ 1.861-9T and 1.954-2.
4. The proposed regulations also address the treatment of a commitment fee paid in connection with a lending transaction. This treatment is based on the rule in Treas. Reg. § 1.954-2(h). The proposed regulations also would treat a swap with significant non-periodic payments as two separate

transactions consisting of an on-market, level payment swap and a loan. The loan would be accounted for by the parties to the contract independently of the swap. The time value component associated with the loan, determined in accordance with Treas. Reg. § 1.446-3(f)(2)(iii)(A), would be recognized as interest expense for the payor and interest income to the recipient.

5. It is interesting to note that the term “interest” is defined differently for purposes of the GILTI rules (*See* Prop. Treas. Reg. §§ 1.951A-4(b)(1)(ii) and (2)(ii)), although the differences would seem not material.
6. Prop. Treas. Reg. § 1.163(j)-2 addresses limitations on the deduction for business interest expense. Prop. Treas. Reg. § 1.163(j)-3 deals with the relationship of the business interest deduction limitations to other provisions affecting interest.
7. Prop. Treas. Reg. § 1.163(j)-4 is entitled “General Rules Applicable to C Corporations (Including REITs, RICs, and Members of Consolidated Groups) and Tax-Exempt Corporations.”
8. Prop. Treas. Reg. § 1.163(j)-4(c) is entitled “Effect on Earnings and Profits.” Distributions by a C corporation to its shareholders out of earnings and profits (“E&P”) are treated as dividends under § 316(a). Although the Code does not define the term “earnings and profits,” the computation of E&P generally is based upon accounting concepts that take into account the economic realities of corporate transactions, in particular, their impact on a corporation’s economic ability to pay dividends to its shareholders, and the applicable tax laws.
9. Prop. Treas. Reg. § 1.163(j)-4(c) generally would provide that the disallowance and carryforward of a deduction for a C corporation’s business interest expense under Prop. Treas. Reg. § 1.163(j)-2 will not affect whether or when such business interest expense reduces the taxpayer’s E&P. In other words, C corporations generally should not wait to reduce their E&P for business interest expense until the taxable year in which the deduction for the expense is allowed under § 163(j). This approach reflects that fact that the payment or accrual of business expense generally reduces the C corporation’s dividend-paying capacity in the year the expense is paid or accrued, without regard to the application of § 163(j). Certain additional E&P adjustments may be required to reflect carryforwards of disallowed disqualified interest within the meaning of the old § 163(j) rules, and special rules apply regarding excess business interest expense allocated from a partnership. Special rules also apply to REITs and RICs.
10. Prop. Treas. Reg. § 1.163(j)-4(d) provides special rules for consolidated groups. The general rule is that a consolidated group has a single § 163(j)

limitation. Thus, the proposed regulations provide special rules regarding calculation of the § 163(j) limitation for a consolidated group. If for a taxable year a member of a consolidated group is allowed a deduction under § 250(a)(1) that is properly allocable to a non-exempted trade or business, then, for purposes of calculating ATI, consolidated taxable income for the taxable year is determined as if the deduction were not subject to the limitation in § 250(a)(2). For this purpose, the amount of the deduction allowed under § 250(a)(1) is determined without regard to the application of § 163(j) and the § 163(j) regulations.

11. Prop. Treas. Reg. § 1.163(j)-5 provides general rules governing disallowed business expense carryforwards for C corporations. Prop. Treas. Reg. § 1.163(j)-6 is entitled “Application of the Business Interest Expense Deduction Limitation to Partnerships and Subchapter S Corporations.” The § 163(j) partnership regulations are 62 pages in length, and they are quite complex. They involve mostly domestic, general partnership issues but also can apply internationally.

C. Specific International Rules.

1. As noted above, Prop. Treas. Reg. § 1.163(j)-7 deals with the application of § 163(j) to U.S. shareholders and their foreign corporations. The proposed regulations would provide that the general rule in § 163(j) applies to determine the deductibility of a CFC’s business interest expense in the same manner as those provisions apply to determine the deductibility of a domestic C corporation’s business interest expense. Thus, a CFC with business interest expense would apply § 163(j) to determine the extent to which that expense is deductible for purposes of computing Subpart F income as defined in § 952, tested income as defined under the GILTI rules of § 951A(c)(2)(A), and income that is effectively connected with the conduct of a U.S. trade or business (“ECI”).
2. Notwithstanding the general applicability of § 163(j) to CFCs under the proposed regulations, Treasury and the IRS believe that it is appropriate in certain cases to modify its application. As discussed immediately below, the proposed regulations would, in certain cases, limit the amount of a CFC’s business interest expense subject to the § 163(j) limitation and modify the computation of a CFC’s ATI. Treasury and the IRS continue to study whether it would be appropriate to provide additional modifications to the application of § 163(j) to a CFC and to whether there are particular circumstances in which it may be appropriate to exempt a CFC from the application of § 163(j). Treasury and the IRS request comments on these points.
3. Computation of amount of business interest subject to § 163(j). If business interest expense is paid by one CFC to a related CFC, the application of § 163(j) could result in an inappropriate mismatch of the

deduction and the payee's income item. This mismatch could inappropriately affect the calculation of the tax liability of a United States shareholder under the GILTI provisions. Consider an example in which a U.S. person ("USP") wholly owns two CFCs (CFC1 and CFC2), and CFC1 has made a loan to CFC2 regarding which CFC1 annually accrues \$100 of business interest income that is included in CFC1's tested income, and CFC2 pays or accrues \$100 of business interest expense, which absent § 163(j), would be fully deductible in computing CFC2's tested income or tested losses applicable.

4. Thus, the intercompany business interest income and business interest expense would fully offset one another for purposes of computing USP's inclusion under § 951A(a). To the extent § 163(j) were to disallow a deduction for business interest expense to CFC2 while the business interest income would be included in CFC1's tested income, the amounts would not fully offset, and USP's inclusion under § 951A(a) could be increased solely due to the use of intercompany debt between CFC1 and CFC2.
5. Treasury and the IRS considered the possibility of completely disregarding all business interest income and business interest expense regarding intercompany debt between related CFCs for purposes of computing the § 163(j) limitation of the lender CFC and the borrower CFC (the disregard approach). However, this approach was rejected because it would cause inappropriate results where, for example, one CFC (CFC FinCo) borrows from a third party and on-lends the debt proceeds to one or more other CFCs within the group (funded CFCs). Assume for purposes of simplicity that CFC FinCo charges interest on loans to the funded CFCs at the same rate that it is charged by the third party.
6. If intercompany business interest income received by CFC FinCo and business interest expense paid or accrued by the funded CFCs were disregarded in determining each CFC's § 163(j) limitation, then CFC FinCo would have no business interest income, and all of CFC FinCo's business interest expense paid to the third party would be subject to the § 163(j) limitation. Furthermore, all of the funded CFCs would have no business interest expense subject to the § 163(j) limitation. This would be the case, even though the funded CFCs have borrowed from CFC FinCo and had the use of the funds originally borrowed from the third party.
7. Treasury and the IRS believe that an approach that better reflects the reality of borrowings by related CFCs is one that takes into account the principle that money is fungible within a group of highly related CFCs (such as group, a "CFC group" and a CFC that is a member of the group, a "CFC group member"). Accordingly, the proposed regulations would provide for an irrevocable election (the "CFC group election") to apply an alternative method that would limit the amount of business interest

expense of a CFC group member subject to the § 163(j) limitation to the amount of the CFC group member's allocable share of the CFC group's net business interest expense. *See* Prop. Treas. Reg. § 1.163(j)-7(b)(3).

8. The elective CFC grouping method will probably be the method preferred by most U.S. based multinational taxpayers. This also might be a reason to make the election to apply the proposed § 163(j) regulations retroactively to 2018 (for calendar year taxpayers). If the election for retroactive application of the proposed regulations is not made, it is unclear whether the new § 163(j) rules apply at the CFC level. If they do not, then the "double counting," or "back-out" rule, as we call it, discussed below, also might not apply, either. If they do, then they likely would apply on a CFC-by-CFC basis (raising potential issues regarding intercompany CFC-to-CFC debt) and concepts similar to the "back-out" rule might be relevant. *See* the NYS Bar Association Report on § 163(j) dated March 28, 2018 ("in the absence of similar guidance [that § 163(j) does not apply to CFCs] under new § 163(j), it appears the provision would apply to CFCs"). Old 163(j) did not apply at the CFC level, but this may or may not be relevant.
9. The applicable net business interest expense of CFC group is the excess, if any, of the sum of the amounts of business interest expense of each CFC group member over the sum of the amounts of business interest income of each CFC group member. *See* Prop. Treas. Reg. § 1.163(j)-7(f)(3). A CFC group member's allocable share is computed by multiplying the applicable net business interest expense of the CFC group by a fraction, the numerator of which is the CFC group member's net business interest expense (computed on a separate company basis), and the denominator of which is the sum of the amounts of the net business interest expense of each CFC group member with net business interest expense (computed on a separate company basis). *See* Prop. Treas. Reg. § 1.163(j)-7(f)(1).
10. Thus, if an election is made to apply the alternative method and if the CFC group has only intercompany debt within the CFC group, then the amount of the CFC group's applicable net business interest expense is zero, and no business interest expense of any CFC group member would be subject to the § 163(j) limitation. As a result, for example, there would be no increase in an inclusion under § 951A(a) solely by reason of the use of intercompany debt within a CFC group. On the other hand, if a CFC group has applicable net business interest expense, then, consistent with the principle that money is fungible, each CFC group member that has net business interest expense, computed on a separate company basis, will determine its allocable share of the applicable net business interest expense and the allocable share of the amount of business interest expense of the CFC group member that is subject to the § 163(j) limitation.

11. Using its allocable share of the CFC group’s applicable net business interest expense, a CFC group member computes its § 163(j) limitation on a separate company basis. However, as discussed below, under the proposed regulations, for purposes of computing a CFC’s ATI, an upper-tier CFC group member takes into account a proportionate share of the “excess” ATI of a lower-tier CFC group member, i.e., there’s a “tiering up” (our term) of the CFC’s “§ 163(j) cushion,” namely, the excess ATI. Note that this only applies in the context of the CFC group election.
12. In general, for purposes of these proposed regulations, a CFC group means two or more CFCs, if at least 80 percent of the stock by value of each CFC is owned, within the meaning of § 958(a), by a single U.S. shareholder or, in aggregate, by related shareholders that own stock of each member in the same proportion. *See* Prop. Treas. Reg. § 1.163(j)-7(f)(6). For purposes of identifying a CFC group, members of a consolidated group are treated as a single person and stock owned by certain passthrough entities is treated as owned by the owners or beneficiaries of the passthrough entity.
13. Treasury and the IRS believe that the alternative method is appropriately limited to situations in which a payor CFC and payee CFC have substantially identical ownership by United States shareholders because the alternative method is based on the principle that money is fungible. The alternative method is based on the principle that money is fungible. However, fungibility should only apply in cases of a close relationship in which borrowings essentially support the entire group. Furthermore, the mismatch of a deduction and a payee income item is most significant when the payee and payor CFC have substantially identical ownership by United States shareholders. The proposed regulations narrow the scope of foreign corporations that are CFCs for this purpose to those foreign corporations in which at least one United States shareholder owns stock, within the meaning of § 958(a). These proposed regulations refer to such a CFC as an “applicable CFC.” *See* Prop. Treas. Reg. § 1.163(j)-7(f)(2).
14. If one or more CFC group members conduct a financial services business, the alternative method is applied by treating those entities as comprising a separate subgroup (such a subgroup, a “financial services subgroup” and such a member, a “financial services subgroup member”). For this purpose, an entity conducts a financial services business if it is an eligible controlled foreign corporation, as defined in § 954(h)(2)(A), is a qualified insurance company, as defined in § 953(e)(3), or is eligible for the dealer exception in computing foreign personal holding company income as described in § 954(c)(2)(C). This would seem to be a narrow definition, which probably is good.
15. Treasury and the IRS believe that it is appropriate to apply the alternative method separately for entities that conduct financial services businesses, because those businesses are typically highly leveraged with significant

amounts of business interest income and business interest expense and could reasonably be expected to cause distortion if included in the alternative method with other, non-financial services business CFC group members.

16. The proposed regulations generally treat a controlled partnership (in general, a partnership in which CFC group members own, in aggregate, at least 80 percent of the interests) as a CFC group member and the interest in the controlled partnership is treated as stock. Thus, for example, if a U.S. person wholly owns two applicable CFCs, which each own a 50-percent interest in a partnership, then, if an election is made to apply the alternative method, the partnership will also apply the alternative method.
17. Treasury and the IRS believe that it is appropriate to extend the relief to partnerships that are substantially owned by CFC group members because the principle that money is fungible is not limited to corporate entities. Furthermore, absent such a rule, a partnership could be used to inappropriately exclude an applicable CFC from the CFC group by having the partnership own the applicable CFC.
18. The proposed regulations exclude from the definition of a CFC group member an applicable CFC that has ECI. Thus, an applicable CFC with ECI may not compute its § 163(j) limitation under the alternative method, and furthermore, the CFC group, and any financial services subgroup, must exclude that CFC from all group-level computations (for example, in determining the amount of the CFC group's applicable net business interest expense).
19. Treasury and the IRS believe that it is appropriate to exclude an applicable CFC with ECI from application of the alternative method so that § 163(j) applies to a CFC with ECI in the same manner as it does to a domestic C corporation. However, although an applicable CFC with ECI cannot use the alternative method, an applicable CFC with ECI is treated as a CFC group member solely for purposes of determining a CFC group. Thus, for example, if an applicable CFC with ECI is wholly owned by an upper-tier CFC and the applicable CFC with ECI wholly owns a lower-tier CFC, the lower-tier CFC may still qualify as a CFC group member.
20. If not all CFC group members have the same taxable year, then, if the election is made, these proposed regulations require that all group-level computations be made with respect to a majority U.S. shareholder taxable year. *See* Prop. Treas. Reg. § 1.163(j)-7(f)(11). Thus, if, for example, USP, a domestic corporation with a calendar taxable year, wholly owns two applicable CFCs, one with a calendar year and one with a November 30 fiscal year, then, with respect to USP's 2019 calendar year, the group-level computations must be determined using amounts for the taxable year

ending November 30, 2019, for the one applicable CFC, and amounts for the taxable year ending December 31, 2019, for the other applicable CFC.

21. Finally, the proposed regulations provide rules concerning the election, including the requirements for making the CFC group election, the manner for making it, and its duration. *See* Prop. Treas. Reg. § 1.163(j)-7(b)(5). Treasury and the IRS have determined that the alternative method should be elective, rather than required, because for certain situations, the general application of § 163(j) may be preferable to taxpayers.
22. Rules for Computing the ATI of an Applicable CFC. Prop. Treas. Reg. § 1.163(j)-7(c) would provide rules for computing the ATI of an applicable CFC. The principles of Treas. Reg. § 1.952-2 for determining the CFC's income and deductions or, for CFCs with ECI, the rules of § 882, apply for purposes of computing the CFC's taxable income. These rules apply whether or not the CFC group election is made. *See* Prop. Treas. Reg. § 1.163(j)-7(c)(1). Treasury and the IRS request comments on the application of the rules under Treas. Reg. § 1.952-2 to determine a CFC's taxable income for purposes of § 163(j). 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. For example, questions have arisen as to whether a CFC should be allowed a dividends-received deduction under § 245A, even though § 245A by its terms applies only to dividends received by a domestic corporation.
23. To mitigate potential double-counting of income in ATI, any dividend received by an applicable CFC from a related person is subtracted from the distributee's taxable income for purposes of computing ATI as the dividend represents income that could be part of the distributing corporation's ATI. *See* Prop. Treas. Reg. § 1.163(j)-7(c)(2).
24. If a CFC group election is in effect regarding a CFC group, then an upper-tier CFC group member takes into account a proportionate share of the "excess" ATI (referred to in the proposed regulations as "CFC excess taxable income") of each lower-tier member in which it directly owns stock for purposes of computing the upper-tier member's ATI. *See* Prop. Treas. Reg. § 1.163(j)-7(c)(3). That is, there is a "tiering up" of the CFC's "§ 163(j) cushion." The meaning of the term CFC excess taxable income is analogous to the meaning of the term "excess taxable income" in the context of a partnership and S corporation, and, in general, means the amount of a CFC group member's ATI in excess of the amount needed before there would be disallowed business interest expense. *See* Prop. Treas. Reg. § 1.163(j)-7(f)(5).
25. A CFC group member that is a partnership does not have CFC excess taxable income because under the statute and Prop. Treas. Reg. § 1.163(j)-

6, the partnership has excess taxable income and such excess taxable income is allocated to the partners of the partnership. The computation of a partnership's excess taxable income and the treatment of a partner's distributive share of any excess taxable income is addressed in the portion of the proposed regulations dealing with partnerships.

26. The process of computing and “rolling up” (“tiering up”) CFC excess taxable income among CFC group members for purposes of computing the ATI of each of the CFC group members begins with a lowest-tier member and continues through the chain of ownership to a highest-tier member of the CFC group (referred to in these proposed regulations as a “specified highest-tier member”). Thus, a lowest-tier member computes its § 163(j) limitation, and if it has CFC excess taxable income, the CFC excess taxable income is taken into account proportionately by one or more higher-tier members that directly own stock of the lower-tier member for purposes of computing ATI; and, if that a higher-tier member has CFC excess taxable income, it is taken into account by a next higher-tier member, and so forth.
27. A higher-tier member that is a partnership may take into account a pro rata share of the CFC excess taxable income of a lower-tier member, other than a partnership, which does not have CFC excess taxable income, for purposes of computing the higher-tier member partnership's ATI and determining if the higher-tier member partnership has excess taxable income that may be allocated to CFC group members that are partners.
28. Rules for Computing ATI of a United States Shareholder. In general, a United States shareholder that owns, within the meaning of § 958(a), stock of a CFC is required to include in its gross income each year its pro rata share of the CFC's Subpart F income, and investments in U.S. property, as defined in § 956. In addition, a United States shareholder that owns stock of a CFC is required to include in its gross income for each year its GILTI amount. Thus, these income inclusions are included in the United States shareholder's taxable income, and absent an exercise of regulatory authority, would be included in ATI.
29. To avoid double counting of the taxable income of a CFC already taken into account to determine the CFC's § 163(j) limitation, Prop. Treas. Reg. § 1.163(j)-7(d)(1)(i) would provide a general rule (we call this the “back-out” rule; the regulations call it the “double counting” rule) that the ATI of a United States shareholder is computed without regard to any amounts included in gross income under §§ 78, 951(a), and 951A(a) that are properly allocable to a non-excepted trade or business of the United States shareholder (each amount, a “specified deemed inclusion” and such amounts, collectively “specified deemed inclusions”) and any deduction allowable under § 250(a)(1)(B), without regard to the taxable income limitation in § 250(a)(2), by reason of a specified deemed inclusion (such

a deduction, a “specified section 250 deduction”). This rule applies whether or not the CFC group election is made.

30. To the extent a United States shareholder includes amounts in gross income under §§ 78, 951(a), or 951A(a) that are not properly allocable to a non-excepted trade or business, for example, because such amounts are treated as investment income, within the meaning of § 163(d), of the United States shareholder, these amounts are not included in ATI. *See* Prop. Treas. Reg. § 1.163(j)-1(b)(1)(ii)(F). Thus, for example, if a United States shareholder that is a domestic partnership includes amounts in gross income under § 951(a) or 951A(a) that are treated as investment income regarding the domestic partnership and therefore are not properly allocable to a trade or business, then such amounts are not included in the ATI of the domestic partnership.
31. However, absent a special rule, to the extent these income inclusions are taken into account as a distributive share of a C corporation partner, the income inclusions would be included in the ATI of the C corporation partner. *See* Prop. Treas. Reg. § 1.163(j)-4(b)(3). This result would be contrary to the purpose of the “back out” rule. Accordingly, to prevent income inclusions under §§ 951(a) and 951A(a) that are treated as investment income regarding a domestic partnership from being included in the ATI of a corporate partner, the proposed regulations provide that a C corporation partner may not treat these amounts as properly allocable to a trade or business of the C corporation partner. *See* Prop. Treas. Reg. § 1.163(j)-7(d)(1)(ii).
32. If a U.S. shareholder owns directly or indirectly through one or more foreign partnerships stock of a CFC group member that is a specified highest-tier member for which a CFC group election is in effect, and the specified highest-tier member has CFC excess taxable income that is treated as being attributable to taxable income of the CFC group that resulted in the United States shareholder having specified income inclusions, the United States shareholder may add to its taxable income an amount equal to its proportionate share of the “eligible” CFC excess taxable income of the specified highest-tier member and any other highest-tier members (the addback rule). *See* Prop. Treas. Reg. § 1.163(j)-7(d)(2). We call this the “Add Back” rule, and it applies in the context of the CFC group election. It’s an important, additional reason why the CFC group election likely will be beneficial.
33. However, the addition to taxable income under the addback rule is limited to the portion of the specified deemed inclusions, all of which are subtracted from taxable income of any United States shareholder under the double-counting rule, that relates to CFC group members, reduced by the portion of any specified section 250 deduction that is allowable by reason of those specified deemed inclusions. The proposed regulations refer to

the portion described in the preceding sentence as “CFC group inclusions.” *See* Prop. Treas. Reg. § 1.163(j)-7(d)(2)(iii).

34. Furthermore, the limitation is computed without regard to amounts included in gross income by reason of § 78 regarding CFC group members. This result is appropriate states Treasury and the IRS because § 78 requires a deemed inclusion only to carry out the purposes of the foreign tax credit provisions.
35. To determine the amount of “eligible” CFC excess taxable income (“ETI”) of a specified highest-tier member (defined under Prop. Treas. Reg. § 1.163(j)-7(d)(2)(ii) as “eligible CFC group ETI”), the CFC excess taxable income is multiplied by the specified ETI ratio.
36. The specified ETI ratio is a fraction (expressed as a percentage) that compares the amounts of taxable income of each specified highest-tier member and each specified lower-tier member of the specified highest-tier member to the portions of the taxable income that gave rise to the inclusions under § 951(a) or 951A(a).
37. The specified ETI ratio includes in the numerator and the denominator of the fraction only taxable income amounts regarding CFC group members that have CFC excess taxable income without regard to the “roll up” of CFC excess taxable income from a lower-tier member. *See* Prop. Treas. Reg. § 1.163(j)-7(f)(14).
38. The purpose of the specified ETI ratio is to address the fact that within the CFC group, the income of a lower-tier member CFC that is neither Subpart F income nor tested income to the extent of GILTI is included in CFC excess taxable income and may be used by an upper-tier CFC group member. It would be distortive for a U.S. shareholder to obtain an increase in ATI regarding such income because this income is not taxed in the U.S.
39. The specified ETI ratio is intended to provide an estimate of the portion of CFC excess taxable income attributable to this income. Treasury and the IRS believe that this formulaic approach is superior to a tracing approach, because a tracing approach would increase complexity and therefore also generally increase administrative and compliance burdens.
40. If a United States shareholder of a CFC group member with a CFC group election in effect is a domestic partnership (a U.S. shareholder partnership), the addback rule does not apply to determine the ATI of the U.S. shareholder partnership. *See* Prop. Treas. Reg. § 1.163(j)-7(d)(3). This is because Treasury and the IRS believe that if a U.S. shareholder partnership includes amounts in gross income under § 951(a) or 951A(a) regarding stock of a CFC group member, then these amounts will, in

virtually all fact patterns, be treated as investment income regarding the partnership, and therefore interest expense of the partnership that is allocable to stock of a CFC group member will be treated as investment interest expense that is not subject to § 163(j) at the partnership-level.

41. In this case, however, if a U.S. shareholder partnership has a domestic C corporation partner (a U.S. corporate partner), the addback rule is applied, with certain modifications, to the U.S. corporate partner for purposes of computing the U.S. corporate partner's ATI. For purposes of computing the amount of the addition to taxable income of the U.S. corporate partner, the addback rule is modified to provide that the U.S. corporate partner takes into account not only its own specified deemed inclusions regarding stock of a CFC group member, but for this purpose also its distributive share, if any, of amounts included in gross income under § 951(a) or 951A(a) of the U.S. shareholder partnership regarding stock of a CFC group member. In addition, the addback rule is modified to provide that for purposes of determining a U.S. corporate partner's pro rata share of eligible CFC excess taxable income of a specified highest-tier member, the U.S. shareholder partnership is treated as if it were a foreign partnership.
 42. Effect on Earnings and Profits. Under Prop. Treas. Reg. § 1.163(j)-7(e), and consistent with the rules in Prop. Treas. Reg. § 1.163(j)-4(c), the disallowance and carryforward of a deduction for a foreign corporation's business interest expense does not affect whether and when the business interest expense reduces the corporation's earnings and profits. For example, in the case of a passive foreign investment company (PFIC), the disallowance and carryforward of a deduction will not affect the amount of inclusions of earnings under § 1293 if the PFIC is treated as a qualified electing fund. Similarly, the disallowance and carryforward of a deduction for an applicable CFC's business interest expense will not affect the limitation of Subpart F income to earnings and profits under § 952(c).
- D. Prop. Treas. Reg. § 1.163(j)-8 addresses the application of § 163(j) to foreign persons with effectively connected income. A nonresident alien or foreign corporation is subject to net basis income taxation only regarding its income that is or is treated as effectively connected with a U.S. trade or business ("ECI"). Deductions are allowed only to the extent they are connected with that income. In certain circumstances, the tax liability may be reduced or eliminated by the provisions of an income tax treaty entered into by the United States with a foreign country. While a nonresident alien individual ("NRA") or foreign corporation that is not an applicable CFC (a non-CFC FC) that has ECI is still subject to § 163(j) and the regulations thereunder, the rules need to be modified since these foreign persons are only taxed on their ECI. Accordingly, the definitions for ATI, business interest expense, business interest income, and floor plan interest expense in Prop. Treas. Reg. § 1.163(j)-1 are modified to limit these amounts to

income that is effectively connected income and expenses properly allocable to it. *See* Prop. Treas. Reg. § 1.163(j)-8(b).

1. Section 163(j)(4) provides that in the case of a partnership, § 163(j) is applied at the partnership level. The partner's ATI is increased by the partnership's excess taxable income, and the partnership's excess business interest expense is allocated to the partner as disallowed business interest expense carryforward that can be deducted when the partners are allocated excess taxable income from the partnership, but only to the extent of that excess.
2. Under § 163(j)(8)(B), which permits adjustments to the computation of ATI, a nonresident alien individual or non-CFC FC that is a partner in a partnership that is engaged in a U.S. trade or business modifies the application of the general allocation rules in Prop. Treas. Reg. § 1.163(j)-6 regarding excess taxable income, excess business interest expense, and excess business interest income of the partnership to take into account the limitation of the foreign person's liability for U.S. tax to its ECI. The excess amounts of the partnership, therefore, can be used by the nonresident alien individual or non-CFC FC only to the extent of the partnership's income that would be effectively connected income regarding the foreign partner.
3. The amount of excess taxable income and excess business interest expense that can be used by the partner is determined by multiplying the amount of the excess taxable income or the excess business interest allocated under Prop. Treas. Reg. § 1.163(j)-6 by a ratio equal to the ATI of the partnership, with adjustments described previously to limit the amount to only effectively connected income or expense items, over the ATI of the partnership determined under Prop. Treas. Reg. § 1.163(j)-6(d). The amount of excess business interest income that can be used by the partner is limited to ECI business interest income over allocable ECI business interest expense. *See* Prop. Treas. Reg. § 1.163(j)-8(c).
4. Prop. Treas. Reg. § 1.163(j)-8(e) would also include rules coordinating § 163(j) and Treas. Reg. § 1.882-5 which provides rules for determining the amount of a foreign corporation's interest expense that is allocable under § 882(c) to ECI. The proposed regulations require that a foreign corporation that has ECI must first determine its business expense allocable to ECI under Treas. Reg. § 1.882-5 before applying § 163(j).
5. The foreign corporation then applies § 163(j) to its business interest expense to determine if any of it is disallowed. If the foreign corporation is also a partner in a partnership that has ECI, the foreign corporation must back out that portion of the business interest expense determined under Treas. Reg. § 1.882-5 which is deemed to have come from the partnership as the business interest expense has already been subject to § 163(j) at the

partnership level and the foreign corporation is then left with only the non-partnership business interest expense.

6. If the partnership also had disallowed business interest expense, a portion of the partnership-level interest expense that was backed out of the amount determined under Treas. Reg. § 1.882-5 will also be disallowed business interest expense. Disallowed business interest expense determined at either the partner-level or partnership level, as appropriate, will not be taken into account for the purpose of determining interest expense under Treas. Reg. § 1.882-5 in subsequent tax years, but rather will be subject to the limitations of § 163(j).
7. As provided in Prop. Treas. Reg. § 1.163(j)-8(d), an applicable CFC that has ECI must first apply the general rules of § 163(j) and the regulations thereunder, under Prop. Treas. Reg. § 1.163(j)-7(b)(2), to determine how § 163(j) applies to the applicable CFC. If, after applying § 163(j) and the regulations thereunder, the applicable CFC has disallowed business interest expense, the applicable CFC must then apportion a part of its disallowed business interest expense to interest expense allocable to effectively connected income as determined under Treas. Reg. § 1.882-5.
8. The regulations also provide that disallowed business interest expense and disallowed business interest expense carryforwards will not affect the determination of effectively connected earnings and profits or U.S. net equity for purposes of the branch profits tax under § 884. These rules are consistent with the general principles of the proposed regulations regarding earnings and profits.

E. Other Provisions.

1. Prop. Treas. Reg. § 1.163(j)-9 deals with elections for excepted trades or businesses; and the safe harbor for certain REITs. Prop. Treas. Reg. § 1.163(j)-10 deals with the allocation of expense and income to excepted trade or business. In general, Prop. Treas. Reg. § 1.163(j)-10(c) would set forth the general rule for allocating interest expense and interest income between excepted and non-excepted trades or businesses based on the adjusted basis in its assets on a quarterly basis. Prop. Treas. Reg. § 1.163(j)-11 deals with certain transition rules.
2. Several of the § 163(j) proposed regulations contains anti-avoidance rules (“a principal purpose”), for example, regarding the definition of “interest”: Prop. Treas. Reg. § 1.163(j)-2(h)’s anti-avoidance rule states that “Arrangements entered into with a principal purpose of avoiding the rules of § 163(j) or the § 163(j) regulations, including the use of multiple entities ... may be disregarded or recharacterized by the Commissioner of the IRS to the extent necessary to carry out the purposes of § 163(j).”

VII. FOREIGN TAX CREDIT REGULATIONS: PART 1.

A. Post-TCJA Foreign Tax Credit Regulations.

1. Treasury and the IRS proposed regulations dealing with a number of post-TCJA foreign tax credit issues. The rules are retroactively effective regarding TCJA changes starting with 2018 (for calendar year taxpayers). The regulations regarding non-TCJA changes generally are also effective in 2018 (for calendar year taxpayers), but with slightly different effective date language, discussed below.

B. Allocation and Apportionment of Deductions and the Calculation of taxable Income for Purposes of Section 904(a).

1. Section 904 GILTI Basket.

- (a) They state that they have received several comments suggesting that § 951A, in combination with § 904(d)(1)(A) (the “§ 951A category”), was intended to provide that the income of a United States shareholder derived through the CFC would be subject to additional U.S. tax if the foreign effective tax rate is below a particular rate, and should be effectively exempt from U.S. tax if the foreign effective tax rate is at or above that rate. This is the important issue regarding whether expenses should be allocated to the § 904 GILTI basket. These comments generally cite language in H.R. Rep. 115-466 (2017) (the “Conference Report”) illustrating that no U.S. “residual tax” applies to foreign earnings subject to a foreign effective tax rate of 13.125% or more.
- (b) We have expressed this view in discussing the congressionally desired direct relationship between the U.S. and foreign tax rates for GILTI purposes and the resulting need to avoid allocating expenses to the § 904(d) GILTI basket.
- (c) Allocated expenses may reduce the amount of § 951A category income included in U.S. taxable income below the amount of the foreign base on which the CFC paid at least a 13.125% foreign effective tax rate, with the effect that the United States shareholder’s foreign taxes deemed paid may exceed the pre-credit U.S. tax on its § 951A category income, resulting in excess credits that may not offset U.S. tax on other income.
- (d) The comments Treasury and the IRS received suggested that taxpayers’ inability to reduce U.S. tax on non-§ 951A category income (such as U.S. source income) with the excess credits is tantamount to imposing U.S. “residual tax” on section 951A category income, even though the actual U.S. tax liability on that income, as reduced by foreign tax credits, is zero. The comments

suggested that to assure full use of foreign tax credits associated with § 951A category income that is subject to a foreign effective tax rate of 13.125% or greater, no expenses should be allocated and apportioned to the § 951A category income.

- (e) Treasury and the IRS, however, disagree. They believe that the TCJA is inconsistent with this view of how the § 904 limitation should apply to the § 951A category. Congress added a new separate category under § 904(d)(1) for amounts includible under § 951A and amended § 904(c) to disallow carryovers of excess foreign tax credits in that category, but did not modify the existing rules under § 904 or §§ 861 through 865 to provide for special treatment of expenses allocable to the § 951A category.
- (f) They believe that other provisions added in the TCJA are inconsistent with the notion described by comments that Congress intended effectively to exempt § 951A category income that was subject to a certain foreign effective tax rate from U.S. tax, since those provisions may result in U.S. tax being imposed on income derived through a CFC even if the foreign effective tax rate on the income exceeds 13.125%. *See*, for example, § 59A (limiting the benefits of foreign tax credits) and 250(a)(2)(B)(ii) (limiting the deduction under § 250 in certain cases).
- (g) In addition, they state that numerous provisions in the Code that were unamended by the TCJA apply by their terms to § 951A category income, also indicating that Congress did not intend to eliminate generally-applicable limitations on foreign tax credits associated with foreign earnings of a CFC even if such earnings were subject to a certain foreign effective tax rate. For example, the TCJA did not amend provisions that limit the availability of foreign tax credits (such as §§ 901(j), (k), (l), or (m)) or that reduce (or increase) the foreign tax credit limitation in the § 951A category based on U.S. or foreign losses in other separate categories or losses in other years (§§ 904(f) and (g)).
- (h) These provisions apply to a GILTI inclusion and related taxes under § 960(d), and as applied the provisions are not consistent with the policy of determining allowable foreign tax credits based solely on a CFC's foreign effective tax rate because they may reduce the amount of taxes that may be credited without regard to the foreign effective tax rate of the CFC.
- (i) Treasury and the IRS say that the TCJA did, however, add § 904(b)(4)(B), which disregards certain deductions other than those that are “properly allocable or apportioned to” amounts includible under §§ 951A(a) or § 951(a)(1) and stock that produces

amounts includible under § 951A(a) or 951(a)(1). According to Treasury and the IRS, this new provision plainly contemplates that deductions will be allocated and apportioned to the § 951A category.

- (j) Thus, the proposed regulations generally apply the existing approach of the expense allocation rules to determine taxable income in the § 951A GILTI category, as well as the new foreign branch category described in § 904(d)(1)(B). However, as discussed below, the proposed regulations also provide for exempt income and exempt asset treatment with respect to income in the § 951A category that is offset by the deduction allowed under § 250(a)(1) for inclusions under § 951A(a) and a corresponding percentage of the stock of CFCs that generates such income. This will generally have the effect of reducing the amount of expenses apportioned to the § 951A category.
- (k) The preamble also says that many of the existing expense allocation rules have not been significantly modified since 1988. Furthermore, for taxable years beginning after December 31, 2020, a worldwide affiliated group will be able to elect to allocate and apportion interest expense on a worldwide basis. *See* § 864(f). Treasury and the IRS expect the implementation of § 864(f) will have a significant impact on the effect of interest expense apportionment and will necessitate a reexamination of the existing expense allocation rules.
- (l) Therefore, they expect to reexamine the existing approaches for allocating and apportioning expenses, including in particular the apportionment of interest, research and experimentation (“R&E”), stewardship, and general & administrative expenses, as well as to reexamine the “CFC netting rule” in Treas. Reg. § 1.861-10(e).

2. Changes and Clarifications to Definitions of Exempt Income and Exempt Asset.

- (a) Section 864(e)(3) provides that, for purposes of allocating and apportioning any deductible expense, any tax-exempt asset (and any income from the asset) is not taken into account. Section 864(e)(3) also provides that a similar rule applies for the portion of any dividend equal to the deduction allowable under § 243 or § 245(a) regarding the dividend and the like portion of any stock the dividends on which would be so deductible. Section 864(e)(3) was not modified by the TCJA.
- (b) The preamble states that some taxpayers have taken the position that under Treas. Reg. § 1.861-8T(d)(2)(ii) assets or income that

are partially exempt, excluded, or eliminated may be treated as entirely exempt. This interpretation is inconsistent with § 864(e)(3). The proposed regulations thus revise the definitions of exempt income and exempt assets to clarify that income or assets are treated as exempt (or partially exempt) under § 864(e)(3) only to the extent that the income or the income from the assets are, or are treated as, exempt, excluded, or eliminated. Prop. Treas. Reg. § 1.861-8(d)(2)(ii)(A).

- (c) New § 250(a)(1) allows a domestic corporate shareholder a deduction (the “§ 250 deduction”) equal to portions of its foreign-derived intangible income (“FDII”), GILTI inclusion, and the amount treated as a dividend under § 78 that is attributable to its GILTI inclusion. Because the § 250 deduction effectively exempts a portion of certain income, the proposed regulations provide that for purposes of applying the expense allocation and apportionment rules, the GILTI gross income offset by the § 250 deduction is treated as exempt income, and the stock or other asset giving rise to that income is treated as a partially exempt asset.
- (d) Prop. Treas. Reg. § 1.861-8(d)(5) Ex. 1 provides:

(i) Facts. USP, a domestic corporation, directly owns all of the stock of CFC1 and CFC2, both of which are controlled foreign corporations. The tax book value of CFC1 and CFC2’s stock is \$10,000 and \$9,000, respectively. Pursuant to Treas. Reg. § 1.861-13(a), \$6,100 of the stock of CFC1 is assigned to the § 951A category under Treas. Reg. § 1.861-13(a)(2) (“§ 951A category stock”) and the remaining \$3,900 of the stock of CFC1 is assigned to the general category (“general category stock”).

Additionally, \$4,880 of the stock of CFC2 is § 951A category stock and the remaining \$4,120 of the stock of CFC2 is general category stock. USP’s GILTI inclusion amount is \$610. The portion of USP’s deduction under § 250 is \$305. No portion of USP’s deduction is reduced by reason of § 250(a)(2)(B)(ii).

(ii) Analysis. \$305 of USP’s gross income attributable to its GILTI inclusion amount is exempt income for purposes of apportioning deductions for purposes of § 904. The GILTI inclusion stock of CFC1 is the \$6,100 of stock that is § 951A category stock and the GILTI inclusion stock of CFC2 is the \$4,880 of stock that is § 951A category stock. The portion of the value of the stock of CFC1 and CFC2 that is treated as an exempt asset equals the portion of the value of the stock of CFC1 and CFC2 that is GILTI inclusion stock multiplied by 50% ($\$305/\610). Accordingly, the exempt portion of the stock of CFC1 is \$3,050 ($50\% \times \$6,100$) and the exempt portion of CFC2’s stock is \$2,440 ($50\% \times \$4,880$).

Therefore, the stock of CFC1 taken into account for purposes of apportioning deductions is \$3,050 of non-exempt § 951A category stock and \$3,900 of general category stock. The stock of CFC2 taken into account for purposes of apportioning deductions is \$2,440 of non-exempt § 951A category stock and \$4,120 of general category stock.

- (e) This rule does not apply for purposes of determining the amount of the FDII in applying § 250 as the operative section, and no inference is intended regarding whether the § 250 deduction is treated as giving rise to exempt income or assets for any other purpose of the Code other than for purposes of the allocation and apportionment of deductions under Treas. Reg. §§ 1.861-8 through 1.861-17.
- (f) Under Prop. Treas. Reg. § 1.861-8(d)(2)(ii)(C)(1), a portion of a domestic corporation's gross income that is FDII or results from a GILTI inclusion (and the corresponding § 78 gross up) is treated as exempt income based on the amount of the § 250 deduction allowed to the United States shareholder under § 250(a)(1). Similarly, the value of a domestic corporation's assets that produce FDII or GILTI is reduced to reflect the fact that the income from the assets is treated in part as exempt. Prop. Treas. Reg. § 1.861-8(d)(2)(ii)(C)(2).
- (g) The amount of the § 250 deduction used to determine the amount of gross income that is exempt is reduced to the extent § 250(a)(2)(B) requires a reduction to the amount of the deduction. Therefore, Prop. Treas. Reg. § 1.861-8(d)(2)(ii)(C) does not apply to treat income or assets as exempt if the domestic corporation is not allowed a deduction under § 250(a)(2), even though the domestic corporation may have FDII or a GILTI inclusion.
- (h) A special rule is provided in Prop. Treas. Reg. § 1.861-8(d)(2)(ii)(C)(2)(ii) to determine the portion of CFC stock that gives rise to a GILTI inclusion that is treated as exempt. The rule provides that a portion of CFC stock owned by a domestic corporation that is a United States shareholder of the CFC is treated as exempt based on a fraction equal to the amount of the § 250 deduction allowed to the domestic corporation under § 250(a)(1)(B)(i) (taking into account the reduction, if any, required under § 250(a)(2)(B)(ii)), divided by the domestic corporation's GILTI inclusion.
- (i) In general, the fraction is applied to the portion of the CFC stock that is treated as giving rise to a GILTI inclusion and that is not assigned to a § 245A subgroup, as determined under the rules in Prop. Treas. Reg. § 1.861-13. To the extent the domestic

corporation is allowed a § 250 deduction for an amount under § 250(a)(1)(B) (because the domestic corporation has a GILTI inclusion), the proposed regulations treat a portion of the stock of a CFC regarding which the domestic corporation is a United States shareholder as exempt even if the CFC has a tested loss for the taxable year.

- (j) Section 245A(a) allows domestic corporate shareholders a deduction equal to the foreign-source portion of dividends received from certain foreign corporations (the “§ 245A deduction”), subject to certain limitations described in § 246. Although § 864(e)(3) contemplates that dividends described in §§ 243 and 245(a) are treated similarly to exempt income to the extent of the deductions allowed under those sections, § 864(e)(3) does not apply to the dividend income reduced by the § 245A deduction. Instead, § 904(b)(4) provides for alternative adjustments. Prop. Treas. Reg. § 1.861-8(d)(2)(iii)(C) clarifies that the § 245A deduction does not give rise to exempt income. Similarly, no asset is treated as an exempt asset by reason of the § 245A deduction. Different treatment is provided under Treas. Reg. § 1.861-8T(d)(2)(ii)(B) for dividends received deductions under §§ 243 and 245 because § 864(e)(3) specifically provides that similar rules to the exempt asset and income rules apply to those deductions.
- (k) The proposed regulations also confirm in Prop. Treas. Reg. § 1.861-8(d)(2)(iv) that earnings and profits excluded from income under § 959 (“previously taxed earnings and profits” or “PTEP”) does not result in any portion of the stock in a CFC being treated as an exempt asset. Under Treas. Reg. §§ 1.861-12 and 1.861-12T, stock in a CFC is characterized by reference to the income generated each year by the CFC’s assets. PTEP is not a type of income that is generated during the taxable year by a CFC’s assets; rather, the CFC’s assets, whether acquired with previously taxed or non-previously taxed earnings and profits or with another source of funds, generate income used to characterize the stock. For the avoidance of doubt, Prop. Treas. Reg. § 1.861-8(d)(2)(iv) confirms that the fact that a CFC has previously taxed earnings and profits does not result in any portion of the CFC’s stock being treated as an exempt asset under § 864(e)(3).

3. Allocation and Apportionment of Foreign Income Taxes, the § 250 Deduction, and a Distributive Share of Partnership Deductions.

- (a) Treas. Reg. § 1.861-8(e) provides rules for allocating and apportioning certain deductions. Treas. Reg. § 1.861-8(e)(6) provides rules for the allocation and apportionment of deductions for state, local, and foreign income, war profits and excess profits

taxes. In the case of deductions for foreign income, war profits and excess profits taxes, the allocation and apportionment rules under Treas. Reg. § 1.861-8(e) are intended to be consistent with the principles of Treas. Reg. § 1.904-6. The proposed regulations clarify this result by expressly incorporating the principles of Treas. Reg. § 1.904-6(a)(1)(i), (ii), and (iv) in allocating and apportioning taxes to the relevant statutory and residual groupings (and not just to separate categories of income for purposes of determining the foreign tax credit limitation).

- (b) The proposed regulations also include rules for allocating and apportioning the § 250 deduction. For these purposes, although the § 250 deduction is a single deduction that equals the sum of the amounts specified in §§ 250(a)(1)(A) and (B), the proposed regulations provide separate rules regarding (i) the portion of the § 250 deduction for FDII and (ii) the portion of the § 250 deduction for the GILTI inclusion and the amount of the § 78 gross up attributable to foreign taxes deemed paid regarding the GILTI inclusion. The amount of each portion of the § 250 deduction to be allocated and apportioned takes into account any reductions required under § 250(a)(2)(B).
- (c) Under Prop. Treas. Reg. § 1.861-8(e)(13), the portion of the § 250 deduction for FDII is treated as definitely related and allocable to the specific class of gross income that is included in the taxpayer's foreign-derived deduction eligible income (as defined in § 250(b)(4)). Although foreign-derived deduction eligible income is an amount net of expenses, the class is determined based solely on the gross income that is used to calculate foreign-derived deduction eligible income. In cases in which the income is allocated to a class that contains multiple categories under § 904(d) or U.S. source income, the deduction is apportioned ratably based on the relative amounts of gross income in the different income groupings.
- (d) Prop. Treas. Reg. § 1.861-8(e)(14) provides a similar rule for the portion of the § 250 deduction allowed for the GILTI inclusion and the corresponding § 78 gross up. In certain cases, gross income from the GILTI inclusion could be in a grouping other than the grouping for § 951A category income (for example, because it is U.S. source or passive category income). In these cases, the deduction for the GILTI inclusion and the § 78 gross up is apportioned ratably based on the relative amounts of gross income in the different income groupings.
- (e) The proposed regulations also clarify the general rule for allocating and apportioning a taxpayer's distributive share of partnership

deductions. Prop. Treas. Reg. § 1.861-8(e)(15) provides that if a taxpayer is a partner in a partnership, the taxpayer's deductions that are allocated and apportioned include the taxpayer's distributive share of the partnership's deductions.

C. Special Rule for Specified Partnership Loans.

1. Although unrelated to the TCJA changes, Treasury and the IRS addressed certain loans made to a partnership by a U.S. person, or a member of its affiliated group, that owns an interest (directly or indirectly) in the partnership. They believe that these loans can result in a distortion in determining the taxpayer's foreign tax credit limitation under § 904 when the same person takes into account both a distributive share of the interest expense and the interest income regarding the same loan. This result occurs because of differences in the rules that govern the source and separate category of the interest income and those that govern the allocation and apportionment of interest expense.
2. To prevent the distortive effect of these differences, Prop. Treas. Reg. § 1.861-9(e)(8)(ii) provides that, to the extent the lender in a specified partnership loan transaction takes into account both interest expense and interest income with respect to the same loan, the interest income is assigned to the same statutory and residual groupings as those groupings from which the interest expense is deducted, as determined under the allocation and apportionment rules in Treas. Reg. §§ 1.861-9 through 1.861-13.
3. Additionally, Prop. Treas. Reg. § 1.861-9(e)(8)(i) provides that, for purposes of applying the allocation and apportionment rules, a portion of the loan is not taken into account as an asset of the lender based on the ratio of the portion of the interest income included by the lender that is subject to this matching rule to the total amount of interest income included by the lender regarding the loan in the taxable year.
4. The proposed regulations include anti-avoidance rules to extend these provisions to certain back-to-back loans or loans made through CFCs. *See* Prop. Treas. Reg. § 1.861-9(e)(8)(iii) and (iv). The proposed regulations also apply the specified partnership loan rules to transactions that are not loans but that give rise to deductions that are allocated and apportioned in the same manner as interest expense under Treas. Reg. § 1.861-9T(b). Prop. Treas. Reg. § 1.861-9(e)(8)(v).

D. Revision to CFC Netting Rule Relating to Hybrid Debt.

1. Treas. Reg. § 1.861-10(e)(8)(vi) provides that for purposes of applying the CFC netting rule of Treas. Reg. § 1.861-10(e), certain related party hybrid debt is treated as related group indebtedness, but the income derived from

the hybrid debt is not treated as interest income derived from related group indebtedness. As a result, no interest expense is generally allocated to income from the hybrid debt, but the debt may nevertheless increase the amount of allocable related group indebtedness for which a reduction in assets is required under Treas. Reg. § 1.861-10(e)(7).

2. This can have a distortive effect on the general allocation and apportionment of other interest expense under Treas. Reg. § 1.861-9. The proposed regulations thus revise Treas. Reg. § 1.861-10(e)(8)(vi) to provide that hybrid debt is not treated as related group indebtedness for purposes of the CFC netting rule.
3. Prop. Treas. Reg. § 1.861-10(e)(8)(vi) also provides that hybrid debt is not treated as related group indebtedness for purposes of determining the foreign base period ratio, which is based on the average of related group debt-to-asset ratios in the five prior taxable years, even if the hybrid debt was otherwise properly treated as related group indebtedness in a prior year. Treasury and the IRS believe this will help to prevent distortions that would otherwise arise in comparing the ratio in a year in which the hybrid debt was treated as related group indebtedness with the ratio in a year in which the hybrid debt is not treated as related group indebtedness.

E. Valuation of Assets for Purposes of Apportioning Interest Expense and Other Deductions.

1. Repeal of Fair Market Value Method and Transition Relief.
 - (a) Section 864(e)(2) requires taxpayers to apportion interest expense based on assets rather than income. Under the asset method, a taxpayer apportions interest expense to the various statutory groupings based on the average total value of assets within each grouping for the taxable year as determined under the asset valuation rules of Treas. Reg. § 1.861-9T(g). Before the TCJA, taxpayers could elect to determine the value of their assets under the tax book value, alternative tax book value, or the fair market value method, and were required to obtain the Service's approval to switch from the fair market value method to the tax book or alternative tax book value methods. *See* Treas. Reg. § 1.861-8T(c)(2). In light of the TCJA's repeal of the fair market value method for apportioning interest for taxable years beginning after December 31, 2017, taxpayers using the fair market value method must switch to the tax book or alternative tax book value method for purposes of apportioning interest expense for the taxpayer's first taxable year beginning after December 31, 2017. Prop. Treas. Reg. §§ 1.861-8(c)(2) and 1.861-9(i)(2) provide that the Service's approval is not required for this change.

- (b) For purposes of determining asset values, an average of values within each statutory grouping is computed for the year based on the values of assets at the beginning and end of the year. *See* Prop. Treas. Reg. § 1.861-9T(g)(2)(i)(A). Taxpayers previously using the fair market value method may not have had an independent reason to calculate the adjusted tax basis of their assets as of the beginning of their first post-2017 taxable year as required by the tax book value and alternative tax book value methods. The proposed regulations provide in Prop. Treas. Reg. § 1.861-9(g)(2)(i) that for the first taxable year beginning after December 31, 2017, a taxpayer that had been using the fair market value method may choose to determine asset values using an average of the end of the first quarter and the year-end values of its assets, provided that all the members of an affiliated group (as defined in Treas. Reg. § 1.861-11T(d)) make the same choice and no substantial distortion would result.
- (c) The TCJA repealed the fair market value method only for purposes of allocating and apportioning interest expense. *See* § 864(e)(2). Accordingly, the fair market value method and the rules in Treas. Reg. § 1.861-9(h) remain applicable for non-interest expenses that are properly apportioned on the basis of the relative fair market values of assets.

2. Clarification of Rules for Adjusting Stock Basis in Nonaffiliated 10 percent Owned Corporations for Earnings and Profits.

- (a) Under § 864(e)(4)(A) and Treas. Reg. § 1.861-12(c)(2)(i)(A), for purposes of apportioning expenses based on the tax book value of assets, certain adjustments are made to the adjusted basis of stock in a 10 percent owned corporation based on the earnings and profits (or deficits in earnings and profits) of the corporation attributable to the stock. Treasury and the IRS understand that some taxpayers have taken the position that the adjustment to basis for earnings and profits under Treas. Reg. § 1.861-12T(c)(2) does not include previously taxed earnings and profits. They believe that this interpretation is inconsistent with the text and purpose of § 864(e)(4) and Treas. Reg. § 1.861-12(c)(2). The adjustment under § 864(e)(4) is intended to better approximate the value of stock.
- (b) Whether or not E&P is reclassified from earnings described in § 959(c)(3) to previously taxed earnings and profits has no bearing on the value of the stock. Therefore, the proposed regulations confirm that PTEP is taken into account for purposes of the adjustment described in Treas. Reg. § 1.861-12(c)(2). In addition, the proposed regulations clarify that the reference to the “rules of

section 1248” in Treas. Reg. § 1.861-12T(c)(2)(i)(B) is intended to provide rules for determining the pro rata share of earnings and profits attributable to the taxpayer’s shares, and is not relevant to determining the amount of the foreign corporation’s earnings and profits subject to the adjustment, which is governed by the rules in § 964(a) and § 986. Prop. Treas. Reg. § 1.861-12(c)(2)(i)(B)(2).

- (c) Treasury and the IRS state that there has been some uncertainty as to which values are used for averaging beginning and year-end values in the case of 10 percent owned corporations whose stock basis is adjusted under Treas. Reg. § 1.861-12(c)(2) (including rules described in Treas. Reg. § 1.861-12T(c)(2)), which, in general, first eliminates any additions to basis on account of previously taxed earnings and profits made under §§ 961 and 1293(d), and then increases or decreases adjusted basis by the shareholder’s pro rata share of total earnings and profits. Prop. Treas. Reg. § 1.861-9(g)(2)(i)(B) thus clarifies that the beginning and end-of-year values of stock are determined without regard to any adjustments under § 961(a) or § 1293(d), and before making the adjustment for earnings and profits provided in Treas. Reg. § 1.861-12(c)(1)(i)(A). The adjustment for total earnings and profits provided in Treas. Reg. § 1.861-12(c)(1)(i)(A) is only made after the average of the beginning and end of year values has been determined.

3. Determination of Stock Basis in Connection with § 965(b).

- (a) In the proposed regulations under § 965, Treasury and the IRS acknowledged that the application of § 965(b)(4)(A) and may warrant the issuance of special rules for the determination of adjusted basis. For example, if the increase in earnings and profits under § 965(b)(4)(B) and Prop. Treas. Reg. § 1.965-2(d)(2) is taken into account for purposes of determining the increase to adjusted basis under Treas. Reg. § 1.861-12(c)(2)(i)(A), and there is no corresponding reduction to the adjusted basis in the stock of the foreign corporation, the tax book value of the stock would be overstated by the amount of the increase.
- (b) If a shareholder elects to make the basis adjustments under Prop. Treas. Reg. § 1.965-2(f)(2)(i), the tax book value of the stock of its foreign corporations that were specified foreign corporations (as defined in Prop. Treas. Reg. § 1.965-1(f)(45)) will generally reflect the proper adjusted basis amounts as long as any amounts included in basis under Prop. Treas. Reg. § 1.965-2(f)(2)(ii)(A) are treated similarly to adjustments under § 961 and not included in the taxpayer’s basis in stock under Treas. Reg. § 1.861-12T(c)(2)(i)(B).

- (c) Accordingly, Prop. Treas. Reg. § 1.861-12(c)(2)(i)(B)(1)(ii) provides that, for purposes of Treas. Reg. § 1.861-12(c)(2), a taxpayer determines the basis in the stock of a specified foreign corporation as if it had made the election under Prop. Treas. Reg. § 1.965-2(f)(2)(i), even if the taxpayer did not in fact make the election, but does not include the amount included in basis under Prop. Treas. Reg. § 1.965-2(f)(2)(ii)(A) (because the amount of that increase would not be included if the increase was by operation of § 961). For this purpose, the amount included in basis under Prop. Treas. Reg. § 1.965-2(f)(2)(ii)(A) is determined without regard to whether any portion of the amount is netted against other basis adjustments under Prop. Treas. Reg. § 1.965-2(h)(2). Prop. Treas. Reg. § 1.861-12(c)(2)(i)(B)(1)(ii) applies to the taxable year of the inclusion under § 965 as well as to future taxable years.

F. Characterization of Stock of Certain Foreign Corporations Under § 1.861-12.

1. Characterization of CFC Stock to Account for § 951A Category, Treaty Categories, and § 904(b)(4).

- (a) Treas. Reg. § 1.861-12 provides special rules for applying the asset method to apportion expenses to the separate categories in computing the foreign tax credit limitation. The proposed regulations clarify in Treas. Reg. § 1.861-12(a) that Treas. Reg. § 1.861-12 also applies in apportioning expenses among statutory and residual groupings for operative sections other than § 904.
- (b) Special rules are provided in Treas. Reg. § 1.861-12T(c) regarding the treatment of stock, including stock in 10 percent owned corporations (as defined in Treas. Reg. § 1.861-12T(c)(2)(ii)) and stock in CFCs. The purpose of the stock characterization rules of Treas. Reg. § 1.861-12T(c) is to characterize the stock by reference to the income which the stock generates to its owner. Regarding CFCs, the rules generally look through to the income generated by the assets of the CFC for purposes of characterizing the stock of the CFC.
- (c) Before the TCJA, the income earned by the CFC was generally assigned to the same separate category to which that income would be assigned if earned directly by the United States shareholder because the categories of income of a CFC and U.S. person were the same, and the look-through rules under § 904(d)(3) generally applied to ensure that once income was assigned to a separate category, the category of the income was maintained when the income was paid or distributed by the CFC to its owner or taken into account as an inclusion by the owner.

- (d) The new separate category for § 951A category income applies only to an inclusion by a United States person of gross income under § 951A(a). Accordingly, gross tested income of a CFC is generally assigned to the general category, even though the stock of the CFC may give rise to a GILTI inclusion that is § 951A category income in the hands of a United States shareholder. Therefore, Treas. Reg. § 1.861-12T(c) would not result in characterizing any of the stock of the CFC as a § 951A category asset because the tested income is assigned to the general category, even though the related income included by the United States shareholder is assigned to the § 951A category.
- (e) Accordingly, Prop. Treas. Reg. § 1.861-13 provides special rules to account for the fact that, for the § 951A category, the application of Treas. Reg. § 1.861-12T(c) to determine the income of the CFC or the income generated by the assets of the CFC does not, on its own, reflect the separate category of the income generated by the stock of the CFC to the United States shareholder. The proposed regulations also address a similar issue that arises when a CFC earns U.S. source income that is included under § 951(a) or 951A(a) in gross income of a United States shareholder who elects under an income tax treaty to treat the inclusion as foreign source income, resulting in separate category treatment for income resourced under a tax treaty (a “treaty category”). *See* § 904(h). Prop. Treas. Reg. § 1.861-13 applies solely for purposes of characterizing stock when § 904 is the operative section.
- (f) Under Prop. Treas. Reg. § 1.861-13, a taxpayer first determines the amount of the stock of a CFC that is characterized in each of the statutory groupings described in Treas. Reg. § 1.861-13(a)(1) under the asset method or the modified gross income method. Under the modified gross income method, stock of a CFC may be characterized as producing general category gross tested income even though the CFC has a tested loss. *See* Prop. Treas. Reg. § 1.861-13(a)(1)(ii).
- (g) Next, a portion of the stock characterized as producing general category gross tested income is assigned to the § 951A category. Only a portion of the stock so characterized is assigned to the § 951A category because the amount of the GILTI inclusion by the United States shareholder may be less than the aggregate tested income of its CFCs because of offsets from another CFC’s tested loss or because of a reduction for net deemed tangible income return described in § 951A(b)(2). The inclusion percentage, as defined in § 960(d)(2), takes into account the percentage of net CFC tested income that is not included under § 951A(a) due to tested losses or the net deemed tangible income return.

Accordingly, Prop. Treas. Reg. § 1.861-13(a)(2) assigns a United States shareholder's stock in a CFC generating gross tested income to the § 951A category based on the United States shareholder's inclusion percentage as determined under Treas. Reg. § 1.960-2(c)(2). In general, earnings and profits related to the gross tested income that is not included under § 951A(a), when distributed, result in dividend income that is assigned to the general category.

- (h) The use of the inclusion percentage to assign stock to the § 951A category applies regardless of whether the stock of the CFC produces tested income or a tested loss for the year, in order to reflect the aggregate nature of the calculation of a United States shareholder's GILTI inclusion. Stock of a CFC is generally assigned to the statutory grouping for gross tested income, under either the asset or modified gross income methods described in Prop. Treas. Reg. § 1.861-12(c)(3), if the CFC's assets generate gross tested income or if the CFC earns gross tested income, even if the CFC ultimately produces a tested loss for the taxable year. However, a United States shareholder with no GILTI inclusion for a taxable year has an inclusion percentage of zero, and therefore none of the stock of its CFCs is assigned to the § 951A category in that year.
- (i) Under Prop. Treas. Reg. § 1.861-13(a)(3), a similar rule applies for characterizing stock as a treaty category asset if stock of a CFC is assigned to the statutory grouping for gross tested income that was resourced under a treaty. The portion of the stock of the CFC that is assigned to a treaty category is based on the United States shareholder's inclusion percentage. In the case of stock of a CFC initially assigned to the statutory groupings for gross Subpart F income that is resourced under a treaty, all of that stock is assigned to a treaty category.
- (j) In the case of stock of a CFC assigned to the general and passive categories or the residual grouping for U.S. source income, Prop. Treas. Reg. § 1.861-13(a)(5) provides rules for subdividing the categories or groupings into a § 245A subgroup and non-§ 245A subgroup for purposes of applying § 904(b)(4). In general, rules under § 904(b)(4) provide that the portion of stock that does not generate income that is included under § 951A(a) or § 951(a)(1) and does not represent income described in § 245(a)(5) (which gives rise to a dividends received deduction under § 245 instead of § 245A) is assigned to the § 245A subgroup.

2. Treatment of Gross Tested Income for Tiers of CFCs.

- (a) The asset method and modified gross income method described in Treas. Reg. § 1.861-12T(c)(3) provide rules to characterize stock in a CFC when there are tiers of CFCs. Under the modified gross income method in Treas. Reg. § 1.861-12T(c)(3)(iii), a taxpayer characterizes the value of the first-tier CFC based on the gross income net of interest expense of the CFC within each relevant separate category. In the case of vertically- owned CFCs, gross income of any higher-tier CFC includes the gross income net of interest expense of any lower-tier CFC, but does not include Subpart F income of any lower-tier CFC. *See* Treas. Reg. § 1.861-9T(j)(2). However, Treas. Reg. § 1.861-12T(c)(3)(iii) provides that for purposes of applying the modified gross income method to characterize CFC stock, the gross income of the first-tier CFC includes the total amount of Subpart F income (net of interest expense apportioned at the level of the CFC that earned the income) of any lower-tier CFC.
- (b) The proposed regulations add similar rules for GILTI inclusions. Prop. Treas. Reg. §§ 1.861-9(j)(2)(ii)(C) and 1.861-12(c)(3)(iii) provide that for purposes of characterizing CFC stock under the modified gross income method, the gross tested income of lower-tier CFCs, net of interest expense apportioned to the tested income, is excluded from the gross income of intermediate-tier CFCs but is included in the gross income of the first-tier CFC.

3. Characterization of Stock of a Noncontrolled 10-Percent Owned Foreign Corporation. The TCJA modified § 904(d)(2)(E) to provide a new definition for a noncontrolled 10-percent owned foreign corporation. The proposed regulations modify Treas. Reg. § 1.861-12(c)(4) to provide that stock in a noncontrolled 10-percent owned foreign corporation is generally characterized under the same rules previously used for noncontrolled § 902 corporations.

G. Allocation and Apportionment of Research and Experimental Expenditures.

- 1. R&E expenditures are apportioned between groupings within product categories according to either a sales or gross income method of apportionment at the taxpayer's election. Treas. Reg. § 1.861-17(c) and (d). Under Treas. Reg. § 1.861-17(e)(1), a taxpayer may choose to use either the sales method or gross income method for its original return for its first taxable year. The taxpayer's use of either method constitutes a binding election to use the method chosen for that year and for the next four years. Within this five-year period, the election can only be revoked with the Service's consent. A taxpayer may change the election at any

time after five years, but the new election is binding for a new five-year period. Treas. Reg. § 1.861-17(e)(2).

2. The proposed regulations provide a one-time exception to the five-year binding election period given the numerous changes to the statute made by the TCJA. Under Prop. Treas. Reg. § 1.861-17(e)(3), even if a taxpayer is subject to the binding election period, for the taxpayer's first taxable year beginning after December 31, 2017, the taxpayer may change its apportionment method without obtaining the Service's consent. This one-time change of method constitutes a binding election to use the method chosen for that year and for the next four taxable years.
3. Treasury and the IRS request comments on whether other aspects of Treas. Reg. § 1.861-17 should be revised in light of the changes to § 904(d), in particular the addition of the § 951A category.
4. For example, because the look-through rules in § 904(d)(3)(C) do not assign interest, rents, or royalties that reduce tested income to the § 951A category, royalties paid by a CFC to a U.S. shareholder are generally general category income even though the sales by the CFC to which the royalties relate may generate income in the § 951A category to the United States shareholder. This could result in R&E expenditures being apportioned under the sales method solely to the § 951A category, even though the royalty income is assigned to the general category.
5. However, under the gross income method, R&E expenditures would be apportioned to both the general and § 951A category.

H. Section 904(b)(4).

1. Effect of § 904(b)(4) on the Foreign Tax Credit Limitation.
 - (a) Under new § 904(b)(4), for purposes of the foreign tax credit limitation in § 904(a), a domestic corporation that is a United States shareholder regarding a specified 10-percent owned foreign corporation disregards the "foreign-source portion" of any dividend received from the foreign corporation and any deductions properly allocable or apportioned to income (other than amounts includible under § 951(a)(1) or § 951A(a)) regarding the stock of the foreign corporation or to the stock itself (to the extent income regarding the stock is other than amounts includible under § 951(a)(1) or § 951A(a)). Dividends and deductions that are disregarded under § 904(b)(4) result in an adjustment to both the taxpayer's foreign source taxable income in the relevant separate category (the numerator of the fraction under § 904(a)) and its worldwide taxable income (the denominator of the fraction under § 904(a)) in all separate categories.

- (b) In general, under § 904(b)(4), disregarding both the dividend income eligible for a deduction under § 245A and the associated deduction under § 245A has no effect on the foreign tax credit limitation in any separate category because they generally net to zero.
- (c) However, additional deductions that are disregarded under § 904(b)(4)(B) generally have the effect of increasing the foreign tax credit limitation regarding the separate category to which the deductions are allocated and apportioned, because both the numerator (foreign source taxable income in the category) and the denominator (worldwide taxable income) of the fraction under § 904(a) are increased by the same amount. In contrast, the limitation in other categories will generally decrease because the numerator is unchanged but the denominator of the fraction is increased.

2. Income Other Than Amounts Includible Under § 951(a)(1) or 951A(a).

- (a) Section 904(b)(4)(B) requires determining what income regarding stock of a specified 10-percent owned foreign corporation is income “other than amounts includible under § 951(a)(1) or § 951A(a).” The terms used in § 904(b)(4) are defined by reference to definitions provided in § 245A.
- (b) Section 864(e)(3) provides that rules regarding other dividends received deductions similar to the exempt income and exempt asset rules apply to the dividends and stock on which the dividends are paid. The TCJA did not extend this treatment to the § 245A deduction but instead added § 904(b)(4). In contrast to § 864(e)(3), which removes the exempt income and assets from the determination before deductions are allocated and apportioned under the rules of Treas. Reg. §§ 1.861-8 through 1.861-17, § 904(b)(4) provides that the deductions are disregarded after they have been allocated and apportioned.
- (c) Disregarding the deductions after they have been allocated and apportioned is consistent with a policy that the deductions are properly allocable and apportioned to income eligible for a § 245A deduction and, therefore, should not be apportioned to income in other separate categories or U.S. source income. By disregarding these deductions, § 904(b)(4) has the effect of computing the foreign tax credit limitation fraction in § 904(a) (but not the pre-credit U.S. tax) as if the deductions had not been allowed.
- (d) The proposed regulations provide that income “other than amounts includible under § 951(a)(1) or § 951A(a)” refers to income for

which a § 245A deduction is allowed. Thus, in the case of § 904(b)(4)(B)(i), Prop. Treas. Reg. § 1.904(b)-3(c)(1) provides that income for which a § 245A deduction is allowed means dividends for which a § 245A deduction is allowed. In the case of § 904(b)(4)(B)(ii), Prop. Treas. Reg. § 1.904(b)-3(c)(1) and (2) provide rules for determining what amount of stock of the foreign corporation corresponds to income that, if distributed, is generally eligible for a § 245A deduction, by subdividing a portion of the stock into a § 245A subgroup and a non-§ 245A subgroup within each separate category.

3. Expenses Properly Allocable to Dividend Income.

- (a) Prop. Treas. Reg. § 1.904(b)-3(a)(1)(ii) provides that deductions “properly allocable” to dividends for which a § 245A deduction is allowed are disregarded. The amount of properly allocable deductions is determined by treating each § 245A subgroup for each separate category as a statutory grouping under Treas. Reg. § 1.861-8(a)(4) for purposes of allocating and apportioning deductions. Only dividend income for which a § 245A deduction is allowed is included in a § 245A subgroup. *See* Treas. Reg. § 1.904(b)-3(b) and (c)(1). Hybrid dividends described in § 245A(e)(4), and dividends on stock regarding which the holding period requirements of § 246(c) are not met, are ineligible for a deduction under § 245A. Thus, the dividends and the deductions allocable or apportioned to them are not disregarded under § 904(b)(4).
- (b) The deductions allocated and apportioned to the § 245A subgroup within each separate category are disregarded under these rules for purposes of determining the foreign source taxable income in the separate category and the entire taxable income included in the fraction under § 904(a) for all separate categories. Deductions allocated and apportioned to the § 245A subgroup within the residual grouping for U.S. source income are disregarded solely for purposes of determining the denominator of the limitation fraction (worldwide taxable income) in the separate categories that have foreign source taxable income. Prop. Treas. Reg. § 1.904(b)-3(a)(2).
- (c) Dividends in the residual grouping for which a § 245A deduction is allowed could include, for example, dividends from a U.S.-owned foreign corporation (as defined in § 904(h)(6)) paid out of U.S. source income that is neither effectively connected income nor dividend income received from a domestic corporation. *See* §§ 245A(c)(3) and 245(a)(5).

- (d) Prop. Treas. Reg. § 1.904(b)-3(b) also provides that the § 245A deduction is always allocated solely to a § 245A subgroup and therefore is always disregarded under § 904(b)(4).

4. Expenses Properly Allocable to Stock.

- (a) To determine the deductions “properly allocable” to stock of a specified 10-percent owned foreign corporation that is in the § 245A subgroup, the stock is first characterized for purposes of allocating and apportioning expenses under Treas. Reg. § 1.861-12 and, if applicable, Treas. Reg. § 1.861-13. In the case of a specified 10-percent owned foreign corporation that is not a CFC, all of the value of its stock is generally in a § 245A subgroup because the stock cannot generate an inclusion under § 951(a)(1) or § 951A(a). Prop. Treas. Reg. § 1.904(b)-3(c)(2).
- (b) If the specified 10-percent owned foreign corporation is a CFC, a portion of the value of stock in each separate category and in the residual grouping for U.S. source income is subdivided between a § 245A and non-§ 245A subgroup under the rules described in Treas. Reg. § 1.861-13(a)(5). The amount of properly allocable deductions is determined by treating the § 245A subgroup for each separate category as a statutory grouping under Treas. Reg. § 1.861-8(a)(4) for purposes of allocating and apportioning deductions based assets, which include the stock.
- (c) PTEP do not affect the amount of expenses that are disregarded under § 904(b)(4). The characterization of stock in a specified 10-percent owned foreign corporation for purposes of § 904(b)(4)(B)(ii) is determined annually by applying the rules in Treas. Reg. § 1.861-12(c), which generally requires applying either the asset method or the modified gross income method. Whether or not the CFC has PTEP, including from prior years or due to § 965, has no bearing on how either method is applied to characterize stock. *See also* Prop. Treas. Reg. § 1.861-12(c)(2)(i)(B)(2).

5. Coordination with OFL/ODL Rules.

- (a) The § 904(b)(4) adjustments apply in computing the foreign tax credit limitation under § 904(a). Thus, Prop. Treas. Reg. § 1.904(b)-3(d) provides that the adjustments under § 904(b)(4), like the adjustments under § 904(b)(2) to account for foreign source capital gain net income and rate differentials, apply before the operation of both the separate limitation loss and overall foreign loss rules in § 904(f) and the overall domestic loss rules in § 904(g). This rule permits loss accounts to be recaptured out of

income that is added to the foreign tax credit limitation calculation by reason of the § 904(b)(4) adjustments.

- I. Foreign Tax Credit Limitation Under Section 904. The proposed regulations update Treas. Reg. §§ 1.904-1 through 1.904-6 (the “§ 904 regulations”) to eliminate deadwood and reflect statutory amendments made to § 904 before the TCJA. For example, Prop. Treas. Reg. §§ 1.904-1 through 1.904-3 reflect the repeal of the overall limitation and per-country limitation. Prop. Treas. Reg. § 1.904-4 reflects statutory amendments made before the TCJA eliminating various separate categories described in § 904(d)(1). The proposed regulations also propose revisions and additions to the § 904 regulations to reflect the changes made under the TCJA.
- J. Transition Rules in Prop. Treas. Reg. §§ 1.904-2(j) and 1.904(f)-12(j) Accounting for the Increase in § 904(d)(1) Separate Categories.
 1. Carryovers and Carrybacks of Unused Foreign Taxes under § 904(c).
 - (a) The TCJA does not provide any transition rules for assigning carryforwards of unused foreign taxes earned in pre-2018 taxable years to a different separate category, including the new post-2017 separate categories for § 951A category income and foreign branch category income. Therefore, Prop. Treas. Reg. § 1.904-2(j)(1)(ii) provides that if unused foreign taxes paid or accrued or deemed paid regarding a separate category of income are carried forward to a taxable year beginning after December 31, 2017, those taxes are allocated to the same post-2017 separate category as the pre-2018 separate category from which the unused foreign taxes are carried.
 - (b) However, double taxation may result if unused foreign taxes paid, accrued, or deemed paid in a pre-2018 taxable year are not assigned to the separate category to which the taxes would have been assigned if the new post-2017 separate categories had existed in the pre-2018 taxable year. This could arise, for example, if unused foreign taxes imposed on income derived through foreign branches in a pre-2018 taxable year are not associated with foreign branch category income. Matching the unused foreign taxes to the separate category that includes income of the same type as the income on which the taxes were imposed furthers the purpose of the § 904(c) foreign tax credit carryover rules to mitigate the effect of timing differences in the recognition of income for U.S. and foreign tax purposes that could otherwise result in double taxation.
 - (c) Therefore, Prop. Treas. Reg. § 1.904-2(j)(1)(iii) provides an exception that permits taxpayers to assign unused foreign taxes in the pre-2018 separate category for general category income to the post-2017 separate category for foreign branch category income to

the extent they would have been assigned to that separate category if the taxes had been paid or accrued in a post-2017 taxable year. Any remaining unused taxes are assigned to the post-2017 separate category for general category income. The exception applies only to unused taxes that were paid or accrued, and not taxes that were deemed paid regarding dividends or inclusions from foreign corporations, because income derived through foreign corporations cannot be foreign branch category income.

- (d) The new post-2017 separate category for foreign branch category income does not include income that would have been passive category income or income in a separate category described in Prop. Treas. Reg. § 1.904-4(m) that is not listed in § 904(d)(1) (a “specified separate category”) if earned in a pre-2018 taxable year. Thus, the exception in Prop. Treas. Reg. § 1.904-2(j)(1)(iii) applies only to unused foreign taxes that were paid or accrued regarding income in the pre-2018 separate category for general category income.
- (e) Further, the determination of taxable income in the § 951A category is intertwined with numerous other new provisions in the Code outside of § 904 that contain novel elements (such as the § 250 deduction and the new inclusion rules in § 951A that permit the sharing of tested losses among CFCs) that did not exist under prior law. Thus, it is not possible to reconstruct the amount of unused foreign taxes in a pre-2018 taxable year that would have been assigned to § 951A category income. Therefore, the reallocation exception in the proposed regulations does not require or allow taxpayers to assign any unused foreign taxes to the post-2017 separate category for § 951A category income, which is not eligible to be sheltered from U.S. tax by foreign tax credit carryovers. *See* § 904(c).
- (f) The proposed regulations require taxpayers applying the exception in Prop. Treas. Reg. § 1.904-2(j)(1)(iii) to analyze general category income earned in prior years in order to determine the extent to which the income would have been foreign branch category income under the rules described in Prop. Treas. Reg. § 1.904-4(f). Unused foreign taxes in the general category arising in those prior years are then allocated and apportioned under § 1.904-6 between the general category and the foreign branch category. This analysis does not require applying any other post-TCJA provisions to prior years (for example, the new expense allocation rules described in the proposed regulations would not be relevant to the analysis).

- (g) Taxpayers could face difficulties in reconstructing the allocation of unused foreign taxes. Therefore, Treasury and the IRS request comments on whether the final regulations should include a simplified rule for taxpayers that choose to reconstruct the allocation of general category unused foreign taxes (for example, by looking to the relative amounts of foreign branch category and general category income or assets in the first post-2017 taxable year to which the unused foreign taxes are carried), what form such a rule should take, and whether there are any special concerns regarding members that have left a consolidated group. *See*, for example, Treas. Reg. § 1.904-7(f)(4)(ii).
- (h) Income included in the post-2017 separate category for foreign branch category income would have been general category income if earned in a pre-2018 taxable year. All income included in the post-2017 separate categories for general category income, passive category income, or income in a specified separate category would have been treated as general category income, passive category income, or income in a specified separate category, respectively, if earned in a pre-2018 taxable year.
- (i) Thus, Prop. Treas. Reg. § 1.904-2(j)(2)(ii) and (iii) provides that any unused foreign taxes regarding general category income or foreign branch category income in a post-2017 taxable year that are carried back to a pre-2018 taxable year are allocated to the pre-2018 separate category for general category income, and any excess foreign taxes with respect to passive category income or income in a specified separate category in a post-2017 taxable year that are carried back to a pre-2018 taxable year are allocated to the same pre-2018 separate category. The proposed regulations do not include rules regarding the post-2017 separate category for § 951A category income because carrybacks are not allowed for unused foreign taxes in that separate category.

2. Separate Limitation Losses, Overall Foreign Losses, and Overall Domestic Losses.

- (a) The proposed regulations provide transition rules for recapture in a post-2017 taxable year of an overall foreign loss (OFL) or separate limitation loss (SLL) in a pre-2018 separate category that offset U.S. source income or income in another pre-2018 separate category, respectively, in a pre-2018 taxable year, as well as for recapture of an overall domestic loss (ODL) that offset income in a pre-2018 separate category in a pre-2018 taxable year.
- (b) Prop. Treas. Reg. § 1.904(f)-12(j) provides that any SLL or OFL accounts in the pre-2018 separate category for passive category

income or income in a specified separate category remain in the same post-2017 separate category. Any SLL or OFL account in the pre-2018 separate category for general category income is allocated between the post-2017 separate categories for general category income and foreign branch category income in the same proportion that any unused foreign taxes regarding the pre-2018 separate category for general category income are allocated to those post-2017 separate categories.

- (c) Therefore, in the case of a taxpayer that does not apply the exception described in Prop. Treas. Reg. § 1.904-2(j)(1)(iii), all of its SLL or OFL accounts in the pre-2018 separate category for general category income remain in the general category. In addition, if there were no unused foreign taxes in the pre-2018 general category to be allocated, Prop. Treas. Reg. § 1.904(f)-12(j)(3)(i) provides that all SLL or OFL accounts in the pre-2018 separate category for general category income remain in the general category.
- (d) Similar rules are provided regarding the recapture of SLLs or ODLs that reduced income in a separate category in a pre-2018 taxable year, as well as for foreign losses that are part of a net operating loss that is incurred in a pre-2018 taxable year and carried forward to post-2017 taxable years.

3. Separate Categories of Income.

- (a) Treatment of Export Financing Interest, High-taxed Income, and Financial Services Income.
 - i. Under § 904(d)(2)(B)(iii), passive income does not include export financing interest and high-taxed income. Before the TCJA, the only separate category described in § 904(d)(1) aside from passive category income was general category income, and therefore Treas. Reg. §§ 1.904-4(c) and (h)(2) treated export financing interest and high-taxed income as general category income.
 - ii. Given the expansion of categories under § 904(d)(1) to include foreign branch category and § 951A category income, and the fact that § 904(d)(2)(B)(iii) only provides that export financing interest and high-taxed income are not passive income, the proposed regulations provide that export financing interest and high-taxed income should be categorized based on whether the income otherwise meets the definition of foreign branch category income, § 951A category income, or general category income. Therefore,

the proposed regulations revise Treas. Reg. § 1.904-4(c) and (h)(2) to provide that export financing interest and high-taxed income are assigned to separate categories other than passive category income based on the general rules in Treas. Reg. § 1.904-4.

- iii. To coordinate the high-taxed income rules of § 904(d)(2)(F) with the new rules for computing foreign income taxes deemed paid under § 960, the proposed regulations revise the grouping rules of Treas. Reg. § 1.904-4(c)(4) to group passive category income from dividends, Subpart F and GILTI inclusions from each foreign corporation, and passive category income derived from each foreign qualified business unit (QBU), under the grouping rules in Treas. Reg. § 1.904-4(c)(3) rather than by reference to the source of the corporation's or QBU's income. Treasury and the IRS request comments on whether additional changes should be made to the high-taxed income rules in Treas. Reg. § 1.904-4(c) in light of changes to § 904(d) made by the TCJA.
- iv. Both before and after the TCJA, § 904(d)(2)(C)(i) provides that certain financial services income is treated as general category income. However, the TCJA's addition of foreign branch category and § 951A category income, which are new and more specific categories, take precedence over the treatment of financial services income as general category income. Therefore, the proposed regulations provide that any financial services income not treated as foreign branch category income or § 951A category income is generally treated as general category income. *See* Prop. Treas. Reg. § 1.904-4(e).
- v. The proposed regulations do not include any substantive changes to the definition of financial services entity in Treas. Reg. § 1.904-4(e)(3). The current classification of an entity as a financial services entity is generally unaffected by the changes made by the proposed regulations to the look-through rules in Treas. Reg. § 1.904-5. However, Treasury and the IRS are considering modifications to the gross income-based test for determining financial services entity status and request comments in this regard, particularly with respect to the appropriate treatment of related party payments.

K. Foreign Branch Category Income.

1. Gross Income in the Category.

- (a) Section 904(d)(1)(B) provides a *new* separate category for foreign branch category income, which is defined in § 904(d)(2)(J) as the business profits of a United States person attributable to a qualified business unit (QBU) in a foreign country (excluding passive category income). Section 904(d)(1)(B) further provides that the amount of business profits attributable to a QBU is determined under rules established by Treasury.
- (b) Section 904(d)(2)(J) limits foreign branch income to income of a United States person. Therefore, foreign persons (including CFCs) cannot have foreign branch category income. While a domestic partnership (or other pass-through entity) that is a United States person may earn income that is attributable to a foreign branch of such partnership, a distributive share of income earned by a domestic partnership cannot be foreign branch category income to foreign partners of the partnership. To avoid any conflict, the proposed regulations define foreign branch category income as the gross income of a United States person (other than a pass-through entity).
- (c) Prop. Treas. Reg. § 1.904-4(f)(1)(i) provides that foreign branch category income means the gross income of a United States person (other than a pass-through entity) that is attributable to foreign branches held directly or indirectly through disregarded entities by the United States person. Foreign branch category income also includes a United States person's (other than a pass-through entity) distributive share of partnership income that is attributable to a foreign branch held by the partnership directly or indirectly through another partnership or other pass-through entity. Similar principles apply for income of any other type of pass-through entity that is attributable to a foreign branch. All the income described is aggregated in a single foreign branch category. There are no separate categories for each foreign branch. Conforming changes are made to the rules for allocating and apportioning partnership deductions and creditable foreign tax expenditures. *See* Prop. Treas. Reg. §§ 1.861-9(e)(9) and 1.904-6(b)(4)(ii).
- (d) Gross income is attributable to a foreign branch to the extent it is reflected on a foreign branch's separate set of books and records. For this purpose, items of gross income must be adjusted to conform to Federal income tax principles. The proposed regulations also provide several rules adjusting the gross income

attributable to a foreign branch from what is reflected on the foreign branch's separate set of books and records.

- (e) First, the proposed regulations provide that gross income attributable to a foreign branch does not include items arising from activities carried out in the United States. Prop. Treas. Reg. § 1.904-4(f)(2)(ii).
- (f) Second, the proposed regulations provide that gross income attributable to a foreign branch does not include items of gross income arising from stock, including dividend income, income included under §§ 951(a)(1), 951A(a), or 1293(a) or gain from the disposition of stock. Prop. Treas. Reg. § 1.904-4(f)(2)(iii)(A); compare Treas. Reg. § 1.987-2(b)(2) (providing a similar rule in connection with attribution of items of income, gain, deduction, or loss to a § 987 QBU). An exception is provided for gain from the disposition of stock, in which the stock would be dealer property. Prop. Treas. Reg. § 1.904-4(f)(2)(iii)(B).
- (g) Third, the proposed regulations provide that foreign branch category income does not include gain realized by a foreign branch owner on the disposition of an interest in a disregarded entity or an interest in a partnership or other pass-through entity. Prop. Treas. Reg. § 1.904-4(f)(2)(iv)(A). However, an exception is provided for the sale of a partnership interest if the gain is reflected on the books and records of a foreign branch and the interest is held in the ordinary course of the foreign branch owner's trade or business. Prop. Treas. Reg. § 1.904-4(f)(2)(iv)(B).
- (h) Fourth, the proposed regulations provide anti-abuse rules relating to the reflection of income on the books and records of a branch. They provide for the reattribution of gross income if a principal purpose of recording, or failing to record, an item on the books and records of a foreign branch avoiding Federal income tax or avoiding the purposes of § 904 or § 250. Prop. Treas. Reg. § 1.904-4(f)(2)(v). The rule further provides a presumption that interest income received by a foreign branch from a related party is not gross income attributable to the foreign branch unless the interest income meets the definition of financial services income.
- (i) Finally, to accurately reflect the gross income attributable to a foreign branch, a determination that affects not only the application of § 904(a) but also the determination of deduction eligible income under § 250(b)(3)(A), the proposed regulations provide that gross income attributable to a foreign branch that is not passive category income must be adjusted to reflect certain transactions that are

disregarded for Federal income tax purposes. Prop. Treas. Reg. § 1.904-4(f)(2)(vi).

- (j) This rule applies to transactions between a foreign branch and its foreign branch owner, as well as transactions between or among foreign branches, involving payments that would be deductible or capitalized if the payment were regarded for Federal income tax purposes. For example, a payment made by a foreign branch to its foreign branch owner may, to the extent allocable to non-passive category income, result in a downward adjustment to the gross income attributable to the foreign branch and an increase in the general category gross income of the United States person. Each payment in a series of disregarded back-to-back payments, for example, a payment from one foreign branch to another foreign branch followed by a payment to the foreign branch owner, must be accounted for separately under these rules.
- (k) Comments are requested on whether special rules are required in the case of a true branch (generally, a branch that is taxable solely on profits from a business conducted in the country and not taxable as a resident of that country) regarding amounts that are deemed to be made to or from the home office of the branch under the foreign jurisdiction's rules for attributing profits to the branch.
- (l) In general, the proposed regulations do not treat disregarded transactions as "regarded" for Federal income tax purposes; rather, they provide that certain disregarded transactions result in a redetermination of whether gross income of the U.S. person is attributable to its foreign branch or to the foreign branch owner.
- (m) Thus, while disregarded transactions may allocate income between the foreign branch category and the general category, those transactions have no effect on the amount, character, or source of a United States person's gross income. U.S. source gross income that is reallocated from the general category to the foreign branch category and that is properly subject to foreign tax may be eligible to be treated as foreign source income under the terms of an income tax treaty, in which case the resourced income would be subject to a separate foreign tax credit limitation for income resourced under a tax treaty. *See* § 904(d)(6).
- (n) The proposed regulations provide an exception from the special rules regarding disregarded transactions that applies to contributions, remittances, and payments of interest (including certain interest equivalents). Prop. Treas. Reg. § 1.904-4(f)(2)(vi)(C). Generally, contributions, remittances, and interest payments to or from a foreign branch reflect a shift of, or return

on, capital rather than a payment for goods and services. However, the different treatment of contributions and remittances, on the one hand, and other disregarded transactions, on the other, could allow for non-economic reallocations of the amount of gross income attributable to the foreign branch category.

- (o) They also require the amount of gross income attributable to a foreign branch (and the amount attributable to the foreign branch owner) to be adjusted to account for consideration that would be due in any disregarded transactions in which property described in § 367(d)(4) is transferred to or from a foreign branch if the transactions were regarded, whether or not a disregarded payment is made in connection with the transfer. Prop. Treas. Reg. § 1.904-4(f)(2)(vi)(D). The proposed regulations further require that the amount of any adjustment under the disregarded payment provisions must be determined under the arm's length principle of § 482 and the regulations under that section. Prop. Treas. Reg. § 1.904-4(f)(2)(vi)(E).
- (p) Treasury and the IRS did not propose any special rules for determining the amount of deductions allocated and apportioned to foreign branch category income, including deductions reflected on the books and records of foreign branches. Therefore, the proposed regulations provide that the rules for allocating and apportioning deductions in Treas. Reg. §§ 1.861-8 through 1.861-17 that apply with respect to the other separate categories also apply to the foreign branch category.

2. Definition of a Foreign Branch.

- (a) The proposed regulations define a foreign branch by reference to the regulations under § 989 (“§ 989 regulations”) by providing that a foreign branch is a QBU described in Treas. Reg. § 1.989(a)-1(b)(2)(ii) and (b)(3) that carries on a trade or business outside the United States. Prop. Treas. Reg. § 1.904-4(f)(3)(iii). In general, Treas. Reg. § 1.989(a)-1(b)(2)(ii) provides rules for treating activities of a branch of a taxpayer as a QBU. Specifically, it provides that the activities of a corporation, partnership, trust, estate, or individual qualify as a separate QBU if the activities constitute a trade or business, and a separate set of books and records is maintained regarding the activities. Treas. Reg. § 1.989(a)-1(b)(3) includes a special rule treating activities generating income effectively connected with the conduct of a trade or business as a separate QBU. A partnership can give rise to a foreign branch without a separate set of branch books and records.

(b) Prop. Treas. Reg. § 1.904-4(f)(4) Ex. 1 provides:

Example 1: Determination of foreign branches and foreign branch owner--(A) Facts--(1) P, a domestic corporation, is a partner in PRS, a domestic partnership. All other partners in PRS are unrelated to P. PRS conducts activities solely in Country A (the Country A Business), and those activities constitute a trade or business outside the United States. PRS reflects items of income, gain, loss, and expense of the Country A Business on the books and records of PRS's home office. PRS's functional currency is the U.S. dollar. PRS is in the business of manufacturing bicycles.

(2) PRS owns FDE1, a disregarded entity organized in Country B. FDE1 conducts activities in Country B (the Country B Business), and those activities constitute a trade or business outside the United States. FDE1 maintains a set of books and records that are separate from those of PRS, and the separate set of books and records reflects items of income, gain, loss, and expense with respect to the Country B Business. Country B Business's functional currency is the U.S. dollar. FDE1 is in the business of selling bicycles manufactured by PRS.

(3) FDE1 owns FDE2, a disregarded entity organized in Country C. FDE2 conducts activities in Country C (the Country C Business), and those activities constitute a trade or business outside the United States. FDE2 maintains a set of books and records that are separate from those of PRS and FDE1, and the separate set of books and records reflects items of income, gain, loss, and expense with respect to the Country C Business. Country C Business's functional currency is the U.S. dollar. FDE2 sells paper. FDE2's paper business is not related to FDE1's bicycle sales business, and FDE1 does not hold its interest in FDE2 in the ordinary course of its trade or business.

(B) Analysis--(1) Country A Business's activities comprise a trade or business conducted outside the United States within the meaning of Treas. Reg. § 1.989(a)-1(b)(2)(ii)(A) and (b)(3) (in each case, as modified by paragraph (f)(3)(iii) of this section). PRS does not maintain a separate set of books and records with respect to the Country A Business. However, the Country A Business's activities are deemed to satisfy the requirement of Treas. Reg. § 1.989(a)-1(b)(2)(ii)(B) that a QBU maintain a separate set of books and records with respect to the relevant activities.

Thus, the activities of the Country A Business constitute a QBU as defined in Treas. Reg. § 1.989-1(b)(2)(ii) and (b)(3), as modified by paragraph (f)(3)(iii) of this section, that conducts a trade or business outside the United States. Accordingly, the activities of the Country A Business constitute a foreign branch within the meaning of this section. PRS, the person that owns the Country A Business,

is the foreign branch owner, within the meaning of this section, with respect to the Country A Business.

(2) Country B Business's activities comprise a trade or business outside the United States within the meaning of § 1.989(a)-1(b)(2)(ii)(A) and (b)(3) (in each case, as modified by this section). PRS maintains a separate set of books and records with respect to the Country B Business, as described in Treas. Reg. § 1.989(a)-1(b)(2)(ii)(B). Thus, for purposes of this section, the activities of the Country B Business constitute a QBU as defined in Treas. Reg. § 1.989-1(b)(2)(ii) and (b)(3), as modified by paragraph (f)(3)(iii) of this section, that conducts a trade or business outside the United States.

(3) Accordingly, the activities of the Country B Business constitute a foreign branch. PRS, the person that owns the Country B Business indirectly through FDE1 (a disregarded entity), but not including the activities of PRS that constitute the Country A business, is the foreign branch owner with respect to the Country B Business.

(4) The same analysis that applies to the Country B Business applies to the Country C Business. Accordingly, the activities of the Country C Business constitute a foreign. PRS, the person that owns the Country C Business indirectly through FDE1 and FDE2 (disregarded entities), but not including the activities of PRS that constitute the Country A Business, is the foreign branch owner with respect to the Country C Business.

- (c) The § 989 regulations treat partnerships and trusts as *per se* QBUs. See Treas. Reg. § 1.989(a)-1(b)(2)(i). As a result, they do not include a rule treating the activities of a partnership or trust that constitute a trade or business, but for which a separate set of books and records is not maintained, as a QBU. For example, Treas. Reg. § 1.989(a)-1(b)(2)(ii) would not treat the activities of a partnership QBU as a QBU if no separate set of books is maintained regarding the activities.
- (d) The proposed regulations' definition of foreign branch does not incorporate the § 989 regulations' *per se* QBU rules, and instead requires that a foreign branch carry on a trade or business. This is to ensure that foreign branch category income does not include income reflected on the books and records of a QBU unless the QBU conducts a trade or business. The proposed regulations also include a special rule, as illustrated by an example, providing that a foreign branch may consist of activities conducted through a partnership or trust that constitute a trade or business conducted outside the United States, but for which no separate set of books

and records is maintained. *See* Prop. Treas. Reg. § 1.904-4(f)(4)(i), Example 1.

- (e) The proposed regulations also modify the trade or business requirements in the § 989 regulations for purposes of the foreign branch definition. Specifically, to constitute a foreign branch, a QBU must carry on a trade or business outside the United States. For this purpose, activities that constitute a permanent establishment in a foreign country under a bilateral U.S. tax treaty, whether or not the activities also rise to the level of a separate trade or business, are presumed to constitute a trade or business. *See* Prop. Treas. Reg. § 1.904-4(f)(3)(iii)(B).
- (f) Under Treas. Reg. § 1.989(a)-1(c), for activities to constitute a trade or business, they must ordinarily include the collection of income and the payment of expenses. The proposed regulations provide that, for purposes of determining whether a set of activities satisfy the trade or business requirement of Treas. Reg. § 1.989(a)-1(c) in the context of the definition of a foreign branch, activities that relate to disregarded transactions are taken into account and may give rise to a trade or business for this purpose. *See* Prop. Treas. Reg. § 1.904-4(f)(3)(iii)(B).

L. Section 951A Category Income.

- 1. Section 904(d)(1)(A) provides that “any amount includible in gross income under § 951A (other than passive category income)” is a separate category of income. Consistent with this language, Prop. Treas. Reg. § 1.904-4(g) provides that the gross income included in the § 951A category is generally the gross income of a United States shareholder from a GILTI inclusion. However, a GILTI inclusion that is allocable to passive category income under the look-through rules in Treas. Reg. § 1.904-5(c)(6) is excluded from § 951A category income. A passive category GILTI inclusion could arise, for example, from a CFC’s distributive share of partnership income in which the CFC owns less than 10 percent of the value in the partnership. *See* Prop. Treas. Reg. § 1.904-4(n)(1)(ii).
- 2. The proposed regulations also amend Treas. Reg. § 1.904-2(a) to reflect the exclusion of foreign tax credit carryovers under § 904(c) for foreign taxes paid or accrued with respect to § 951A category income or with respect to § 951A category income that is treated as income in a separate category for income resourced under a tax treaty.

M. Items Resourced Under a Treaty. Section 904(d)(6) provides that if, without regard to any treaty obligation of the United States, any item of income would be treated as derived from sources within the United States, under a treaty obligation

of the United States the item of income would be treated as arising from sources outside the United States, and the taxpayer chooses the benefits of the treaty obligation to treat the income as arising from sources outside the United States, then subsections 904(a), (b), and (c) and §§ 907 and 960 shall be applied separately to each item. Thus, § 904(d)(6)(A) applies a separate foreign tax credit limitation to each item of resourced income, without regard to the separate category to which the item would otherwise be assigned.

1. Grouping Methodology.

- (a) Prop. Treas. Reg. § 1.904-4(k)(2) adopts a grouping methodology similar to that employed in Treas. Reg. § 1.904-5(m)(7) regarding income treated as in a separate category under the separate treaty resourcing rules of § 904(h)(10). Under the proposed regulations, the taxpayer must segregate income treated as foreign source under each treaty and then compute a separate foreign tax credit limitation for income in each separate category that is resourced under that treaty.
- (b) For purposes of allocating foreign taxes to each grouping of § 904(d)(6) income, the principles of Treas. Reg. § 1.904-6 apply to allocate to the § 904(d)(6) separate category all foreign income taxes related to the income included in that group, including taxes imposed by a third country. Treasury and the IRS are considering whether the regulations should provide a special rule limiting the tax assigned to a § 904(d)(6) separate category to tax paid to the foreign country that is a party to the income tax treaty under which the income is resourced, and request comments on this issue.

2. Coordination with Certain Treaty and Code Provisions.

- (a) Some U.S. income tax treaties contain provisions for the tax treatment in both Contracting States of certain types of income derived from sources within the United States by U.S. citizens who are residents of the other Contracting State.
- (b) These rules generally use a three-step approach to determine the U.S. citizen's ultimate U.S. income tax liability with respect to an applicable item of income. First, the other Contracting State provides a credit against its tax for the notional U.S. tax that would apply under the treaty to a resident of the other Contracting State who is not a U.S. citizen. Second, the United States provides a credit against U.S. tax for the income tax paid or accrued to the other Contracting State after the application of the credit for notional U.S. tax by the other Contracting State. Finally, the income is deemed to arise in the other Contracting State to the extent necessary to avoid double taxation under these rules.

- (c) These treaty rules are generally designed to preserve the United States' primary right to tax U.S. source income and to resource only enough income to allow a taxpayer to claim a credit for the related foreign taxes, as reduced by the notional credit for U.S. source-based tax.
- (d) Although excess foreign tax credits may arise from the operation of these rules, excess limitation permitting the use of unrelated foreign tax credits to offset the U.S. tax on the resourced income generally cannot. Since U.S. citizens subject to these provisions generally cannot generate excess limitation, and it would be burdensome to subject individuals to the operation of § 904(d)(6) when they are already subject to the three-step treaty rule, the proposed regulations exclude the income of these individuals from the operation of § 904(d)(6).
- (e) Accordingly, Prop. Treas. Reg. § 1.904-4(k)(4)(i) provides that income resourced under the relief from double taxation provisions in U.S. income tax treaties that are solely applicable to U.S. citizens who are residents of the other Contracting State is not subject to § 904(d)(6)(A) and § 1.904-4(k)(1).
- (f) In addition, under the mutual agreement procedures of U.S. income tax treaties, U.S. taxpayers may request assistance from the U.S. competent authority, such as for the relief of double taxation in cases not provided for in the treaty. Where the U.S. competent authority agrees to grant relief to a taxpayer that involves resourcing, the taxpayer has effectively chosen the benefit of a treaty obligation of the United States to treat the item of income as foreign source. Accordingly, Prop. Treas. Reg. § 1.904-4(k)(4)(ii) clarifies that § 904(d)(6) separate category treatment applies to items of income resourced pursuant to a competent authority agreement.

N. Section 78 Gross Up and Section 986(c) Gain or Loss.

1. Taxpayers were concerned about the separate category to which the gross up described in § 78 attributable to foreign taxes deemed paid under § 960(d) should be assigned. Consistent with prior Treasury and IRS statements, Prop. Treas. Reg. § 1.904-4(o) provides a rule consistent with existing Treas. Reg. § 1.904-6(b)(3) that assigns the § 78 gross up to the same separate category as the deemed paid taxes. A Technical Correction would provide for this result. *See* Section XI.
2. Prop. Treas. Reg. § 1.904-4(p) also provides a rule assigning gain or loss under § 986(c) with respect to a distribution of previously taxed earnings and profits to the separate category from which the distribution was made.

- (a) This can result in § 986(c) currency gain or loss going into the general, passive or GILTI § 904 baskets, except that under Notice 2019-01, § 965 PTEP is first in the order of priority when PTEP is distributed.
- (b) Section 986(c) gain or loss arising from distributions of § 965 PTEP will be in the general and passive baskets. Further, § 965 PTEP will have a reduced § 986(c) content.
- (c) Only after that will § 986(c) gain or loss go into the GILTI basket.
- (d) *See* Section VIII.F.

O. Noncontrolled 10-percent Foreign Corporation.

- 1. Under § 904(d)(2)(E), as amended by the TCJA, the term “noncontrolled § 902 corporation” has been revised to “noncontrolled 10-percent owned foreign corporation.” The definition has also been amended to reflect the repeal of § 902, but maintains pre-Act rules for when a taxpayer meets the requisite stock ownership with respect to a passive foreign investment company (“PFIC”). The proposed regulations update the references in the § 904 regulations to noncontrolled § 902 corporations to reflect the revised statutory term and definition.
- 2. The ownership requirement for PFICs differs from the United States shareholder requirement that generally applies to a noncontrolled 10-percent owned foreign corporation described in § 904(d)(2)(E)(i)(I). Prop. Treas. Reg. § 1.904-5(a)(4)(vi) provides that for purposes of the regulations under § 904, any reference to a United States shareholder in the context of a noncontrolled 10-percent owned foreign corporation also includes a taxpayer that meets the stock ownership requirements described in § 904(d)(2)(E)(i)(II), even if the taxpayer is not a United States shareholder within the meaning of § 951(b).

P. Look-Through Rules.

- 1. Before amendments made by the TCJA, § 904(d)(3) generally provided that dividends, interest, rents, and royalties (“look-through payments”) received or accrued by a taxpayer from a CFC in which the taxpayer is a United States shareholder were treated as income in the separate category to which the payment was allocable. Section 904(d)(4) provided similar look-through rules for dividends from noncontrolled § 902 corporations. The TCJA reduced the number of separate categories from nine to two, and revised § 904(d)(3).
- 2. Under § 904(d)(3)(A) as amended by the TCJA, except as otherwise provided by § 904(d)(3), dividends, interest, rents, and royalties received or accrued by a taxpayer from a CFC in which the taxpayer is a United

States shareholder are not treated as passive category income. Exceptions are provided when the payment is allocable to passive category income. However, the existing regulations under Treas. Reg. § 1.904-5 were largely unchanged after the TCJA amendments and retained the pre-TCJA approach to assigning dividends, interest, rents, and royalties based on the separate category of the income to which the payment was allocable.

3. The TCJA added two new separate categories to § 904(d)(1) but made no changes to the look-through rules in § 904(d)(3) and (4). In addition, the legislative history does not provide any indication of how the look-through rules were intended to operate with the addition of the new separate categories.
4. The proposed regulations provide that the look-through rules under § 904(d)(3) provide look-through treatment solely for payments allocable to the passive category. Any other payments described in § 904(d)(3) are assigned to a separate category other than the passive category based on the general rules in Treas. Reg. § 1.904-4. Therefore, Prop. Treas. Reg. § 1.904-5 revises the various look-through rules to reflect their application of look-through rules solely regarding payments allocable to passive category income. Dividends, interest, rents, or royalties paid from a CFC to a United States shareholder thus are not assigned to a separate category (other than the passive category) under the look-through rules, but are assigned to the foreign branch category, a specified separate category described in Prop. Treas. Reg. § 1.904-4(m), or the general category under the rules of Prop. Treas. Reg. § 1.904-4(d).
5. Consistent with the general rule for look-through payments, § 904(d)(3)(B) assigns amounts included under § 951(a)(1)(A) (“Subpart F inclusions”) to the passive category to the extent the inclusion is attributable to passive category income. Under the authority of § 951A(f)(1)(B), the proposed regulations treat GILTI inclusions in the same manner as Subpart F inclusions for purposes of § 904(d)(3)(B). Therefore, Prop. Treas. Reg. § 1.904-5(c)(6) provides that GILTI inclusions are treated as passive category income to the extent the amount so included is attributable to income received or accrued by the CFC that is passive category income.
6. Under the proposed regulations, the look-through rules also do not apply to treat deductible payments made by a foreign branch that are allocable to foreign branch category income (for example, payments made by a foreign disregarded entity that constitutes a foreign branch to a related look-through entity) as foreign branch category income. Instead, the rules of Treas. Reg. § 1.904-4 apply to characterize the income in the hands of the recipient.

7. Finally, because of the proposed revisions to Treas. Reg. § 1.904-5 that limit the look-through rules generally to passive category income, the proposed regulations include a rule addressing income subject to the separate category required under § 901(j)(1)(B). These rules ensure that income from sources within countries described in § 901(j)(2) that is paid or accrued through one or more entities retains its source and therefore continues to be subject to the separate category described in § 901(j)(1)(B). *See* Prop. Treas. Reg. § 1.901(j)-1(a).

Q. Allocation and Apportionment of Foreign Taxes.

1. Special Rule for Base and Timing Differences.

- (a) Section 904(d)(2)(H)(i) and Treas. Reg. § 1.904-6(a)(1)(iv) provide a special rule for allocating foreign tax that is imposed on an amount that does not constitute income under Federal income tax principles (a “base difference”). Prop. Treas. Reg. § 1.904-6(a)(1)(iv) also provides special rules for timing differences.
- (b) The proposed regulations clarify that base differences arise only in limited circumstances, such as in the case of categories of items such as life insurance proceeds or gifts, which are excluded from income for Federal income tax purposes but may be taxed as income under foreign law. In contrast, a computational difference attributable to differences in the amounts, as opposed to the types, of items included in U.S. taxable income and the foreign tax base does not give rise to a base difference. *See* Prop. Treas. Reg. § 1.904-6(a)(1)(iv). For example, a difference between U.S. and foreign tax law in the amount of deductions that are allowed to reduce gross income, like a difference in depreciation conventions or in the timing of recognition of gross income, is not considered to give rise to a base difference.
- (c) In addition, the proposed regulations clarify that the fact that a distribution of previously taxed earnings and profits is exempt from Federal income tax does not mean that a tax imposed on the distribution is attributable to a base difference. Instead, because the PTEP was included in U.S. taxable income in a prior year, the tax imposed on the distribution is treated as attributable to a timing difference and is allocated to the separate category to which the earnings and profits from which the distribution was paid are attributable.

2. Taxes Imposed in Connection with Foreign Branches.

- (a) Treas. Reg. § 1.904-6(a) generally provides that foreign taxes are allocated and apportioned to separate categories by reference to the

separate category of the income to which the foreign tax relates. Disregarded transactions between a foreign branch and the United States owner of the foreign branch (or between two foreign branches of the same United States person) may involve disregarded payments that are subject to foreign tax, including disregarded payments that result in the reallocation of gross income between the foreign branch category and the general category under the proposed regulations in Prop. Treas. Reg. § 1.904-4(f)(2)(vi). See Prop. Treas. Reg. § 1.904-4(f).

- (b) While existing regulations under Treas. Reg. § 1.904-6(a) provide general rules for allocating and apportioning foreign taxes imposed with respect to income of a foreign branch, Prop. Treas. Reg. § 1.904-6(a)(2) provides special rules to coordinate the existing regulations under Treas. Reg. § 1.904-6(a)(1) with the computation of foreign branch category income in Prop. Treas. Reg. § 1.904-4(f).
- (c) The proposed regulations are consistent with the general principles and purpose of Treas. Reg. § 1.904-6(a)(1) and are intended to provide clarity where the application of these principles would be difficult or uncertain.

3. Taxes Deemed Paid Under Section 960. Treas. Reg. § 1.904-6(b) would be revised to reflect the TCJA's repeal of § 902 and revisions to § 960. In general, the proposed regulations provide that foreign income taxes deemed paid under § 960(a) or (d) are allocated to the same separate category to which the related §§ 951(a)(1) or 951A(a) inclusion is assigned. Similarly, in the case of a distribution of previously taxed earnings and profits described in § 960(b)(1) or (2), any foreign tax deemed paid with respect to the distribution under § 960(b) is allocated to the separate category to which the distribution is attributable.

4. Creditable Foreign Tax Expenditures. A U.S. or foreign partnership does not characterize any of its income as foreign branch category income. Instead, a distributive share of a partnership's income may be characterized as foreign branch category income in the hands of certain U.S. partners. In order to ensure that creditable foreign tax expenditures (CFTEs) that are allocated to a partner that has a distributive share of income that is assigned to the foreign branch category are appropriately assigned, Prop. Treas. Reg. § 1.904-6(b)(4) provides rules for allocating and apportioning CFTEs to the foreign branch category.

R. Treatment of Subsequent Reductions in Tax in Applying § 954(b)(4).

- 1. Certain jurisdictions that have a type of integration regime in which all or substantially all of the corporate income tax paid by the CFC on its

earnings is refunded to its shareholder when the earnings are distributed, even though the shareholder is not subject to any foreign tax on the distribution. Treasury and the IRS are concerned that these taxpayers might rely on the rules in Treas. Reg. § 1.954-1(d)(3), which provide that a subsequent reduction in corporate foreign income taxes when earnings are later distributed to a shareholder does not affect the amount of foreign income taxes used to compute the effective tax rate on an item of income unless the reduction requires a redetermination of the United States shareholder's U.S. tax under § 905(c). These taxpayers then could claim that the high-tax exception from foreign base company income under § 954(b)(4) allows them to exclude the CFC's income from current taxation under Subpart F, even though all or substantially all of the foreign corporate income tax is later refunded to the shareholder.

2. Treas. Reg. § 1.954-1(d)(3) would be modified to provide that to the extent the foreign income taxes paid or accrued by a CFC are reasonably certain to be returned to a shareholder upon a subsequent distribution to the shareholder, the foreign income taxes are not treated as paid or accrued for purposes of the high-tax exception under § 954(b)(4). The IRS may also challenge these arrangements under existing law, for example, on the ground that the payment to the shareholder constitutes a refund under Treas. Reg. § 1.901-2(e)(2) or a subsidy under § 901(i) and Treas. Reg. § 1.901-2(e)(3) that reduces the amount of tax the CFC is considered to have paid.

S. Deemed Paid Taxes Under § 960 and § 78.

1. Section 960(a) and (d) deem a domestic corporation that is a U.S. shareholder of a CFC to pay the portion of the foreign income taxes paid or accrued by the CFC that is properly attributable to income of the CFC that the United States shareholder takes into account in computing its Subpart F or GILTI inclusion, subject to certain limitations. Section 960(b) provides rules for taxes that are deemed paid in connection with distributions by a CFC of previously taxed earnings and profits to either a U.S. shareholder that is a domestic corporation or to a shareholder that is a CFC. Compare § 960(a)(3) (as in effect on December 21, 2017). Prop. Treas. Reg. §§ 1.960-1 through 1.960-3 provide rules for determining a domestic corporation's deemed paid taxes under § 960(a), (b), and (d).
2. Additionally, the TCJA redesignated former § 960(b), relating to excess limitation accounts, without change, as § 960(c). The proposed regulations treat a GILTI inclusion amount as a Subpart F inclusion for purposes of § 960(c). *See* § 951A(f)(1)(B). Therefore, the proposed regulations modify Treas. Reg. §§ 1.960-4 and 1.960-5 to reflect the additional application of § 960(c) to GILTI inclusion amounts.

3. Finally, Prop. Treas. Reg. § 1.960-7 includes updated applicability dates for Treas. Reg. §§ 1.960-1 through 1.960-6, which are consistent with the effective dates of the TCJA.
4. The TCJA also amended § 78 to, among other things, reflect the addition of deemed paid credits under § 960(d) and to provide that any amount of taxes deemed paid under § 960 that is treated as a dividend under § 78 (a “§ 78 dividend”) is not eligible for a § 245A deduction. The proposed regulations revise Treas. Reg. § 1.78-1 to reflect changes made to § 78.
5. Computational and Grouping Rules for Purposes of Calculating Taxes Deemed Paid Under § 960.
 - (a) Current Year Taxes.
 - i. A CFC may have Subpart F income or tested income that is taken into account by a domestic corporation that is a United States shareholder of the CFC under §§ 951(a)(1)(A) or 951A(a), and may incur foreign income taxes related to that income that may be treated as deemed paid by the United States shareholder under §§ 960(a) or (d). Additionally, a CFC may receive distributions of previously taxed earnings and profits and incur foreign income taxes regarding those distributions that may subsequently be treated as deemed paid by the United States shareholder or an upper-tier CFC under § 960(b).
 - ii. Prop. Treas. Reg. § 1.960-1 provides definitions as well as computational and grouping rules that associate the current year foreign income taxes (“current year taxes”) of the CFC with current year income of the CFC or a distribution of previously taxed earnings and profits received by the CFC. These taxes, in turn, may be deemed paid by the U.S. shareholder or upper-tier CFC under § 960. Foreign income taxes generally include income, war profits, and excess profits taxes that are imposed by a foreign country or a possession of the United States. *See* Prop. Treas. Reg. § 1.960-1(b)(5). The term “possession of the United States” means American Samoa, Guam, the Commonwealth of the Northern Mariana Islands, Puerto Rico, or the U.S. Virgin Islands.
 - iii. Current year taxes of a CFC are foreign income taxes paid or accrued by the CFC in its current taxable year, and the rules of § 461 and the “relation-back” doctrine apply to determine the timing of the accrual of foreign income taxes and the year for which they are taken into account. *See*

Prop. Treas. Reg. § 1.960-1(b)(4). Thus, for example, foreign income taxes calculated on the basis of net income accrue in the U.S. taxable year of the CFC with or within which its foreign taxable year ends, and are eligible to be deemed paid in the taxable year of the U.S. shareholder with or within which the U.S. taxable year of the CFC ends, even if a portion of the foreign taxable year of the CFC falls within an earlier or later U.S. taxable year of the CFC or its United States shareholder.

- iv. Current year taxes of a CFC that are imposed on an amount under foreign law that would be income under U.S. law in a different taxable year are eligible to be deemed paid in the year in which the foreign tax accrues, and not in the earlier or later year when the related income is recognized for U.S. tax purposes. The current taxable year of the CFC is its U.S. taxable year for which a domestic corporation that is a United States shareholder of the CFC has a Subpart F or GILTI inclusion regarding the CFC, or during which the CFC receives a § 959(b) distribution or makes a § 959(a) distribution or a § 959(b) distribution.

(b) Computational Rules.

- i. Prop. Treas. Reg. § 1.960-1(c)(1) describes and orders the computations involved in calculating the foreign income taxes deemed paid by either a domestic corporation that is a United States shareholder of a CFC or by a CFC that is a shareholder of another CFC. These steps are applied by each CFC in a chain of ownership beginning with the lowest-tier CFC regarding which the domestic corporation is a United States shareholder.
- ii. Under these computational rules, a U.S. shareholder first applies the grouping rules to assign the income of the CFC to separate categories of income described in Prop. Treas. Reg. § 1.904-5(a)(4)(v) (each a “§ 904 category”) and then to groups that correspond to certain types of income (each, an “income group”) in a § 904 category. If the CFC receives a distribution of previously taxed earnings and profits (“PTEP”), it increases the group or groups (a “PTEP group”) within an annual PTEP account that corresponds both to the taxable year for which a CFC took into account the income from which the previously taxed earnings and profits arose, and to the separate category of the United States shareholder to which the amount of the resulting inclusion under § 951(a)(1)(A) or 951A was assigned. The

rules for grouping previously taxed earnings and profits within an annual PTEP account are described below. The income and PTEP groups, which are discussed in more detail below, are the mechanism for computing taxes deemed paid under § 960.

- iii. Second, deductions of the CFC, including for expenses attributable to current year taxes, are allocated and apportioned to the income groups. Current year taxes are also allocated and apportioned to a PTEP group that was increased in the first step. Third, taxes deemed paid by the United States shareholder under §§ 960(a) and (d), and taxes deemed paid by the CFC under § 960(b)(2) in connection with its receipt of a § 959(b) distribution, are calculated. Fourth, the previously taxed earnings and profits resulting from the Subpart F inclusion or GILTI inclusion of the United States shareholder are added to an annual PTEP account and further assigned to the relevant PTEP groups within the account. Fifth, the first four steps are repeated for each higher-tier CFC. Sixth, regarding the highest-tier CFC, the United States shareholder computes its taxes deemed paid under § 960(b)(1).
- iv. Prop. Treas. Reg. § 1.960-1(c)(2) provides that only items that the CFC takes into account during its current taxable year are used in the computational rules of Treas. Reg. 1.960-1(c)(1). The items of gross income and expense that are in a § 904 category and income group within a § 904 category are therefore items that the CFC accrues and takes into account in its current taxable year, and the foreign income taxes that are eligible to be deemed paid are foreign income taxes that the CFC pays or accrues in its current taxable year. Prop. Treas. Reg. § 1.960-1(c)(3) provides rules relating to foreign currency and translation.

(c) Associating Current Year Taxes with Income Groups.

- i. To determine the foreign income taxes paid or accrued by the CFC that are properly attributable to amounts that a domestic corporation that is a United States shareholder of the CFC takes into account in determining its Subpart F or GILTI inclusions, Prop. Treas. Reg. § 1.960-1(d) provides rules associating current year taxes of the CFC with the types of income earned by the CFC from which the inclusions arise. Prop. Treas. Reg. § 1.960-1(d) requires a CFC to assign its income to one or more income groups within each § 904 category. Deductions of the CFC,

including for current year taxes, are allocated and apportioned to the income groups in order to determine net income (or loss) in each income group and to identify the current year foreign income taxes that relate to the income in each income group for § 960 purposes.

(a) *Income Group Definitions*

- (I) Prop. Treas. Reg. § 1.960-1(d)(2)(ii) defines several separate income groups regarding the Subpart F income of the CFC (“Subpart F income groups”) within each applicable § 904 category. Each single item of foreign base company income as defined in Treas. Reg. § 1.954-1(c)(1)(iii) is a separate Subpart F income group. For example, with respect to a CFC, Treas. Reg. § 1.954-1(c)(1)(iii)(A)(2) identifies as a single item of income all foreign base company income (other than foreign personal holding company income) that falls within both a single separate category (typically, general category income) and a single category of foreign base company income described in each of Treas. Reg. § 1.954-1(c)(1)(iii)(A)(2)(i) through (v). Therefore, there is a single Subpart F income group within the general category that consists of all of a CFC’s foreign base company sales income.
- (II) Treas. Reg. § 1.954-1(c)(1)(iii)(B) provides grouping rules for items of passive category foreign personal holding company income, each of which is also treated as a separate Subpart F income group under Treas. Reg. § 1.960-1. Prop. Treas. Reg. § 1.960-1(d)(2)(ii)(B)(2) also defines a separate Subpart F income group for the CFC’s insurance income described in § 952(a)(1), for its international boycott income described in § 952(a)(3), for the sum of its illegal bribes and kickbacks described in § 952(a)(4), and for income included in a § 901(j) separate category described in § 952(a)(5).

- (III) Prop. Treas. Reg. § 1.960-1(d)(2)(ii)(C) also defines separate income groups for tested income (a “tested income group”) in each § 904 category. In general, tested income will be in a single tested income group within the general category. Because a CFC cannot earn § 951A category income or foreign branch category income at the CFC level, there is no tested income group within either § 904 category. For the CFC’s general category tested income group, GILTI inclusion amounts and taxes regarding the tested income group will generally be treated as income and deemed paid taxes in the § 951A category. See Treas. Reg. §§ 1.904-4(g), 1.904-6(b)(1).
 - (IV) Income in a § 904 category that is not of a type that is included in one of the Subpart F income groups or tested income groups is assigned to the residual income group. See Prop. Treas. Reg. § 1.960-1(d)(2)(ii)(D).
- (b) *Computing Net Income in an Income Group and Assigning Current Year Taxes to an Income Group*
- (I) To determine its net income in each income group, a CFC first assigns its items of gross income to a § 904 category and to the appropriate income group within the category, and then allocates and apportions its deductions and expenses, including current year taxes, to the categories and to the income groups within the categories under the rules of §§ 861 through 865 and 904(d) and the regulations under those sections.
 - (II) Current year taxes are allocated and apportioned to income groups for two purposes. The first purpose is to deduct current year taxes (in functional currency) from gross income in the income group in computing the net income in the income group. The second purpose is to associate an amount of current year taxes (in U.S. dollars) with an income group. These

current year taxes associated with an income group are eligible to be deemed paid by a United States shareholder that has a Subpart F or GILTI inclusion that is attributable to that income group. The rules for allocating and apportioning current year taxes are the same for both purposes. *See also* Prop. Treas. Reg. § 1.861-8(e)(6) (clarifying that the rules for allocating and apportioning deductions for foreign income tax expense are the same as the rules for allocating and apportioning foreign income taxes to separate categories under Treas. Reg. § 1.904-6).

- (III) Prop. Treas. Reg. § 1.960-1(d)(3)(ii) applies the rules of Treas. Reg. § 1.904-6 to allocate and apportion current year taxes to and among the § 904 categories based upon the amount of taxable income, as calculated under foreign law, of the CFC that is in each § 904 category. Prop. Treas. Reg. § 1.960-1(d)(3)(ii) then applies the principles of Treas. Reg. § 1.904-6 to allocate and apportion current year taxes to and among the income groups. If a PTEP group of the CFC is increased as a result of a § 959(b) distribution that it receives in the current taxable year, then for purposes of allocating and apportioning current year taxes that are imposed solely by reason of the § 959(b) distribution, the PTEP group is treated as an income group within the § 904 category.
- (IV) Rules for tracking amounts in PTEP groups and for computing deemed paid credits regarding distributions of previously taxed earnings and profits from a PTEP group are described below. Current year taxes that are not allocated and apportioned to a Subpart F or tested income group, or to a PTEP group that is treated as an income group, are allocated and apportioned to a residual income group. Current year taxes allocated and apportioned to a residual income group cannot be deemed paid under § 960 for any

taxable year. Prop. Treas. Reg. § 1.960-1(e).

- (V) Under Treas. Reg. § 1.904-6, Federal income tax principles apply to determine the separate category, income group, or PTEP group of the CFC's gross items of income and expense, the amounts of which are computed under foreign law, that are included in the foreign tax base. For example, if the United States treats a distribution as resulting in capital gain that is passive category income, but foreign law treats the item as a dividend that would be general category income, the item is assigned to the passive category for purposes of allocating and apportioning current year taxes of the CFC to the item. *See also* Prop. Treas. Reg. § 1.904-6(a)(1)(i). The amount of the item, however, is determined under foreign law, and expenses (also determined under foreign law) are allocated and apportioned to the income under foreign law principles or as otherwise provided in Treas. Reg. § 1.904-6(a)(1)(ii).
- (VI) Prop. Treas. Reg. § 1.960-1(d)(3)(ii)(B) also provides a rule for addressing base and timing differences (within the meaning of Prop. Treas. Reg. § 1.904-6(a)(1)(iv)) for purposes of allocating and apportioning current year taxes of a CFC to income groups and PTEP groups. Current year taxes that are attributable to a base difference are allocated to the residual income group, and therefore are ineligible to be deemed paid. Current year taxes that are attributable to a timing difference -- namely, current year tax imposed on an amount that is income of the CFC in a different taxable year under Federal income tax law -- are allocated and apportioned to a § 904 category and income group as though the income that foreign law recognizes in the CFC's current taxable year were also recognized for Federal income tax purposes

in that year. Prop. Treas. Reg. § 1.960-1(d)(3)(ii)(B) includes a special rule for current year taxes that are attributable to a timing difference resulting from a § 959(b) distribution.

T. Taxes Deemed Paid under § 960(a) and (d) for Subpart F Inclusions and GILTI Inclusion Amounts.

1. Section 960(a) provides that a domestic corporation that is a United States shareholder of a CFC is deemed to have paid the CFC's foreign income taxes that are properly attributable to the item of income of the CFC that the United States shareholder includes in gross income under § 951(a)(1) as a Subpart F inclusion.
2. Section 960(d) provides that a domestic corporation that is a United States shareholder is deemed to have paid 80 percent of an amount that is equal to the product of the United States shareholder's inclusion percentage and the aggregate of the tested foreign income taxes paid or accrued by the CFCs of the United States shareholder. The inclusion percentage of the United States shareholder is the ratio of the United States shareholder's GILTI inclusion amount regarding its CFCs to the aggregate amount of the United States shareholder's pro rata share of tested income of those CFCs.
3. Section 960(d)(3) defines tested foreign income taxes as the foreign income taxes paid or accrued by a CFC of a United States shareholder that are properly attributable to the tested income of the CFC that the United States shareholder takes into account in computing its GILTI inclusion amount.
4. Subpart F Inclusions.
 - (a) Under Prop. Treas. Reg. § 1.960-2(b), the amount of the foreign income taxes of a CFC that its United States shareholder that is a domestic corporation is deemed to pay under § 960(a) is computed regarding the income of the CFC, determined under Federal income tax principles in each Subpart F income group within a § 904 category. A domestic corporate shareholder that has a Subpart F inclusion regarding its CFC is deemed to pay the CFC's foreign income taxes that are properly attributable to the items of income of the CFC that give rise to the Subpart F inclusion of that shareholder.
 - (b) The amount of taxes that are properly attributable to an item of income for this purpose is equal to the domestic corporate shareholder's proportionate share of the current year taxes of the

CFC that are allocated and apportioned to the Subpart F income group within a § 904 category of the CFC to which the item of income is attributable. The proportionate share for each Subpart F income group is equal to the current year taxes that are allocated and apportioned to a Subpart F income group within a § 904 category multiplied by a fraction equal to the portion of the Subpart F inclusion that is attributable to that Subpart F income group to the total income in that Subpart F income group.

- (c) Therefore, no tax is deemed paid by a corporate United States shareholder of a CFC regarding a Subpart F income group to which current year taxes of the CFC are allocated and apportioned (including by reason of the rule for timing differences) but to which no portion of a Subpart F inclusion is attributable.
- (d) The denominator of the fraction, the net income in the Subpart F income group, is not reduced to reflect any prior year deficits because those deficits do not reduce the Subpart F income of the CFC in the current year. A pro rata share of a prior year qualified deficit reduces the amount of a United States shareholder's Subpart F inclusion, and therefore by its own account reduces the numerator of the fraction. Prop. Treas. Reg. § 1.960-2(b)(3)(ii). The denominator of the fraction is, however, reduced to reflect the limitation in § 952(c)(1)(A) of the Subpart F income of the CFC to its current year earnings and profits. The denominator is also reduced to reflect any reduction in the Subpart F income of a CFC under § 952(c)(1)(C), which allows a CFC to reduce certain of its Subpart F income by an amount of certain current year deficits of certain CFCs in the same chain of ownership. Prop. Treas. Reg. § 1.960-2(b)(3)(iii).
- (e) Prop. Treas. Reg. § 1.960-2(b)(1) treats taxes as deemed paid under § 960(a) specifically with respect to Subpart F inclusions because the inclusions are with respect to items of income of the CFC. In contrast, an inclusion under § 951(a)(1)(B) is not an inclusion of an "item of income" of the CFC but instead is an inclusion equal to an amount that is determined under the formula in § 956(a). Therefore, Prop. Treas. Reg. § 1.960-2(b)(1) provides that no foreign income taxes are deemed paid under § 960(a) with respect to an inclusion under § 951(a)(1)(B).

5. GILTI Inclusion Amounts.

- (a) Prop. Treas. Reg. § 1.960-2(c) provides that the amount of the tested foreign income taxes that a United States shareholder is deemed to pay under § 960(d) is computed regarding the income of the CFC in each tested income group within a § 904 category. For

purposes of determining a United States shareholder's tested foreign income taxes, the CFC's current year taxes are first allocated and apportioned to the tested income group within a § 904 category in order to determine the foreign income taxes "properly attributable" to the tested income group.

(b) The U.S. shareholder's tested foreign income taxes for a tested income group within a § 904 category is equal to its proportionate share of the CFC's current year taxes, determined by multiplying the CFC's current year taxes that are allocated and apportioned to a tested income group within a § 904 category by a fraction that is equal to the tested income of the CFC in the tested income group that is included in computing the domestic corporation's aggregate amount described in § 951A(c)(1)(A) and Prop. Treas. Reg. § 1.951A-1(c)(2)(i), divided by the total income in the tested income group.

(a) The U.S. shareholder's inclusion percentage is required to determine the amount of taxes deemed paid by the United States shareholder. In general, current year taxes allocated and apportioned to a tested income group will be in the general category at the level of the CFC, although in limited cases involving passive category tested income, current year taxes may be allocated and apportioned to the passive category. However, the domestic corporation computes only a single inclusion percentage with respect to all of its tested income, regardless of the § 904 category to which the tested income is assigned.

(b) In the case of a U.S. shareholder that is a member of a consolidated group, the numerator of the inclusion percentage is computed using the GILTI inclusion amount of a U.S. shareholder as determined under Treas. Reg. § 1.1502-51. *See* § 1.951A-1(c)(4).

(c) Taxes Deemed Paid Under § 960(b) With Respect to § 959 Distributions.

i. Section 960(b)(1) provides that a U.S. shareholder of a CFC is deemed to have paid the CFC's foreign income taxes that the U.S. shareholder has not been previously deemed to pay and that are properly attributable to a distribution from the CFC that the U.S. shareholder excludes from its income under § 959(a) (a "§ 959(a) distribution"). Section 960(b)(2) provides that a CFC is

deemed to have paid the foreign income taxes of another CFC that have not previously been deemed paid by a U.S. shareholder and that are properly attributable to a distribution from the other CFC to which § 959(b) applies (a “§ 959(b) distribution,” and together with a § 959(a) distribution, a “§ 959 distribution”).

U. Previously Taxed Earnings and Profits.

1. PTEP Groups in Annual PTEP Accounts and Associated Taxes.

- (a) Prop. Treas. Reg. § 1.960-3(c)(1) requires a CFC to establish a separate, annual account (“annual PTEP account”) for its earnings and profits for its current taxable year to which Subpart F or GILTI inclusions of United States shareholders of the CFC are attributable. Each account must correspond to the inclusion year of the previously taxed earnings and profits and to the § 904 category of the inclusions at the United States shareholder level. Accordingly, a CFC may have an annual PTEP account in the § 951A category or a treaty category (as defined in Treas. Reg. § 1.861-13(b)(6)), even though income of the controlled foreign corporation cannot initially be assigned to the § 951A category or a treaty category.
- (b) The PTEP in each annual account are then assigned to one of ten possible groups of previously taxed earnings and profits described in Prop. Treas. Reg. § 1.960-3(c)(2) (each, a “PTEP group”).⁵ The PTEP groups serve a similar function to the Subpart F income groups and tested income groups -- they are the mechanism for associating foreign taxes paid or accrued, or deemed paid, by a CFC with § 959 distributions of previously taxed earnings and profits. If, following the issuance of new guidance under § 959 (which will be addressed in a separate guidance project), it is determined that maintaining all ten of the PTEP groups is unnecessary, or that grouping of annual accounts into multi-year accounts is permissible, Treasury and the IRS will consider consolidating PTEP groups as part of finalizing the proposed regulations.
- (c) A CFC accounts for a § 959(b) distribution that it receives by adding the distribution amount to an annual PTEP account and PTEP group that corresponds to the annual PTEP account and PTEP group from which the distributing CFC made the distribution. Prop. Treas. Reg. § 1.960-3(c)(3). A CFC that makes

⁵ Notice 2019-01 increases this to 16 PTEP accounts. See Section VIII. Notice 2019-01 also addresses other issues that interrelate with this proposed regulation.

a § 959 distribution must similarly reduce the annual PTEP account and PTEP group within the account from which the distribution is made by the distribution amount. A CFC must also reduce PTEP groups that relate to previously taxed earnings and profits described in § 959(c)(2) (“§ 959(c)(2) PTEP”) to account for reclassification of amounts into those groups as previously taxed earnings and profits described in § 959(c)(1) (“reclassified PTEP”), and increase the PTEP group that corresponds to the reclassified amount. Prop. Treas. Reg. § 1.960-3(c)(4).

i. Associating Foreign Income Taxes with PTEP Groups.

- (a) A CFC must account for the foreign income taxes that it pays, accrues or is deemed to pay regarding the amount in each PTEP group (“PTEP group taxes”). PTEP group taxes are accounted for regarding previously taxed earnings and profits assigned to a PTEP group within an annual PTEP account. PTEP group taxes consist of (1) the current year taxes paid or accrued by the CFC as the result of its receipt of a § 959(b) distribution that are allocated and apportioned to the PTEP group; (2) foreign income taxes that are deemed paid by the CFC with respect to an amount in a PTEP group; and (3) in the case of a reclassified PTEP group, foreign income taxes that were paid, accrued or deemed paid with respect to an amount that was initially included in a § 959(c)(2) PTEP group and subsequently added to a corresponding reclassified PTEP group. Prop. Treas. Reg. § 1.960-3(d)(1).
- (b) PTEP group taxes are reduced by the amount of foreign income taxes in the group that are deemed paid by a United States shareholder under § 960(b)(1) or by another CFC under § 960(b)(2), and foreign income taxes relating to a PTEP group that is reclassified to a § 959(c)(1) PTEP group. Prop. Treas. Reg. § 1.960-3(d)(2).
- (c) Prop. Treas. Reg. § 1.960-1(d)(3)(ii)(A) associates current year taxes of a CFC with a PTEP group for purposes of § 960(b) only in the case of an increase in a PTEP group as a result of the receipt of a § 959(b) distribution. The increased PTEP group is treated as an income group to which current year taxes that are imposed solely by reason of that § 959(b) distribution are allocated and apportioned.

For example, a withholding tax imposed on a § 959(b) distribution received by an upper-tier CFC is allocated and apportioned to the PTEP group that is increased by the § 959(b) distribution. The withholding tax also reduces (as a deduction) the amount in that same PTEP group.

- (d) Prop. Treas. Reg. § 1.960-1(d)(3)(ii)(B) generally applies the timing difference rule of Treas. Reg. § 1.904-6(a)(1)(iv) to allocate and apportion current year taxes that are attributable to a timing difference to a § 904 category and income group as if the CFC recognized the related income under Federal income tax principles in its current taxable year. Prop. Treas. Reg. § 1.960-1(d)(3)(ii)(B) also clarifies the rule for previously taxed earnings and profits by providing that if current year taxes are attributable to a timing difference, the taxes are only treated as related to a PTEP group if the taxes are imposed solely by reason of a § 959(b) distribution that increases the PTEP group.
- (e) For example, a timing difference described in Prop. Treas. Reg. § 1.904-6(a)(1)(iv) could include a situation in which Federal income tax principles require marking-to-market gain on an asset, resulting in an inclusion under § 951A(a), but the foreign jurisdiction only imposes tax when the asset is disposed of in a later year. Under Prop. Treas. Reg. § 1.960-1(d)(3)(ii)(B), the later-imposed foreign income tax is treated as related to the tested income group (if any) for the year in which the tax is imposed, and not to a PTEP group in an annual PTEP account for the earlier year in which the gain was recognized for Federal income tax purposes.
- (f) In addition, an income tax imposed on a distributing CFC (in contrast to a tax, such as a withholding tax, imposed on the recipient of the distribution) by reason of a § 959 distribution is treated as a timing difference and is treated as related to the Subpart F income group or tested income group for the current taxable year (if any) in which the distribution is made, and not to a PTEP group in an annual PTEP account for the earlier year in which the distributed earnings and profits were recognized for Federal income tax purposes.

- (g) Therefore, under Prop. Treas. Reg. § 1.960-1(d)(3)(ii)(B), the only taxes that are allocated and apportioned to a PTEP group are taxes that are imposed solely by reason of a CFC's receipt of a § 959(b) distribution and that are otherwise allocated and apportioned to the PTEP group under Treas. Reg. § 1.904-6 principles.
- (h) For example, a net basis tax imposed on a CFC's receipt of a § 959(b) distribution by the CFC's country of residence is treated as related to a PTEP group. Similarly, a withholding tax imposed regarding a CFC's receipt of a § 959(b) distribution is allocated and apportioned to a PTEP group.
- (i) In contrast, a withholding tax imposed on a disregarded payment from a disregarded entity to a CFC owner is treated as a timing difference and is never treated as related to a PTEP group (even if all of the CFC's E&P is PTEP from income earned by the disregarded entity), because the tax is not imposed solely by reason of a § 959(b) distribution. The withholding tax, however, may be treated as related to a Subpart F income group or tested income group under the rule for timing differences.

ii. Computational Rules.

- (a) Prop. Treas. Reg. § 1.960-3(b) provides rules for determining the amount of taxes deemed paid regarding a § 959(a) distribution. A domestic corporation that receives a § 959(a) distribution is deemed to have paid the foreign income taxes that are properly attributable to the § 959(a) distribution from the PTEP group of the distributing CFC, to the extent the PTEP group taxes have not already been deemed to have been paid in the current taxable year or any prior taxable year.
- (b) Under Prop. Treas. Reg. § 1.960-3(b)(1), the amount of foreign income taxes that are properly attributable to a domestic corporation's receipt of a § 959(a) distribution from a PTEP group within a § 904 category is its proportionate share of PTEP group taxes associated with the PTEP group. The domestic corporation's proportionate share of foreign income taxes associated with a § 959(a)

distribution from a PTEP group is determined by a fraction equal to the amount of the § 959(a) distribution attributable to the PTEP group over the total amount of previously taxed earnings and profits in the PTEP group.

- (c) A single § 959(a) distribution could be attributable to multiple PTEP groups, for multiple different inclusion years, of the distributing CFC. The proposed regulations, including the order of the list of PTEP groups in Treas. Reg. § 1.960-3(c)(2), do not provide rules for the allocation of distributions among different kinds of previously taxed earnings and profits under § 959(c). Future regulations under § 959 will provide ordering rules for determining the annual PTEP account and PTEP group to which a § 959 distribution is attributable.
- (d) Prop. Treas. Reg. § 1.960-3(b)(2) provides similar rules to those in Prop. Treas. Reg. § 1.960-3(b)(1) for taxes deemed paid under § 960(b)(2) regarding a CFC's receipt of a § 959(b) distribution.
- (e) Prop. Treas. Reg. § 1.960-3(d)(3) provides a rule relating to foreign income taxes paid or accrued in a taxable year of a CFC that began before January 1, 2018, with respect to an annual PTEP account, and a PTEP group within such account, that was established for an inclusion year of a CFC that began before January 1, 2018. Specifically, in certain cases, the foreign income taxes may be deemed paid under § 960(b) regarding a § 959 distribution in a year of the CFC that begins after December 31, 2017.
- (f) Treasury and the IRS state that the application of § 960(a)(3) was uncertain regarding CFC taxable years beginning before January 1, 2018 and some taxpayers may have added taxes paid or accrued regarding a § 959 distribution to post-1986 foreign income taxes described in § 902(c)(2) (as in effect on December 21, 2017). In that case, those foreign income taxes could have been included in computing foreign taxes deemed paid under § 902 regarding a distribution or inclusion of post-1986 undistributed earnings (including by reason of §§ 960 and 965) in taxable years of CFCs beginning

before January 1, 2018, in which case the taxes are not available to be deemed paid under § 960(b).

(d) Section 965 and Section 960(b).

- i. The proposed regulations under § 965 reserved on the application of § 965(g) to taxes deemed paid under new § 960(b). The preamble to the regulations under § 965 indicated that future regulations would provide rules for new § 960(b) similar to the rules that apply for § 960(a)(3) (as in effect on December 21, 2017).
- ii. The new proposed regulations provide a rule in Prop. Treas. Reg. § 1.965-5(c)(1)(iii) similar to the rule that applies to taxes deemed paid under § 960(a)(3) that is in Prop. Treas. Reg. § 1.965-5(c)(1)(i) and (ii). In particular, no credit is allowed for the applicable percentage of taxes deemed paid under § 960(b) that are attributable to the PTEP groups described in Treas. Reg. § 1.960-3(c)(2) that relate to § 965.
- iii. To ensure that the disallowance under § 965(g) only applies once, the rule in Prop. Treas. Reg. § 1.965-5(c)(1)(iii) does not apply to taxes deemed paid under § 960(b)(2) with respect to a § 959(b) distribution, but only applies when previously taxed earnings and profits are distributed to a domestic corporate shareholder.

(e) Domestic Partnerships.

- i. If a domestic corporation owns an interest in a CFC through a domestic partnership, to the extent the domestic corporation is a United States shareholder regarding the CFC, the proposed regulations provide that the domestic corporation is deemed to have paid foreign income taxes as if the domestic corporation had included the income from the CFC directly rather than as a distributive share of the partnership's income. Prop. Treas. Reg. § 1.960-2(b)(4) provides that a domestic corporation that has a distributive share of a domestic partnership's Subpart F inclusion and is also a United States shareholder with respect to the CFC that gives rise to a Subpart F inclusion is treated as a Subpart F inclusion of the domestic corporation for purposes of § 960(a).
- ii. Similarly, the domestic corporation's distributive share of a domestic partnership's receipt of a § 959(a) distribution is

treated as a receipt by the domestic corporation directly for purposes of Prop. Treas. Reg. § 1.960-3(b)(1). *See* Prop. Treas. Reg. § 1.960-3(b)(5). In the case of § 960(d), the GILTI inclusion amount of a domestic corporation that is also a United States shareholder of a CFC through its interest in a domestic partnership is generally determined at the partner level and therefore the rules in Prop. Treas. Reg. § 1.960-2(c) apply in the same manner as if the domestic corporation included the GILTI inclusion amount directly. *See* Prop. Treas. Reg. § 1.951A-5(c).

(f) Section 78 Dividends.

- i. The proposed regulations revise Treas. Reg. § 1.78-1 to reflect the amended § 78, as well as make conforming changes to reflect pre-Act statutory amendments. In addition, the proposed regulations provide that § 78 dividends that relate to taxable years of foreign corporations that begin before January 1, 2018, are not treated as dividends for purposes of § 245A. This rule is necessary by reason of the enactment of § 245A to ensure that similarly situated taxpayers do not have different tax consequences under § 245A regarding § 78 dividends.
- ii. Absent this rule, a United States shareholder of a CFC using a fiscal year beginning in 2017 as its U.S. taxable year (a “fiscal year CFC”) could potentially claim a § 245A deduction with respect to its § 78 dividend attributable to the United States shareholder’s inclusion under § 951 (including by reason of § 965) for the CFC’s fiscal year ending in 2018, whereas a United States shareholder of a CFC using the calendar year as its U.S. taxable year could not claim a § 245A deduction regarding any § 78 dividend for any taxable year.
- iii. Treasury and the IRS believe there is no indication that Congress intended to treat these similarly situated taxpayers differently with respect to the § 78 dividend given that the purpose of the § 78 dividend -- to prevent a taxpayer from obtaining the benefit of both a credit under § 901 and a deduction regarding the same foreign tax -- is unrelated to the CFC’s U.S. taxable year.
- iv. Accordingly, Prop. Treas. Reg. § 1.78-1(c) includes a special applicability date to prevent this potential disparate

treatment and double benefit to taxpayers with fiscal year CFCs.⁶

V. Effect of Section 965(n) Election.

1. Section 965(n) allows a taxpayer to exclude § 965(a) inclusions (reduced by § 965(c) deductions) and associated § 78 gross ups in determining the amount of the net operating loss carryover or carryback that is absorbed in the taxable year of the inclusions. Prop. Treas. Reg. § 1.965-7(e)(1) provides that the election also applies to the determination of the amount of the net operating loss for the taxable year.
2. The proposed regulations at § 1.965-7(e)(1)(i) clarify that if the § 965(n) election creates or increases a net operating loss under § 172 for the taxable year, then the taxable income of the person for the taxable year cannot be less than the amount described in Prop. Treas. Reg. § 1.965-7(e)(1)(ii). Treasury and the IRS believe this rule is necessary to prevent the same deduction from being taken into account in the taxable year and also used again to create a net operating loss that is deducted in a different taxable year. The amount of the deductions that create or increase a net operating loss for the taxable year in each separate category and the U.S. source residual category by reason of the § 965(n) election is determined under Prop. Treas. Reg. § 1.965-7(e)(1)(iv), and those amounts are not also taken into account in computing taxable income or the foreign tax credit limitations under § 904 for that year.
3. Prop. Treas. Reg. § 1.965-7(e)(1)(iv)(A) clarifies that the election under § 965(n) applies solely for purposes of determining the amount of the net operating loss for the election year and the amount of net operating loss carryover or carryback to that year. The proposed regulations provide ordering rules to coordinate the election's effect on § 172 with the computation of the foreign tax credit limitations under § 904.
4. First, deductions that would have been allowed for the taxable year but for the § 965(n) election, other than the amount of any net operating loss carryover or carryback to the election year that is not allowed by reason of the election, are allocated and apportioned under Treas. Reg. §§ 1.861-8 through 1.861-17 in the taxable year for which the § 965(n) election is made. The § 965(a) inclusions and associated § 78 gross ups are taken into account for this purpose, and also in applying the rules under Treas. Reg. § 1.904(g)-3(b)(3) to determine the source components of a partial net operating loss carryover to the taxable year for which the § 965(n) election is made, if any, including when the amount deducted under § 172 in that year is reduced by reason of the § 965(n) election. Prop. Treas. Reg. § 1.965-7(e)(1)(iv)(B)(1).

⁶ This would be addressed by a Technical Correction. See Section XI.

5. Second, the proposed regulations provide that the amount by which a net operating loss is created or increased by reason of the § 965(n) election, if any, is considered to comprise a ratable portion of all of the taxpayer's deductions (other than the § 965(c) deduction) that are allocated and apportioned to each statutory and residual grouping for the taxable year under the rules in Prop. Treas. Reg. § 1.965-7(e)(1)(iv)(B)(1). Prop. Treas. Reg. § 1.965-7(e)(1)(iv)(B)(2).
6. Third, deductions allocated and apportioned to the statutory and residual groupings, to the extent deducted in the election year rather than deferred to create or increase a net operating loss, are combined with income in those groupings to determine the foreign tax credit limitations for the year. Deductions allocated and apportioned to the § 965(a) inclusions and associated § 78 gross ups therefore reduce income in the separate category or categories (or U.S. source residual category) to which those § 965 amounts are assigned, and are not re-allocated to reduce other income, other than by operation of the separate limitation loss and overall domestic loss allocation rules of § 904(f) and (g). See Prop. Treas. Reg. § 1.965-7(e)(1)(iv)(B)(3).
7. Accordingly, the § 965(a) inclusions and associated § 78 gross ups may both attract and absorb deductions in the election year in calculating the separate foreign tax credit limitations under § 904.

W. Applicability Dates.

1. The portions of the proposed regulations that relate to statutory amendments made by the TCJA apply to taxable years beginning after December 22, 2017. Portions of the proposed regulations that do not relate to TCJA changes apply for taxable years both beginning after December 31, 2017 and ending on or after the date the regulations were filed with the Federal Register, December 4, 2018. Certain portions of the proposed regulations contain rules that relate to the TCJA as well as rules that do not. These regulations generally apply to taxable years that satisfy both of the following two conditions: (1) the taxable year begins after December 22, 2017, and (2) ends on or after the date the regulations were filed with the Federal Register, December 4, 2018.
2. A special applicability date is provided in Treas. Reg. § 1.861-12(k) in order to apply Treas. Reg. § 1.861-12(c)(2)(i)(B)(1)(ii) to the last taxable year of a foreign corporation beginning before January 1, 2018, since there may be an inclusion under § 965 for that taxable year. A special applicability date is also provided in Treas. Reg. § 1.904(b)-3(f) regarding that section because § 904(b)(4) applies to deductions with respect to taxable years ending after December 31, 2017. Finally, a special applicability date is provided in Prop. Treas. Reg. § 1.78-1(c) in order to apply the second sentence of Prop. Treas. Reg. § 1.78-1(a) to § 78

dividends received after December 31, 2017, regarding a taxable year of a foreign corporation beginning before January 1, 2018.

3. Prop. Treas. Reg. §§ 1.965-5(c)(1)(iii) and 1.965-7(e)(1)(i) and (iv) have the applicability dates provided in Prop. Treas. Reg. § 1.965-9.

VIII. FOREIGN TAX CREDIT REGULATIONS: PART 2.

A. Treas. Reg. §§ 1.78-1, 1.861-12(c)(2), and 1.965-7(e): Foreign Tax Credit final Regulations.

1. Special Applicability Date Under § 78.

- (a) The foreign tax credit proposed regulations would have revised Treas. Reg. § 1.78-1 to reflect the amendments to § 78 made by the TCJA, as well as make conforming changes to reflect pre-TCJA statutory amendments. In addition, the foreign tax credit proposed regulations provided that amounts treated as dividends under section 78 (“§ 78 dividends”) that relate to taxable years of foreign corporations that begin before January 1, 2018 (as well as § 78 dividends that relate to later taxable years), are not treated as dividends for purposes of § 245A.
- (b) Comments questioned whether Treasury and the IRS have authority to treat § 78 dividends relating to taxable years of foreign corporations beginning before January 1, 2018, as ineligible for the dividends-received deduction under § 245A, which generally applies to certain dividends paid after December 31, 2017. Although some comments acknowledged that allowing a dividends-received deduction for § 78 dividends would provide taxpayers with a double benefit that clearly was not intended by Congress, the comments claimed that the statutory language directly provides for the dividends-received deduction, and therefore the rule applying Prop. Treas. Reg. § 1.78-1(c) to taxable years beginning before January 1, 2018, should be eliminated.
- (c) Treasury and the IRS believe that §§ 7805(a), 7805(b)(2), and 245A(g) provide ample authority for the rule and therefore finalized the proposed applicability date without change. Section 7805(a) provides that Treasury and the IRS shall prescribe all needful rules and regulations for the enforcement of title 26, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue. The enactment of the TCJA and the addition of § 245A necessitated regulations to ensure that § 78 continues to serve its intended purpose.

- (d) They state that the purpose of the § 78 dividend is to ensure that a U.S. shareholder cannot effectively both deduct and credit the foreign taxes paid by a foreign subsidiary that are deemed paid by the U.S. shareholder. Allowing a dividends-received deduction for a § 78 dividend would undermine the purpose of the § 78 dividend because taxpayers would effectively be allowed both a credit and deduction for the same foreign tax. For this reason, § 78 (as revised by the TCJA) provides that a § 78 dividend is not eligible for a dividends-received deduction under § 245A.
- (e) As noted in the preamble to the foreign tax credit proposed regulations, the special applicability date rule under Treas. Reg. § 1.78-1(c) is necessary to ensure that this principle is consistently applied regarding a CFC that uses a fiscal year beginning in 2017 as its U.S. taxable year (a “fiscal year CFC”) in order to prevent the arbitrary disparate treatment of similarly situated taxpayers. Otherwise, a U.S. shareholder of a fiscal year CFC would effectively be able to take both a credit and a deduction for foreign taxes by claiming a § 245A deduction regarding its § 78 dividend. In contrast, § 78 (as revised by the TCJA) would apply correctly to a U.S. shareholder of a CFC using the calendar year as its U.S. taxable year that was also subject to § 245A.
- (f) The special applicability date is also consistent with the grant of authority under § 245A(g) to provide rules as may be necessary or appropriate to carry out the provisions of § 245A. Section 245A was intended to provide for tax-exempt treatment of certain E&P earned through foreign subsidiaries as part of a new participation exemption system. It would be incompatible with the purpose of § 245A to exempt income arising by reason of a § 78 dividend, which is not paid out of a foreign corporation’s undistributed foreign earnings but instead represents earnings that could not be distributed since they were used to pay foreign tax.

2. Application of Basis Adjustment for Purposes of Characterizing Certain Stock.

- (a) Prop. Treas. Reg. § 1.861-12(c)(2) clarified certain rules for adjusting the stock basis in a 10% owned corporation, including that the adjustment to basis for E&P includes PTEP. Prop. Treas. Reg. § 1.861-12(c)(2)(i)(B)(2). Additionally, in order to account for the application of § 965(b)(4)(A) and (B), relating to the treatment of reduced E&P of a deferred foreign income corporation and increased E&P of an E&P deficit foreign corporation, Prop. Treas. Reg. § 1.861-12(c)(2)(i)(B)(1)(ii) provided that, for purposes of Treas. Reg. § 1.861-12(c)(2), a taxpayer determines the basis in the stock of a specified foreign

corporation as if it had made the election under Treas. Reg. § 1.965-2(f)(2), even if the taxpayer did not in fact make the election.

- (b) However, the taxpayer does not include the amount by which basis regarding a deferred foreign income corporation is increased under Treas. Reg. § 1.965-2(f)(2)(ii)(A), because the amount of that increase would be reversed if the increase were by operation of § 961. After issuance of the foreign tax credit proposed regulations, final regulations issued under § 965 altered the election under Treas. Reg. § 1.965-2(f)(2) to allow taxpayers to limit the reduction in basis regarding an E&P deficit foreign corporation under the election to the amount of the taxpayer's basis in the respective share of stock of the relevant foreign corporation.
- (c) A comment requested that the rule in Prop. Treas. Reg. § 1.861-12(c)(2)(i)(B)(1)(ii) be revised in light of the changes to Treas. Reg. § 1.965-2(f)(2) to similarly provide that any reductions in basis be limited to the amount of the taxpayer's basis in the 10% owned corporation. This comment noted that in the absence of such a rule, the application of Prop. Treas. Reg. § 1.861-12(c)(2)(i)(B)(1)(ii) could reduce the adjusted basis of the stock below zero, which would be inappropriate for purposes of applying the expense allocation rules. Treasury and the IRS agreed that, for purposes of applying the expense allocation rules, a taxpayer should not have an adjusted basis below zero in the stock of a 10% owned corporation.
- (d) However, rather than limit the reduction in stock basis to the amount of the taxpayer's basis in the 10% owned corporation, the final regulations provide that Treas. Reg. § 1.861-12(c)(2)(i)(B)(1)(ii) may cause the taxpayer's adjusted basis in the stock of the corporation to be negative, as long as the adjustment for E&P provided for in Treas. Reg. § 1.861-12(c)(2)(i)(A) increases the taxpayer's adjusted basis to zero or an amount above zero.
- (e) If the taxpayer's adjusted basis in the 10% owned corporation is still below zero after application of Treas. Reg. § 1.861-12(c)(2)(i)(A)(1) and (2), then for purposes of Treas. Reg. § 1.861-12, the taxpayer's adjusted basis in the 10% owned corporation is zero for the taxable year. Treas. Reg. § 1.861-12(c)(2)(i)(A)(3); Treas. Reg. § 1.861-12(c)(2)(i)(C)(3) (Example 3) and (4) (Example 4). Treasury and the IRS believe that allowing the adjusted basis in stock to be negative before the application of the adjustment for E&P most accurately reflects the value of the stock in the 10% owned corporation.

- (f) Additionally, the final regulations modified Prop. Treas. Reg. § 1.861-12(c)(2)(i)(B)(1)(ii) to make clear that the adjustment in Treas. Reg. § 1.861-12(c)(2)(i)(B)(1)(ii) may cause a taxpayer's adjusted basis in stock in the 10% owned corporation to be negative, and to account for the changes made to Treas. Reg. § 1.965-2(f)(2). Specifically, Treas. Reg. § 1.861-12(c)(2)(i)(B)(1)(ii) now provides that the taxpayer first adjusts its basis in the 10% owned corporation as if it did not make the election in Treas. Reg. § 1.965-2(f)(2)(i) and then, if applicable, adjusts the basis in the 10% owned corporation by the amount described in Treas. Reg. § 1.965-2(f)(2)(ii)(B)(1).
- (g) These changes were not intended to alter the outcome of the application of the rule to the taxpayer's adjusted basis in the stock of the 10% owned corporation as compared to the rule articulated in the foreign tax credit proposed regulations; rather, the changes were intended to make the rule more straightforward for taxpayers to apply and to clarify any ambiguities about the application of the rule where the adjustment exceeded the taxpayer's adjusted basis in the stock. Treas. Reg. § 1.861-12(c)(2)(i)(C)(1) (Example 1) and (2) (Example 2).

3. Effect of § 965(n) Election.

- (a) Under § 965(n), a taxpayer may elect to exclude the amount of § 965(a) inclusions (reduced by § 965(c) deductions) and associated § 78 dividends in determining the amount of the net operating loss carryover or carryback that is deductible in the taxable year of the inclusions. Treas. Reg. § 1.965-7(e)(1) provides that, if the taxpayer makes a § 965(n) election, the taxpayer does not take into account the amount of the § 965(a) inclusions (reduced by § 965(c) deductions) and associated § 78 dividends in determining the amount of the net operating loss for the taxable year.
- (b) Prop. Treas. Reg. § 1.965-7(e)(1)(i), included in the foreign tax credit proposed regulations, provides that the amount by which the § 965(n) election creates or increases the net operating loss for the taxable year is the "deferred amount." Prop. Treas. Reg. § 1.965-7(e)(1)(iv)(B) provided ordering rules to coordinate the election's effect on § 172 with the computation of the foreign tax credit limitations under § 904. The foreign tax credit proposed regulations provide that the deferred amount comprises a ratable portion of the deductions (other than the § 965(c) deduction) allocated and apportioned to each statutory and residual grouping for § 904 purposes.

- (c) Before the issuance of the foreign tax credit proposed regulations, Treasury and the IRS were aware that some taxpayers were taking the position that the source and separate category of the deferred amount consisted solely of deductions allocated and apportioned to the § 965(a) inclusion. Under this approach, the deferred amount would likely consist primarily of deductions allocated and apportioned to foreign source general category income because that is the likely source and separate category of the § 965(a) inclusion; as a result, the electing taxpayer would generally have a greater amount of foreign source general category income and thus be able to credit more foreign taxes paid or accrued regarding general category income (relative to the result under the foreign tax credit proposed regulations).
- (d) After publication of the foreign tax credit proposed regulations, a comment recommended not finalizing the proposed ordering rules because taxpayers did not have a chance to consider those ordering rules before deciding to make an election under § 965(n). The comment also stated that the foreign tax credit proposed regulations are inconsistent with the statutory language in § 965(n), and with existing rules on the allocation and apportionment of expenses under § 904, to the extent they defer deductions that would be taken against income other than the § 965(a) inclusion.
- (e) The comment also stated that the foreign tax credit proposed regulations are inconsistent with the operation of § 965 and § 904 to the extent they treat the § 965(a) inclusion net of the § 965(c) deduction, rather than the § 965(a) inclusion without reduction for the § 965(c) deduction, as the gross income in the statutory grouping for § 904 purposes. The comment also suggested that the exclusion of the § 965(c) deductions from the deferred amount was inappropriate.
- (f) The comment further stated that, if the regulations are finalized as proposed, taxpayers should be allowed to revoke the § 965(n) election. Finally, the comment recommended that Prop. Treas. Reg. § 1.965-7(e)(1)(iv)(B) be revised to refer to allocation of all deductions (other than the net operating loss carryover or carryback to that year that is not allowed by reason of the § 965(n) election), rather than refer solely to allocation of deductions that would have been allowed for the year but for the § 965(n) election.
- (g) The final regulations include the ordering rules from the foreign tax credit proposed regulations, with some modifications to take into account the comments. In general, Treasury and the IRS believe that these rules are consistent with §§ 965(n) and 904. Section 965(n) does not modify the generally applicable rules

concerning the allocation and apportionment of expenses for § 904 purposes, nor does it provide an ordering rule for determining which deductions create or increase the amount of a current year net operating loss by reason of the § 965(n) election.

- (h) Section 965(n) applies solely to determine the amount of the net operating loss for the election year and the amount of net operating loss carryover or carryback to that year. It does not require or permit the reallocation of deductions that are allocated and apportioned to the separate category containing the § 965(a) inclusion and associated § 78 dividends, regardless of whether any deductions are deferred by reason of the § 965(n) election. For example, if a taxpayer with only U.S. source and general category income has U.S. source taxable income exceeding the amount of deductions allocated and apportioned to foreign source general category income that includes a § 965(a) inclusion and associated § 78 dividends, a § 965(n) election would not result in a deferred amount and would not affect the calculation of the taxpayer's foreign tax credit limitation.
- (i) Similarly, a taxpayer with U.S. source income in excess of its net operating loss carryover would have no basis to prevent general category income that includes a § 965(a) inclusion from being reduced by a general category § 172 deduction. A pro rata convention for determining the source and separate category of the deferred amount is more neutral and more consistent with the operation of the expense allocation rules in the absence of a deferred amount than a rule stacking the deferred amount first out of deductions that would reduce the § 965(a) inclusion and associated § 78 dividends.
- (j) Therefore, the final regulations include the proposed rules applying the existing rules on the allocation and apportionment of expenses for purposes of § 904, and determining the source and separate category of the deferred amount on a pro rata basis. However, in response to the comment regarding the exclusion of the § 965(c) deductions from the deferred amount, Treasury and the IRS agreed that § 965(n) does not provide that the deferred amount includes or excludes specific deductions for purposes of § 904. Therefore, the final regulations include the § 965(c) deduction in determining the source and separate category of the deferred amount. Treas. Reg. § 1.965-7(e)(1)(iv)(B)(2).
- (k) Separately, Treasury and the IRS believe that nothing in Prop. Treas. Reg. § 1.965-7(e)(1)(iv)(B)(2) suggested that the allocation and apportionment of expenses is based on the § 965(a) inclusion net of the § 965(c) deduction, as opposed to the § 965(a) inclusion

not reduced by the § 965(c) deduction. All expenses are allocated and apportioned according to the regulations under Treas. Reg. §§ 1.861-8 through 1.861-17. Prop. Treas. Reg. § 1.965-7(e)(1)(iv)(B)(1). The § 965(c) deduction is definitely related to the § 965(a) inclusion. Treas. Reg. § 1.861-8(b). Other deductions are allocated and apportioned according to the regulations under Treas. Reg. §§ 1.861-8 through 1.861-17. For example, a deduction that is not definitely related to any gross income must be ratably apportioned between the statutory grouping of gross income and the residual grouping. The gross income utilized for such ratable apportionment is not reduced by the § 965(c) deduction. Treas. Reg. § 1.861-8(c)(3).

- (l) The final regulations also adopted the comment's alternative suggestion to allow taxpayers a limited period to revoke a prior election under § 965(n) in order to account for the fact that the foreign tax credit proposed regulations were issued after some taxpayers were required to make the election under § 965(n). Treas. Reg. § 1.965-7(e)(2)(ii)(B). For administrability reasons, in order to minimize the number of amended returns that a taxpayer may need to file in connection with § 965, the deadline for a revocation is based on the extended due dates for the taxpayer's returns. In addition, in response to the comment's request for clarification, Prop. Treas. Reg. § 1.965-7(e)(1)(iv)(B)(1) is revised in the final regulation to clarify that it refers to all deductions (other than the net operating loss carryover or carryback to that year that is not allowed by reason of the § 965(n) election).
- (m) Another comment requested guidance providing that a taxpayer that had made a timely election under § 965(n) be treated as having made a timely election under § 965(h). Under § 965(h), a taxpayer may elect to pay its § 965(h) net tax liability in eight installments. Section 965(h)(5) provides that the election must be made no later than the due date for the tax return for the inclusion year and in the manner prescribed by the IRS. Treas. Reg. § 1.965-7(b)(2)(ii) provides that relief is not available under § 301.9100-2 or § 301.9100-3 to file a late election.
- (n) The comment explained that, as a result of the ordering rules in the foreign tax credit proposed regulations, some taxpayers will have a § 965(h) net tax liability in excess of amounts paid regarding the tax year ending December 31, 2017. Those taxpayers did not make a timely election under § 965(h) because they may have determined that they did not have a § 965(h) net tax liability in excess of amounts paid because they calculated their § 904 foreign tax credit limitation in the inclusion year without allocating or apportioning any expenses to reduce the amount described in

Treas. Reg. § 1.965-7(e)(1)(ii), which is inconsistent with the rules in the foreign tax credit proposed regulations.

- (o) The final regulations did not adopt this recommendation. The statute requires that the election must be made not later than the due date for the tax return for the inclusion year. § 965(h)(5). Moreover, regulations deeming an election to be made by default would not be appropriate, because the statute requires an affirmative election. 83 FR 39514, 39533-39534 (August 9, 2018) (denying a similar request to provide for default § 965(h) elections). For these reasons, these regulations do not treat a taxpayer that has made a timely election under § 965(n) as having made a timely election under § 965(h).
- (p) Finally, the final regulations included two new examples to illustrate the application of Treas. Reg. § 1.965-7(e)(1). Treas. Reg. § 1.965-7(e)(3).
- (q) Consistent with Treas. Reg. § 1.965-9, the final regulations in Treas. Reg. § 1.965-7(e) apply to the last taxable year of a foreign corporation that begins before January 1, 2018, and regarding a U.S. person, beginning the taxable year in which or with which such taxable year of the foreign corporation ends.

4. Applicability Date.

- (a) No significant changes were made to the applicability dates of the portions of the final regulations that relate to rules that were in the foreign tax credit proposed regulations. Under Treas. Reg. § 1.965-9(a), the provisions of Treas. Reg. § 1.965-7 contained in this final regulation apply beginning the last taxable year of a foreign corporation that begins before January 1, 2018, and regarding a U.S. person, beginning the taxable year in which or with which such taxable year of the foreign corporation ends. In general, Treas. Reg. § 1.78-1 applies to taxable years of foreign corporations that begin after December 31, 2017, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end, and Treas. Reg. § 1.861-12(c) applies to taxable years that both begin after December 31, 2017, and end on or after December 4, 2018.
- (b) A special applicability date was provided in Prop. Treas. Reg. § 1.861-12(k) in order to apply Treas. Reg. § 1.861-12(c)(2)(i)(B)(1)(ii) to the last taxable year of a foreign corporation beginning before January 1, 2018, since there may be an inclusion under § 965 for that taxable year. In the final regulations, this special applicability date is extended to Treas. Reg. § 1.861-

12(c)(2)(i)(A) to accommodate the changes that were made to that rule to further implement the rule in Treas. Reg. § 1.861-12(c)(2)(i)(B)(1)(ii). A special applicability date is provided in Treas. Reg. § 1.78-1(c) in order to apply the second sentence of Treas. Reg. § 1.78-1(a) to § 78 dividends received after December 31, 2017, regarding a taxable year of a foreign corporation beginning before January 1, 2018.

B. Allocation of Partnership Creditable Foreign Taxes.

1. On February 4, 2016, Treasury and the IRS proposed regulations under § 704 on February 4, 2016 (“2016 temporary regulations”) that addressed partnership creditable foreign tax expenditures (“CFTEs”).
2. Treas. Reg. § 1.704-1(b)(4)(viii) provides a safe harbor under which allocations of CFTEs are deemed to be in accordance with the partners’ interests in the partnership. The related 2016 temporary regulations addressed the effect of § 743(b) adjustments on the determination of net income in a CFTE category. The 2016 temporary regulations also included special rules regarding how deductible allocations and nondeductible guaranteed payments (that is, allocations that give rise to a deduction under foreign law, and guaranteed payments that do not give rise to a deduction under foreign law) are taken into account for purposes of determining net income in a CFTE category. Finally, they included a clarification of the rules regarding the treatment of disregarded payments between branches of a partnership for purposes of determining income attributable to an activity included in a CFTE category.
3. After consideration of the only comment received, the proposed regulations under § 704 were adopted. The revisions are discussed below.
4. The comment requested revising the regulations to provide that disregarded payments between CFTE categories are taken into account in computing the net income in a CFTE category. It stated that the placement of a disregarded payment rule in a paragraph that discussed attribution of income to an activity is potentially confusing and requested that the language be moved to the portion of the regulation that addresses the basic definition of activities and that in its place a statement be added providing that disregarded payments between CFTE categories will reduce net income in one CFTE category and increase net income in the other category.
5. Treasury and the IRS believe the rule is clear as originally drafted in the 2016 temporary regulations. Income in a CFTE category is determined first by assigning items of income to activities. Activities are then grouped together in a CFTE category to the extent the income attributable

to activities is allocated using the same allocation percentages. Treas. Reg. § 1.704-1(b)(4)(viii)(c)(3).

6. Disregarded payments are not taken into account in determining income assigned to an activity. However, if a partnership makes allocations to give economic regard to the disregarded payment, it can result in more than one allocation percentage being applied to income within the same activity. Treas. Reg. § 1.704-1(b)(4)(viii)(c)(3)(iv). This will result in the activity being subdivided and the subdivided portions being assigned to different CFTE categories. Example 24 in Treas. Reg. § 1.704-1(b)(5)(xxiv).
7. In other words, while the 2016 temporary regulations did not literally provide that a disregarded payment “reduces” the net income in a CFTE category in that case, the 2016 temporary regulations provided for a result similar to the result suggested by the comment by instead subdividing an activity and then assigning one sub-activity to a different CFTE category.
8. Treasury and the IRS believe this approach is more consistent with the fact that income items are determined based on regarded items and not disregarded items, including disregarded payments. The final regulations add a cross reference to the disregarded payment rule for assigning income to an activity in Treas. Reg. § 1.704-1(b)(4)(viii)(c)(3)(iv) in the paragraph that provides the basic definition of an activity to further highlight the interaction of those two paragraphs. Treas. Reg. § 1.704-1(b)(4)(viii)(c)(2)(iii).
9. The 2016 temporary regulations unintentionally deleted Treas. Reg. § 1.704-1(b)(4)(viii)(d)(1)(i) and (ii). Those paragraphs were restored without change by these regulations. Examples 25, 36 and 37 in Treas. Reg. § 1.704-1T (b)(5) in the 2016 temporary regulations appear without further changes in Treas. Reg. § 1.704-1(b)(6) through (iii) of the final regulations, Examples 1, 2, and 3, respectively.
10. Examples.

Example 1. (a) A contributes \$750,000 and B contributes \$250,000 to form AB, a country X eligible entity (as defined in Treas. Reg. § 301.7701-3(a) of this chapter) treated as a partnership for U.S. Federal income tax purposes. AB operates business M in country X. Country X imposes a 20% tax on the net income from business M, which tax is a CFTE. In 2016, AB earns \$300,000 of gross income, has deductible expenses of \$100,000, and pays or accrues \$40,000 of country X tax. Pursuant to the partnership agreement, the first \$100,000 of gross income each year is specially allocated to A as a preferred return on excess capital contributed by A. All remaining partnership items, including CFTEs, are split evenly between A and B (50% each). The gross income allocation is

not deductible in determining AB's taxable income under country X law. Assume that allocations of all items other than CFTEs are valid.

(b) AB has a single CFTE category because all of AB's net income is allocated in the same ratio. The net income in the single CFTE category is \$200,000. The \$40,000 of taxes is allocated to the single CFTE category and, thus, is related to the \$200,000 of net income in the single CFTE category. In 2016, AB's partnership agreement results in an allocation of \$150,000 or 75% of the net income to A (\$100,000 attributable to the gross income allocation plus \$50,000 of the remaining \$100,000 of net income) and \$50,000 or 25% of the net income to B. AB's partnership agreement allocates the country X taxes in accordance with the partners' shares of partnership items remaining after the \$100,000 gross income allocation.

Therefore, AB allocates the country X taxes 50% to A (\$20,000) and 50% to B (\$20,000). AB's allocations of country X taxes are not deemed to be in accordance with the partners' interests in the partnership because they are not in proportion to the allocations of the CFTE category shares of income to which the country X taxes relate. Accordingly, the country X taxes will be reallocated according to the partners' interests in the partnership. Assuming that the partners do not reasonably expect to claim a deduction for the CFTEs in determining their U.S. Federal income tax liabilities, a reallocation of the CFTEs would be 75% to A (\$30,000) and 25% to B (\$10,000). If the reallocation of the CFTEs causes the partners' capital accounts not to reflect their contemplated economic arrangement, the partners may need to reallocate other partnership items to ensure that the tax consequences of the partnership's allocations are consistent with their contemplated economic arrangement over the term of the partnership.

(c) The facts are the same as in (a) above, except that country X allows a deduction for the \$100,000 allocation of gross income and, as a result, AB pays or accrues only \$20,000 of foreign tax. The net income in the single CFTE category is \$100,000, determined by reducing the net income in the CFTE category by the \$100,000 of gross income that is allocated to A and for which country X allows a deduction in determining AB's taxable income. Pursuant to the partnership agreement, AB allocates the country X tax 50% to A (\$10,000) and 50% to B (\$10,000). This allocation is in proportion to the partners' CFTE category shares of the \$100,000 net income. Accordingly, AB's allocations of country X taxes are deemed to be in accordance with the partners' interests in the partnership.

(d) The facts are the same as in (c) above, except that, in addition to \$20,000 of country X tax, AB is subject to \$30,000 of country Y withholding tax with respect to the \$300,000 of gross income that it earns in 2016. Country Y does not allow any deductions for purposes of

determining the withholding tax. There is a single CFTE category with respect to AB's net income. Both the \$20,000 of country X tax and the \$30,000 of country Y withholding tax relate to that income and are therefore allocated to the single CFTE category. However, net income in a CFTE category is reduced by the amount of an allocation for which a deduction is allowed in determining a foreign taxable base, but only for purposes of applying the new rules to allocations of CFTEs that are attributable to that foreign tax.

Accordingly, because the \$100,000 allocation of gross income is deductible for country X tax purposes but not for country Y tax purposes, the allocations of the CFTEs attributable to country X tax and country Y tax are analyzed separately. For purposes of applying these new rules to allocations of the CFTEs attributable to the \$20,000 tax imposed by country X, the analysis described in the new rules applies. For purposes of applying these new rules to allocations of the CFTEs attributable to the \$30,000 tax imposed by country Y, which did not allow a deduction for the \$100,000 gross income allocation, the net income in the single CFTE category is \$200,000.

Pursuant to the partnership agreement, AB allocates the country Y tax 50% to A (\$15,000) and 50% to B (\$15,000). These allocations are not deemed to be in accordance with the partners' interests in the partnership under the new rules because they are not in proportion to the partners' CFTE category shares of the \$200,000 of net income in the category, which is allocated 75% to A and 25% to B under the partnership agreement. Accordingly, the country Y taxes will be reallocated according to the partners' interests in the partnership.

(e) If, rather than being a preferential gross income allocation, the \$100,000 was a guaranteed payment to A within the meaning of § 707(c), the amount of net income in the single CFTE category of AB for purposes of applying the new rules to allocations of CFTEs would be the same as in the fact patterns described above.

Example 2. (a) A, B, and C form ABC, an eligible entity (as defined in Treas. Reg. § 301.7701-3(a) of this chapter) treated as a partnership for U.S. Federal income tax purposes. ABC owns three entities, DEX, DEY, and DEZ, which are organized in, and treated as corporations under the laws of, countries X, Y, and Z, respectively, and as disregarded entities for U.S. Federal income tax purposes. DEX operates business X in country X, DEY operates business Y in country Y, and DEZ operates business Z in country Z. Businesses X, Y, and Z relate to the licensing and sublicensing of intellectual property owned by DEZ. During 2016, DEX earns \$100,000 of royalty income from unrelated payors on which it pays no withholding taxes. Country X imposes a 30% tax on DEX's net income.

DEX makes royalty payments of \$90,000 during 2016 to DEY that are deductible by DEX for country X purposes and subject to a 10% withholding tax imposed by country X. DEY earns no other income in 2016. Country Y does not impose income or withholding taxes. DEY makes royalty payments of \$80,000 during 2016 to DEZ. DEZ earns no other income in 2016. Country Z does not impose income or withholding taxes. The royalty payments from DEX to DEY and from DEY to DEZ are disregarded for U.S. Federal income tax purposes.

(b) As a result of these payments, DEX has taxable income of \$10,000 for country X purposes on which \$3,000 of taxes are imposed, and DEY has \$90,000 of income for country X withholding tax purposes on which \$9,000 of withholding taxes are imposed. Pursuant to the partnership agreement, all partnership items from business X, excluding CFTEs paid or accrued by business X, are allocated 80% to A and 10% each to B and C. All partnership items from business Y, excluding CFTEs paid or accrued by business Y, are allocated 80% to B and 10% each to A and C. All partnership items from business Z, excluding CFTEs paid or accrued by business Z, are allocated 80% to C and 10% each to A and B.

Because only business X has items that are regarded for U.S. Federal income tax purposes (the \$100,000 of royalty income), only business X has partnership items. Accordingly A is allocated 80% of the income from business X (\$80,000) and B and C are each allocated 10% of the income from business X (\$10,000 each). There are no partnership items of income from business Y or Z to allocate.

(c) Because the partnership agreement provides for different allocations of partnership net income attributable to businesses X, Y, and Z, the net income attributable to each of businesses X, Y, and Z is income in separate CFTE categories. An item of gross income that is recognized for U.S. Federal income tax purposes is assigned to the activity that generated the item, and disregarded inter-branch payments are not taken into account in determining net income attributable to an activity.

Consequently, all \$100,000 of ABC's income is attributable to the business X activity for U.S. Federal income tax purposes, and no net income is in the business Y or Z CFTE category. The \$3,000 of country X taxes imposed on DEX is allocated to the business X CFTE category. The additional \$9,000 of country X withholding tax imposed with respect to the inter-branch payment to DEY is also allocated to the business X CFTE category because for U.S. Federal income tax purposes the related \$90,000 of income on which the country X withholding tax is imposed is in the business X CFTE category.

Therefore, \$12,000 of taxes (\$3,000 of country X income taxes and \$9,000 of the country X withholding taxes) is related to the \$100,000 of

net income in the business X CFTE. The allocations of country X taxes will be in proportion to the CFTE category shares of income to which they relate and will be deemed to be in accordance with the partners' interests in the partnership if such taxes are allocated 80% to A and 10% each to B and C.

Example 3. (a) Assume that the facts are the same as Example 2(a) above, except that in order to reflect the \$90,000 payment from DEX to DEY and the \$80,000 payment from DEY to DEZ, the partnership agreement treats only \$10,000 of the gross income as attributable to the business X activity, which the partnership agreement allocates 80% to A and 10% each to B and C. Of the remaining \$90,000 of gross income, the partnership agreement treats \$10,000 of the gross income as attributable to the business Y activity, which the partnership agreement allocates 80% to B and 10% each to A and C; and the partnership agreement treats \$80,000 of the gross income as attributable to the business Z activity, which the partnership agreement allocates 80% to C and 10% each to A and B. In addition, the partnership agreement allocates the country X taxes among A, B, and C in accordance with which disregarded entity is considered to have paid the taxes for country X purposes. The partnership agreement allocates the \$3,000 of country X income taxes 80% to A and 10% to each of B and C, and allocates the \$9,000 of country X withholding taxes 80% to B and 10% to each of A and C. Thus, ABC allocates the country X taxes \$3,300 to A (80% of \$3,000 plus 10% of \$9,000), \$7,500 to B (10% of \$3,000 plus 80% of \$9,000), and \$1,200 to C (10% of \$3,000 plus 10% of \$9,000).

(b) In order to prevent separating the CFTEs from the related foreign income, the special allocations of the \$10,000 and \$80,000 treated under the partnership agreement as attributable to the business Y and the business Z activities, respectively, which do not follow the allocation ratios that otherwise apply under the partnership agreement to items of income in the business X activity, are treated as divisible parts of the business X activity and, therefore, as separate activities.

Because the divisible part of the business X activity attributable to the portion of the disregarded payment received by DEY and not paid on to DEZ (\$10,000) and the net income from the business Y activity (\$0) are both shared 80% to B and 10% each to A and C, that divisible part of the business X activity and the business Y activity are treated as a single CFTE category. Because the divisible part of the business X activity attributable to the disregarded payment paid to DEZ (\$80,000) and the net income from the business Z activity (\$0) are both shared 80% to C and 10% each to A and B, that divisible part of the business X activity and the business Z activity are also treated as a single CFTE category.

Accordingly, \$10,000 of net income attributable to business X is in the business X CFTE category, \$10,000 of net income of business X attributable to the net disregarded payments of DEY is in the business Y CFTE category, and \$80,000 of net income of business X attributable to the disregarded payment to DEZ is in the business Z CFTE category.

(c) Under the new rules, the \$3,000 of country X tax imposed on DEX's income is allocated to the business X CFTE category. Because the \$90,000 on which the country X withholding tax is imposed is split between the business Y CFTE category and the business Z CFTE category, those withholding taxes are allocated on a pro rata basis, \$1,000 [$\$9,000 \times (\$10,000 / \$90,000)$] to the business Y CFTE category and \$8,000 [$\$9,000 \times (\$80,000 / \$90,000)$] to the business Z CFTE category. The \$3,000 of country X taxes allocated to the business X CFTE category must be allocated in proportion to the CFTE category shares of income to which they relate, and therefore would be deemed to be in accordance with the partners' interests in the partnership if such taxes were allocated 80% to A and 10% each to B and C.

The allocation of the \$1,000 of country X withholding taxes allocated to the business Y CFTE category would be in proportion to the CFTE category shares of income to which they relate, and therefore would be deemed to be in accordance with the partners' interests in the partnership if such taxes were allocated 80% to B and 10% each to A and C. The allocation of the \$8,000 of country X withholding taxes allocated to the business Z CFTE category would be in proportion to the CFTE category shares of income to which they relate, and therefore would be deemed to be in accordance with the partners' interests in the partnership if such taxes were allocated 80% to C and 10% each to A and B.

Thus, to satisfy the safe harbor, ABC must allocate the country X taxes \$3,300 to A (80% of \$3,000 plus 10% of \$1,000 plus 10% of \$8,000), \$1,900 to B (10% of \$3,000 plus 80% of \$1,000 plus 10% of \$8,000), and \$6,800 to C (10% of \$3,000 plus 10% of \$1,000 plus 80% of \$8,000).

(d) ABC's allocations of country X taxes are not deemed to be in accordance with the partners' interests in the partnership because they are not in proportion to the partners' CFTE category shares of income to which the country X taxes relate. Accordingly, the country X taxes will be reallocated according to the partners' interests in the partnership.

IX. PREVIOUSLY TAXED INCOME POST-TRA.

A. § 959 Previously Tax Income and § 986(c) After the Tax Reform Act.

1. Section 959 previously taxed income ("PTI") was discussed in Section I.A. no. 67 (special § 965/§ 986(c) rules) above in the context of

§ 965, Prop. Treas. Reg. § 1.986-1(c)-1, and Notices 2018-07 and 2018-13. It's further discussed in Sections VII.N. (§ 904(d) baskets) and T. and U. (FTC related issues).

2. Inclusions under the § 965 transition-inclusion rules and the GILTI provisions will result in substantial amounts of previously taxed income under § 959 ("PTI"). Distributions of this PTI will result in currency gain or loss under § 986(c). Prop. Treas. Reg. § 1.986(c)-1(b) and (c) discussed in Section I above, specifically consider the application of § 986(c) to PTI created under the § 965 inclusion rules, including § 965(b) PTI, when those amounts are distributed. It reduces the currency gain or loss amount in the context of § 965. Although seemingly well-intended, the statutory support for this amelioration seems lacking. In any event, the currency gain or loss still could be significant. The currency gain or loss amount also remains undiminished under the GILTI provisions, which are not addressed in the Notice.
3. We thought it would be helpful to discuss some of the rules applicable in the context of § 986(c). The seminal learning starts with Notice 88-71, a 30-year old notice issued shortly after the 1986 Tax Act. The Notice is an "administrative pronouncement" that may be relied on to the same extent as a revenue ruling. Thus, taxpayers can follow the rules in the Notice without concerns about penalties.
4. Eighteen years later, in 2006, Treasury and the IRS issued proposed regulations under § 959. The writers of the proposed regulations, however, seem to have ignored the § 986(c) rules as they were set forth in the 1988 Notice or assumed that taxpayers were not all following the Notice.
5. The proposed § 959 regulations were never finalized. Twelve years have passed since they were issued. Taxpayers, of course, can rely on these regulations or take contrary positions as is the case with all proposed regulations. Treasury and the IRS also could finalize them, although with a prospective effective date since they state they will be prospectively applied when finalized. The proposed regulations state that, after the regulations are adopted, taxpayers will have to conform their accounting for PTI distributions to the rules in the regulations.

B. Notice 88-71.

1. For purposes of determining the amount of foreign currency gain or loss under § 986(c) that must be recognized by a U.S. shareholder with respect to a distribution of PTI, the distribution will not be considered related to a particular tax year. Rather, the amount of § 986(c) currency gain or loss is to be determined using the following formula for each separate § 904(d) category ("basket") of a shareholder:

$$\begin{array}{rcl}
\text{Total dollar inclusions} & & \text{Units of functional} \\
\text{under } \S 951(a)(1) \text{ less} & & \text{currency PTI distributed} \\
\text{dollar basis of prior PTI} & \times & \frac{\text{Total units of functional}}{\text{currency PTI}} \\
\text{inclusions} & & \\
& & = \text{Dollar basis} \\
& & \text{attributed to PTI} \\
& & \text{distribution} \\
\\
\text{Dollar value of PTI} & & \text{Dollar basis attributed to} \\
\text{distribution} & - & \text{PTI distribution} \\
\text{(Spot Rate)} & & \\
& & = \text{Foreign} \\
& & \text{Currency gain} \\
& & \text{or loss}
\end{array}$$

2. Thus, to compute foreign currency gain or loss under § 986(c), a shareholder must determine for each of its separate § 904(d) categories the shareholder's functional currency account of PTI and the shareholder's dollar basis in that account. Amounts distributed in any taxable year are removed from the accounts before calculating foreign currency gain or loss in a later taxable year. A distribution of PTI is allocated among the shareholder's PTI accounts in separate categories on an annual LIFO basis with the distribution allocated within each year among the separate categories on a pro rata basis.
3. In an example, a 100%-owned CFC has three years of earnings that generated Subpart F income: 150u, 50u and 200u for 1987, 1988 and 1989 respectively. (The letter "u" refers to the CFC's functional currency.) The exchange rates are \$1:1u for 1987 and 1988, \$.9:1u in 1989, and \$.8:1u in 1990. Thus, the dollar has been strengthening against the relevant foreign currency.
4. The § 986(c) foreign currency gain or loss on a 100u distribution in 1990 is computed with reference to each separate category of the domestic owner's PTI to which the distribution is attributable. In the example, the domestic corporate owner has only general-limitation PTI. Thus, the distribution is attributable only to that PTI account. If more than one account existed, the distribution would need to be allocated to each account.
5. The total dollar basis in each account is computed by adding together the "u" amounts of PTI for each year translated into dollars as provided in § 989(b)(3). This is the same rate used to determine the domestic corporation's Subpart F income inclusion. Thus, the total dollar basis in the domestic corporation's general limitation PTI account before any distribution is made is \$380 ((150u of 1987 PTI x \$1/1u) + (50u of 1988 PTI x \$1/1u) + (200u of 1989 PTI x \$.9/1u)).
6. The dollar value of the PTI distribution is computed by translating the distribution at the spot rate on the date of the distribution as required by § 989(b)(1). Thus, \$80 is received. The § 986(c) foreign currency gain or loss with respect to the 100u distribution of PTI in 1990 is computed as follows:

$$\$380 \quad \times \quad \frac{100u}{400u} \quad = \quad \$95 \text{ dollar basis attributable to PTI distribution}$$

$$\$80 \text{ PTI distribution} \quad - \quad \$95 \text{ dollar basis} \quad = \quad \$15 \text{ (foreign currency loss under } \S 986(c))$$

7. The \$15 loss is a foreign-source general-limitation loss. After the distribution, 100u is removed from the domestic corporation's general basket PTI account and the dollar basis in that account is reduced by \$95 (from \$380 to \$285) for purposes of determining the domestic corporation's § 986(c) foreign currency gain or loss on later distributions.
8. These rules operate separately for § 956 PTI (§ 959(c)(1)) and Subpart F income PTI (§ 959(c)(2)) unless an election is made to combine them. The Notice says regulations will provide how to make the election.
9. The Notice also provides that on a distribution of PTI through a chain of ownership described in § 958(a)(2), the PTI account with respect to the distributee corporation is reduced by the amount of any additional foreign taxes paid on or with respect to the distribution. *See* Treas. Reg. § 1.959-3(d). For purposes of determining foreign currency gain or loss under § 986(c), a shareholder's functional currency account of PTI attributable to a particular upper-tier foreign corporation is reduced by the functional currency amount of those taxes imposed on or with respect to the PTI when distributed through a chain of ownership.
10. In addition, the shareholder's dollar basis in the functional currency account of PTI with respect to the upper-tier will be reduced by the dollar value of the taxes when paid or accrued (taking into account any § 905(c) adjustment). The Notice states that regulations will provide for allocation where there is more than one shareholder to which PTI is attributable.
11. An example in the Notice illustrates the distribution of PTI from lower-tier to upper-tier CFCs. The lower-tier PTI is kept in local currency.
12. In the case of § 1248 transactions, the Notice states that solely for purposes of computing any exchange gain or loss under § 986(c), PTI attributable to stock with respect to which a § 1248 transaction (or § 1291 PFIC transaction) is relevant will be treated as if it were distributed immediately prior to the transaction.
13. The dollar value of the PTI is computed using the spot rate on the date of the transaction as required by § 989(b)(2). Exchange gain or loss will be recognized by the U.S. shareholder. The exchange gain or loss so recognized will increase (or decrease) the U.S. shareholder's adjusted basis in the stock of the foreign corporation for purposes of computing

gain or loss with respect to the stock in the transaction. The shareholder's dollar basis with respect to each account of PTI will be increased (or decreased) by the exchange gain or loss recognized.

14. The Notice contains an example illustrating § 1248 and its interaction with § 986(c).

C. Proposed § 959 Regulations.

1. The proposed regulations under § 959, which as noted above were issued 18 years after the Notice was published, state at Prop. Treas. Reg. § 1.959-3(b)(3)(ii) that for purposes of computing foreign currency gain or loss under § 986(c) and adjustments to stock basis under §§ 961(b) and (c) with respect to distributions of PTI of any foreign corporation, *in lieu of maintaining annual dollar basis accounts* with respect to PTI, a taxpayer may maintain an aggregate dollar basis pool that reflects the dollar basis of all of the corporation's PTI described in §§ 959(c)(1) and 959(c)(2) and treat a pro rata portion of the dollar basis pool as attributable to distributions of that PTI.
2. A taxpayer makes this election by using a dollar-basis pool to compute foreign currency gain or loss under § 986(c) with respect to distributions of PTI or to compute gain or loss with respect to its stock in the foreign corporation, whichever occurs first. Any subsequent change in the taxpayer's method of assigning dollar basis may be made only with the consent of the IRS.
3. The proposed regulations seem to assume that in the absence of an election, taxpayers must maintain annual dollar basis accounts for purposes of § 986(c). This is contrary to Notice 88-71. For the 18 years between 1988 and 2006, taxpayers presumably were following Notice 88-71's directed methodology, which is a rolling-average methodology. It's unclear why the regulations' draftspersons apparently thought the rule was otherwise or that taxpayers were not following those rules.
4. Possibly, the regulations' draftspersons were concerned that taxpayers with § 986(c) losses might be using a method to accelerate their losses while taxpayers with gains were using a different method to minimize their gains. The election might have been designed to ensure that taxpayers could not switch back and forth.
5. Under the proposed regulation, separate annual dollar-basis accounts also must be maintained for § 959(c)(1) PTI and § 959(c)(2) PTI.
6. While the proposed regulations' annual-dollar-basis approach is different from the rolling-average method provided in Notice 88-71, taxpayers using the Notice's method likely have effectively made the election provided in the proposed regulations in any event. If not, any change

would require consent, at least if the proposed regulations were finalized as they were proposed, although a question would arise as to when the election needs to be made since the regulations by their own terms would be prospective in application.

7. As a result of the new Tax Reform Act we now have three § 904(d) baskets that are potentially relevant: general, passive, and GILTI. The foreign branch category is not likely to have PTI. As to GILTI, this again raises the question whether a CFC can have income in the GILTI basket. If not, PTI would seem to be limited to general and passive basket accounts. Thus, applying the rules of Notice 88-71, we have three baskets from which PTI can be distributed: general, passive and possibly GILTI. A LIFO approach apparently will need to be used to determine from which basket the PTI is distributed and then the § 986(c) calculations can be done.
8. Interestingly, the proposed § 959 regulations make no mention of maintaining separate PTI accounts for each separate § 904(d) basket.

D. Section 864(e)(4).

1. A related PTI issue involves the allocation of interest expense under Treas. Reg. § 1.861-9. Section 864(e)(4) provides that for purposes of allocating and apportioning expenses on the basis of assets, the asset basis of any stock in a non-affiliated 10-percent owned corporation must be (1) increased by the amount of earnings and profits of such corporation attributable to such stock and accumulated during the period the taxpayer held the stock or (2) reduced (but not below zero) by any deficit in earnings and profits of the corporation attributable to that stock for the period.
2. Section 864(e)(4)(D) provides that for purposes of these rules, “proper adjustment” must be made to the earnings and profits of any corporation to take into account any earnings and profits included in gross income under § 951 or under any other provision of the Code and reflected in the adjusted basis of the stock. Thus, stock basis for these purposes is not increased due to the CFC’s E&P that is PTI. This presumably is to avoid a double counting. This could be a bigger issue now that CFCs will have so much PTI.

E. NYSBA Comments on Previously Taxed Earnings.

1. The NYSBA submitted a report that provides several PTI recommendations. The report also analyzes and compares the results of multiple CFCs conducting foreign activities to the results if the foreign activities were conducted by a single CFC. The report articulates recommendations based on the principle of avoiding double taxation or

unintended non-taxation of the same earnings. The report illustrates the need for PTI modifications through a number of helpful examples.

2. The issue of whether and how PTI attributes can be shared within a consolidated group as is very different after the TCJA, and requires consideration of the ability to take FTCs and the complexities of § 1059 (which can operate to reduce basis or create gain if a dividend is extraordinary and there is no 1-year holding period (or if it is *per se* an extraordinary dividend under § 1059(e)).
3. The limited gain reduction rule in Notice 2018-7 and the § 965 proposed regulations only applies to distributions of § 965(a) PTI and § 965(b) PTI during the transition year. The NYSBA report recommends that the Treasury should resolve the issue by modifying Treas. Reg. §§ 1.961-1(a)(1) and 1.961-2(a)(1) to clarify that for purposes of determining § 961(b)(2) gain, basis decreases in CFC stock under § 961(b) (and negative basis adjustments pursuant to an election under Prop. Treas. Reg. § 1.965-2(g) (2018)), and gain under § 961(b)(2), do not occur prior to giving effect to basis increases under § 961(a).
4. If Treasury does not clarify that basis decreases, then Treasury should allow distributions during the transition year to be treated as being made first out of § 965(a) PTI and § 965(b) PTI (before other types of PTI), so that such distributions, if necessary, would be eligible for the gain reduction rule.
5. The NYSBA recommends regulations providing that there should be no gain recognition (or basis reduction) by reason of PTI distributions in excess of basis in cases where the upper-tier CFC did not previously increase its basis in lower-tier CFC stock under § 961(a) and (c).
6. Treasury should also issue regulations providing that § 961(c) basis adjustments in lower-tier CFC stock apply not only for purposes of calculating the Subpart F income of upper-tier CFCs, but also for purposes of calculating GILTI tested income of upper-tier CFCs.
7. The NYSBA report states that Treasury should confirm that § 1248 recharacterization is available for § 961(b)(2) gain and should clarify whether § 1248(a)(1) excludes § 965(b) PTI from availability to recharacterize gain as a dividend.
8. Treasury should also consider issuing regulations providing that a § 969(c)(3) deficit is not netted with the amount of PTI; rather, both amounts can coexist as disaggregated components of a CFC's E&P.
9. The NYSBA recommends regulations providing that a distribution under § 301(c)(2) does not reduce PTI; rather, that PTI should only be reduced

by the amount of a distribution that otherwise would have been included in gross income by a U.S. shareholder.

10. Treasury should consider if policies, including policies to prioritize the distribution of § 965(a) PTI and § 965(b) PTI, dictate a priority between different types of § 959(c)(2) PTI.
11. The report states that the merits of the proposed PTI account maintenance system and other features of the 2006 proposed § 959 regulations are beyond its scope, and refers the reader to the 2015 NYSBA report on the 2006 proposed § 959 regulations. The scope of the new report generally is limited to issues raised by the TCJA. *See* A. above for a discussion of computational issues.

F. Previously Taxed Earnings and Profits Accounts.

1. IRS Notice 2019-01 explains regulations that will be issued regarding foreign corporations with previously taxed earnings and profits (“PTEP”). The notice is essential reading necessary to an understanding of some of the foreign tax credit rules discussed in Section VII, specifically in subsection U. thereof.
2. Background.
 - (a) The term PTEP refers to earnings and profits (“E&P”) of a foreign corporation attributable to amounts which are, or have been, included in the gross income of a U.S. shareholder (as defined under § 951(b)) under § 951(a) or under § 1248(a). Under § 959(a)(1), distributions of PTEP are excluded from the U.S. shareholder’s gross income, or the gross income of any other U.S. person who acquires the U.S. shareholder’s interest in the foreign corporation.
 - (b) Section 959(a)(2) further excludes PTEP from a U.S. shareholder’s gross income if the E&P would be included in the gross income of the U.S. shareholder or successor in interest under § 951(a)(1)(B) as an amount determined under § 956. Distributions of PTEP to a U.S. shareholder or successor in interest generally are not treated as dividends except that they immediately reduce the E&P of the foreign corporation. § 959(d).
 - (c) Section 959(c) provides that distributions from a foreign corporation are first attributable to PTEP described in § 959(c)(1) (“§ 959(c)(1) PTEP”) and then to PTEP described in § 959(c)(2) (“§ 959(c)(2) PTEP”), and finally to non-previously taxed E&P (“§ 959(c)(3) E&P”). In addition, in determining the amount of any inclusion under §§ 951(a)(1)(B) and 956 regarding a foreign corporation, PTEP attributable to § 951(a)(1)(A) inclusions

remaining after any distributions during the year are taken into account before non-previously taxed E&P described in § 959(c)(3). § 959(f).

- (d) Regulations proposed in 2006 addressed some of the complexities and open issues regarding the application of §§ 959 and 961 that are not specifically addressed in the current final regulations, which were originally published in 1965. The 2006 proposed regulations have not been finalized. Treasury and the IRS intend to withdraw those proposed regulations and to issue new proposed regulations under §§ 959 and 961.
- (e) Under Prop. Treas. Reg. § 1.959-3(b), shareholders must account for PTEP regarding their stock in a foreign corporation, and foreign corporations must account for the aggregate amount of PTEP of all shareholders, as well as § 959(c)(3) E&P. The Notice states that before the TCJA, annual accounts generally were maintained for each separate category of income described in § 904(d)(1) and segregated between § 959(c)(1) PTEP and § 959(c)(2) PTEP, and cites Notice 88-71, 1988-2 C.B. 374.
- (f) Under the provisions of the TCJA, the portion of a U.S. shareholder's global intangible low-taxed income ("GILTI") included in gross income under § 951A(a) that is allocated to a controlled foreign corporation under § 951A(f)(2) and Prop. Treas. Reg. § 1.951A-6(b)(2) is treated as an amount included in the gross income of a U.S. shareholder under § 951(a)(1)(A) for purposes of § 959. Section 951A(f)(1).
- (g) Similarly, amounts determined under § 965(a) regarding certain foreign corporations are treated as increases to Subpart F income, and a U.S. shareholder generally includes in gross income under § 951(a)(1)(A) its pro rata share of those amounts, subject to reduction under § 965(b) for certain deficits attributable to stock in another foreign corporation owned by the U.S. shareholder.
- (h) Amounts of a U.S. shareholder's inclusions under § 965(a) that are reduced by deficits attributable to stock of another foreign corporation under § 965(b) are treated as amounts included in the shareholder's gross income under § 951(a) for purposes of § 959. § 965(b)(4)(A).
- (i) Section 245A(e)(2) treats certain hybrid dividends received by a CFC as Subpart F income for purposes of § 951(a)(1)(A). Section 964(e)(4) treats a certain portion of gain on the disposition of CFC stock as Subpart F income of the selling CFC for purposes of § 951(a)(1)(A).

- (j) Accordingly, after the TCJA, § 959(c)(2) PTEP may arise from income inclusions under § 951(a)(1)(A) (including by reason of §§ 245A(e)(2), 951A(f)(1), 959(e), 964(e)(4), 965(a) or § 965(b)(4)(A).
- (k) Section 965 and the proposed regulations thereunder provide special foreign tax credit and deduction rules. Proposed regulations under § 986 provide special foreign currency gain or loss rules for distributions of PTEP attributable to income inclusions under § 965(a) and PTEP attributable to the application of § 965(b)(4)(A) (collectively, “§ 965 PTEP”). *See* Prop. Treas. Reg. §§ 1.965-5 and 1.986(c)-1. Section 245A(e)(3) applies the disallowance of foreign tax credits in § 245A(d) regarding any amount included in the income of a U.S. shareholder pursuant to § 245A(e)(2).
- (l) As discussed above in Section VII, Prop. Treas. Reg. § 1.960-3(c) establishes, for purposes of determining the amount of foreign income taxes deemed paid, a system of accounting for PTEP in annual accounts for each separate category of income as defined in Prop. Treas. Reg. § 1.904-5(a)(4)(v) (“§ 904 category”). It also segregates each annual account into ten PTEP groups. The groups correspond to various types of income inclusions under § 951(a) (including amounts treated as giving rise to an income inclusion under § 951(a) for purposes of § 959) and PTEP reclassifications that can arise after the TCJA.⁷
- (m) The TCJA also provides for a deduction regarding certain amounts that are included in the income of a domestic corporation and treated as § 951(a)(1)(A) inclusions for purposes of § 959. Sections 245A and 1248(j) generally allow a deduction with respect to gain on the sale of stock of a foreign corporation treated as a dividend under § 1248. In the case of gain treated as a dividend under § 964(e)(1) upon the sale or exchange by a CFC of stock of a lower tier foreign corporation and included in the CFC’s Subpart F income under § 964(e)(4), § 964(e)(4) generally allows a deduction under § 245A with respect to a domestic corporation’s pro rata share of the Subpart F income that it includes in gross income as a dividend pursuant to § 964(e)(4).

⁷ Prop. Treas. Reg. § 1.904-4(p) would cause § 986(c) currency gain or loss regarding distributions of PTEP to be included in the general or passive § 904(d) baskets. It also can result in § 986(c) currency gain or loss in the GILTI basket, but due to the ordering rules discussed later in the text (§ 965 PTEP is distributed first), the GILTI basket issue might be years away for many taxpayers.

G. PTEP Regulations To Be Issued.

1. Annual Accounts and Groups of Previously Taxed Earnings and Profits.

- (a) The TCJA created the need to account for new groups of PTEP because § 959(c)(2) PTEP may arise by reason of income inclusions under §§ 951(a)(1)(A), 245A(e)(2), 951A(f)(1), 959(e), 964(e)(4), 965(a) or 965(b)(4)(A), and those different groups of PTEP may be subject to different rules under §§ 960, 965(g), 245A(e)(3), and 986(c).
- (b) Because § 959(c)(2) PTEP may be reclassified as § 959(c)(1) PTEP as a result of §§ 956 and 959(a)(2), similar groups for § 959(c)(1) PTEP must be maintained in order to properly apply §§ 960, 965(g), 245A(e)(3), and 986(c) when earnings are reclassified.
- (c) Groups of § 959(c)(1) PTEP must also be maintained with respect to inclusions under § 951(a)(1)(B) and § 951(a)(1)(C) (before its repeal).
- (d) The notice states regulations will provide that an annual account must be maintained and that each annual PTEP account must be segregated into 16 groups. For rules regarding the year and § 904 category to which an account corresponds, *see* Prop. Treas. Reg. § 1.960-3(c)(1). These 16 groups include the ten groups identified in Prop. Treas. Reg. § 1.960-3(c)(2) and six additional groups. The 16 groups are described in the Notice; we do not describe them here.
- (e) Section 959(c)(1) PTEP will be comprised of PTEP groups 1 through 9 in the Notice, and § 959(c)(2) PTEP will be comprised of PTEP groups 10 through 16.
- (f) The regulations will provide that once PTEP is assigned to a PTEP group within an annual PTEP account for the year of the income inclusion under § 951(a)(1) (including by reason of §§ 245A(e)(2), 951A(f)(1), 959(e), 964(e)(4), or 965(a)) or the year of application of § 965(b)(4)(A), the PTEP will be maintained in an annual PTEP account with a year that corresponds to the year of the account from which the PTEP originated if PTEP is distributed or reclassified in a subsequent taxable year.
- (g) *See also* Prop. Treas. Reg. §§ 1.960-3(c)(3) and 1.960-3(c)(4) (providing similar rules for purposes of determining the amount of foreign income taxes deemed paid under § 960(b)).

- (h) As discussed above, Prop. Treas. Reg. § 1.960-3(c) provides that, for purposes of determining the amount of foreign income taxes deemed paid under § 960(b), with respect to a CFC, a separate annual PTEP account is maintained in each relevant § 904 category and the PTEP in each such account is assigned to one or more of the PTEP groups. However, Treasury and the IRS recognize that for purposes of applying the ordering rules described below, it may be necessary to aggregate amounts across § 904 categories.
- (i) According to the notice, the regulations will provide that, to the extent a CFC has E&P in a PTEP group that is in more than one § 904 category, any distribution out of that PTEP group is made pro rata out of the earnings and profits in each § 904 category.
- (j) Additionally, the rules in Prop. Treas. Reg. §§ 1.960-1 and 1.960-3 addressing the types of PTEP groups and their treatment for purposes of applying § 960(b) will be coordinated, as appropriate, with the forthcoming regulations when finalized.
- (k) The regulations will provide that dollar basis must be tracked for each annual PTEP account, and, to the extent provided in the forthcoming regulations, separately for each PTEP group within an annual account. They will confirm that distributions from any PTEP group reduce the shareholder's stock basis under § 961(b)(1) without regard to how that basis was originally created, including if the basis was created under § 961(a) due to an inclusion unrelated to the PTEP group being distributed.
- (l) Annual PTEP accounts established for taxable years before the applicability date of the regulations will only need to be segregated between the § 951(a)(1)(B) PTEP group, the § 956A PTEP group, and the § 951(a)(1)(A) PTEP group, except for the taxable year to which § 965 applies.
- (m) For the taxable year to which § 965 applies, annual PTEP accounts must also be segregated between the reclassified § 965(a) PTEP group, the reclassified § 965(b) PTEP group, the § 965(a) PTEP group, and the § 965(b) PTEP group (the "§ 965 PTEP groups").
- (n) A shareholder that has maintained a multi-year pool instead of annual PTEP accounts for its § 951(a)(1)(B) PTEP, § 956A PTEP, or its § 951(a)(1)(A) PTEP will be permitted to treat the respective pool as a PTEP group in a single annual PTEP account with an average dollar basis, and that annual PTEP account will be considered the annual PTEP account for the last taxable year ending before the applicability date of the proposed regulations.

- (o) A shareholder that has maintained aggregate dollar basis pools to reflect the dollar basis of its total § 959(c)(1) PTEP or its total § 959(c)(2) PTEP (or both) for taxable years before the applicability date of the regulations will be permitted to assign an average dollar basis to the PTEP in each annual account (other than the § 965 PTEP groups), if it maintained annual accounts for § 959(c)(1) PTEP and § 959(c)(2) PTEP.
- (p) According to the Notice, the regulations are intended to allow for the most flexibility in applying the limitations on the creditability of certain foreign income taxes, and the rules under § 986(c) regarding the recognition of foreign currency gain or loss, to the different types of PTEP. Implementing all of the operative provisions relating to PTEP following the TCJA with complete precision requires maintaining PTEP in 16 PTEP groups across the § 904 categories in annual accounts.
- (q) The Preamble states that Treasury and the IRS recognize the complexity and both the administrative and compliance challenges associated with maintaining such a large number of PTEP groups. They are weighing those considerations against the need for precision in applying the related foreign tax credit and foreign currency rules. They could consolidate PTEP groups or group accounts into multi-year accounts and request comments in this regard.
- (r) Treasury and the IRS made similar comments that we discussed in addressing the related proposed § 960 regulations. See our column of January 7, 2019 at pp. 55-56. They also said there that they might consider consolidating some of the PTEP groups.
- (s) The preamble says that some of the proposed PTEP groups, such as reclassified § 245A(e) PTEP, reclassified § 959(e) PTEP, reclassified § 964(e)(4) PTEP, § 956A PTEP, § 245A(e) PTEP, § 959(e) PTEP, and § 964(e)(4) PTEP are unlikely to arise on a routine basis. Additionally, because of the one-time nature of § 965, once all of the PTEP in the § 965 PTEP groups are distributed (if ever), those groups will be completely eliminated.

2. Ordering of E&P upon Distribution and Reclassification.

- (a) Section 959(c) provides that, for purposes of §§ 959(a) and (b), § 316(a)(2) (relating to E&P of the taxable year) and then § 316(a)(1) (relating to E&P accumulated after February 28, 1913) apply first to § 959(c)(1) PTEP, then to § 959(c)(2) PTEP, and finally to § 959(c)(3) E&P.

- (b) The Notice states that a distribution of PTEP, thus, is dependent upon the existence of E&P otherwise sufficient to support a dividend under § 316. The regulations will clarify that a distribution will be a distribution of PTEP only to the extent it would have otherwise been a dividend under § 316. For example, if a foreign corporation has no current E&P or accumulated E&P at the end of a taxable year, a distribution from the corporation to a shareholder during the taxable year will be a return of basis or treated as gain from the sale or exchange of property under §§ 301(c)(2) or (3), respectively, regardless of whether the shareholder has one or more annual PTEP accounts with respect to its stock in the foreign corporation.⁸
- (c) Under § 316, distributions are considered first as distributions from current E&P, to the extent thereof, and then as distributions from the most recently accumulated E&P, to the extent thereof. As noted above, PTEP will be maintained in annual PTEP accounts. To facilitate the rule in § 959(c), which incorporates the ordering rule of § 316, the forthcoming regulations will require a “last in, first out” approach to the sourcing of distributions from annual PTEP accounts, subject to a special priority rule for PTEP arising by reason of the application of § 965, as discussed in the following paragraph.
- (d) Thus, in general, § 959(c)(1) PTEP in the most recent annual PTEP account will be distributed first (with an exception for § 965 PTEP), followed by the next most recent annual PTEP account, and so on, after which the same approach will apply to § 959(c)(2) PTEP. Within each annual PTEP account, the PTEP attributable to each group of PTEP earned in that year will be distributed in the order prescribed in the following paragraphs.
- (e) The regulations will provide that PTEP attributable to income inclusions under § 965(a) or by reason of § 965(b)(4)(A) receive priority when determining the group of PTEP from which a distribution is made. This priority will be integrated into the general ordering rule of § 959(c) that sources PTEP first from § 959(c)(1) PTEP and then from § 959(c)(2) PTEP.
- (f) Starting with § 959(c)(1) PTEP, as an exception to the last-in, first-out approach, distributions will be sourced first from the reclassified § 965(a) PTEP and then from the reclassified § 965(b)

⁸ This apparently will not result in a loss of PTEP. See the next section (“Adjustments”) paragraph (e).

PTEP.⁹ Once those PTEP groups are exhausted, under the last-in, first-out approach, distributions will be sourced pro rata from the remaining § 959(c)(1) PTEP groups in each annual PTEP account, starting from the most recent annual account.

- (g) Once the PTEP groups relating to § 959(c)(1) PTEP are exhausted, distributions will be sourced from § 959(c)(2) PTEP. As described in the preceding paragraph, the regulations will provide that, as an exception to the last-in, first-out approach, distributions will be sourced first from § 965(a) PTEP and then § 965(b) PTEP. Once those two PTEP groups are exhausted, under the last-in, first-out approach, distributions will be sourced pro rata from the remaining § 959(c)(2) PTEP groups in each annual PTEP account, starting from the most recent annual PTEP account. Finally, once all the PTEP groups have been exhausted, the remaining amount of any distributions will be sourced from § 959(c)(3) E&P, to the extent thereof.
- (h) The regulations will also provide that reclassifications of PTEP pursuant to the application of § 959(a)(2) will be sourced first from § 965(a) PTEP, then § 965(b) PTEP, and then, under a last-in, first-out approach, pro rata from the remaining § 959(c)(2) PTEP groups in each annual PTEP account, starting from the most recent annual PTEP account.
- (i) According to the Notice, these ordering rules are expected to simplify PTEP recordkeeping in the future because, once a foreign corporation distributes all of its § 965 PTEP, the foreign corporation and its U.S. shareholder(s) will have reduced the number of PTEP groups that need to be tracked. Absent the ordering rules, the last in, first out approach to PTEP distributions would trap annual PTEP accounts with § 965 PTEP behind subsequent annual PTEP accounts, requiring the § 965 PTEP to be tracked indefinitely.

3. Adjustments Due to an Income Inclusion in Excess of Current E&P.

- (a) A U.S. shareholder's income inclusion under § 951A is not subject to a limitation based on the E&P of its CFCs for the taxable year. Consequently, in a year in which the portion of a U.S. shareholder's GILTI inclusion amount allocated to a CFC under § 951A(f)(2) and Prop. Treas. Reg. § 1.951A-6(b)(2) exceeds the CFC's current E&P, the PTEP resulting by reason of § 951A(f)(1)

⁹ This could have the effect of greatly delaying triggering § 986(c) currency gain or loss built into PTEP regarding Subpart F and GILTI. The great majority of § 965 PTEP will not trigger § 986(c) currency gain or loss. See Prop. Treas. Reg. § 1.986(c)-1(c) discussed above in Section I.

and Prop. Treas. Reg. § 1.951A-6(b)(1) will exceed the CFC's current E&P and, in some cases, may exceed the CFC's accumulated E&P as well.

- (b) Similarly, an income inclusion under § 951(a)(1)(A) by reason of § 965 is not subject to an E&P limitation. Further, while an inclusion under § 951(a)(1)(A) (other than by reason of § 965) with respect to a CFC is generally subject to an E&P limitation under § 952(c)(1)(A), a U.S. shareholder's inclusion under § 951(a)(1)(A) regarding the CFC can exceed its E&P if such CFC has a tested loss. *See* § 951A(c)(2)(B)(ii) and Prop. Treas. Reg. § 1.951A-6(d) (increasing a CFC's E&P by the amount of a tested loss solely for purposes of applying the E&P limitation of § 952(c)(1)(A)).
- (c) The aggregate of the amounts of § 959(c)(1) PTEP, § 959(c)(2) PTEP, and § 959(c)(3) E&P of a foreign corporation must equal the amount of E&P of the foreign corporation. The regulations under § 959 will provide that current E&P are first classified as § 959(c)(3) E&P and then § 959(c)(3) E&P are reclassified as § 959(c)(1) PTEP or § 959(c)(2) PTEP, as appropriate, in full, which may have the effect of creating or increasing a deficit in § 959(c)(3) E&P.
- (d) For example, in a case in which the portion of a U.S. shareholder's GILTI inclusion amount allocated to a CFC under § 951A(f)(2) and Prop. Treas. Reg. § 1.951A-6(b)(2) exceeds the current E&P of the CFC, § 959(c)(3) E&P will first be increased by the CFC's current E&P and then decreased by the entire amount of the portion of the GILTI inclusion amount allocated to the CFC, possibly below zero, and § 959(c)(2) PTEP will be increased by the same amount. For a similar rule in the case in which a U.S. shareholder's inclusion under § 951(a) by reason of § 965(a) exceeds E&P. *See* Prop. Treas. Reg. § 1.965-2(d)(1).
- (e) In a case where a foreign corporation has a current-year deficit in E&P, that deficit will solely reduce the foreign corporation's § 959(c)(3) E&P without affecting the amount of its § 959(c)(1) PTEP or § 959(c)(2) PTEP.

4. Examples.

Example 1--(i) Facts. USP, a domestic corporation, wholly owns FC, a foreign corporation that has the U.S. dollar as its functional currency. Both USP and FC use the calendar year as their taxable year. Before 2018, the PTEP of FC was maintained in annual accounts. As of December 31, 2018, FC's \$300x of E&P (before taking into account

distributions made or inclusions under § 951(a)(1)(B) in 2018) applicable to USP's interest in FC are classified under the notice.

In 2018, FC has an amount described in § 956(a) (“§ 956(a) amount”) of \$125x, without considering the application of § 959(a)(2). In 2019, FC earns \$25x of current E&P, and the amount of USP's income inclusion under § 951A(a) that is allocated to FC under § 951A(f)(2) and Prop. Treas. Reg. § 1.951A-6(b)(2) is \$20x. FC also makes a distribution of \$195x in 2019. In 2020, FC earns no current E&P, but FC makes a distribution of \$60x. For all years, the PTEP of FC in each PTEP group is described in a single § 904 category, and all § 959(c)(3) E&P of FC are described in a single § 904 category.

(ii) Analysis--(A) 2018. As of December 31, 2018, before considering FC's § 956(a) amount, FC has total § 959(c)(2) PTEP of \$255x. Under § 959(a)(2) and (f)(1), because FC's § 959(c)(2) PTEP exceeds its § 956(a) amount, USP does not include any amount in income under § 951(a)(1)(B). However, under § 959(c)(1)(A), \$125x of FC's § 959(c)(2) earnings must be reclassified as § 959(c)(1) PTEP. Under the rules described in the notice, the reclassification is sourced first from § 965(a) PTEP and then from § 965(b) PTEP. Under the rules of the notice, the reclassified PTEP remains in the 2017 annual PTEP account. Thus, in FC's 2017 annual PTEP account, FC's reclassified § 965(a) PTEP is increased by \$100x and its § 965(a) PTEP is decreased by \$100x. Additionally, FC's reclassified § 965(b) PTEP is increased by \$25x and its § 965(b) PTEP is decreased by \$25x. Accordingly, as of December 31, 2018, FC's E&P applicable to USP's interest in FC are classified under the notice.

(B) 2019--(1) Current year adjustments. During 2019, FC earns \$25x of current E&P, and the amount of USP's income inclusion under § 951A(a) that is allocated to FC under § 951A(f)(2) and proposed § 1.951A-6(b)(2) is \$20x. Thus, before taking into account USP's income inclusions with respect to FC and any distributions by FC, FC's § 959(c)(3) E&P is initially increased by \$25x. As a result of USP's income inclusion under § 951A, FC's § 951A PTEP increases by \$20x and FC's § 959(c)(3) E&P is decreased by \$20x. Accordingly, as of December 31, 2019, FC's E&P (before taking into account distributions made in 2019) applicable to USP's interest in FC are classified under the notice.

(2) Distribution. FC's distribution of \$195x is from PTEP because the entire distribution would be a dividend under § 316(a) without regard to § 959 (that is, for purposes of § 316, at the end of 2019, FC has \$325x of E&P (without regard to the distribution), \$25x of which is current E&P). Under § 959(c), the distribution is first treated as attributable to § 959(c)(1) PTEP.

(i) Section 959(c)(1) PTEP. Under the rules described in the notice, the distribution is (i) first sourced from reclassified § 965(a) PTEP and then from reclassified § 965(b) PTEP, and then pro rata from the remaining PTEP groups that contain § 959(c)(1) PTEP under a last-in, first-out (“LIFO”) approach. Thus, in FC’s 2017 annual PTEP account, FC’s reclassified § 965(a) PTEP is decreased by \$100x and its reclassified § 965(b) PTEP is decreased by \$25x. In FC’s 2016 annual PTEP account, FC’s § 951(a)(1)(B) PTEP is reduced by \$25x. Thus, of the distribution of \$195x, \$150x is treated as attributable to § 959(c)(1) PTEP (\$100x + \$25x + \$25x).

(ii) Section 959(c)(2) PTEP. After the § 959(c)(1) PTEP is exhausted, the remaining portion of the distribution (\$45x) is treated as attributable to § 959(c)(2) PTEP, to the extent thereof. Under the rules described in the notice, distributions are first sourced from § 965(a) PTEP and then from § 965(b) PTEP, and then pro rata from the remaining PTEP groups that contain § 959(c)(2) PTEP under a LIFO approach. Thus, in FC’s 2017 annual PTEP account, FC’s § 965(b) PTEP is decreased by \$25x. In FC’s 2019 annual PTEP account, FC’s § 951A PTEP is decreased by \$20x. Because the entire distribution has been accounted for, the remaining PTEP groups that contain § 959(c)(2) PTEP and FC’s § 959(c)(3) E&P are not affected. Accordingly, as of December 31, 2019, FC’s E&P applicable to USP’s interest in FC are classified under the notice.

(C) 2020. FC’s distribution of \$60x is from PTEP because the entire distribution would be a dividend under § 316(a) without regard to § 959 (that is, for purposes of § 316, at the end of 2020, FC has \$130x of E&P (without regard to the distribution), all which is accumulated E&P). Under § 959(c), the distribution is first treated as attributable to § 959(c)(1) PTEP; however, FC has no § 959(c)(1) PTEP. Additionally, FC has no § 965(a) PTEP or § 965(b) PTEP. Under the rules described in the notice, the distribution is sourced pro rata from the remaining PTEP groups that contain § 959(c)(2) PTEP under a LIFO approach. Thus, in FC’s 2018 annual PTEP account, FC’s § 951A PTEP is decreased by \$37.5x ($\$60x \times \$50x/\$80x$) and its § 951(a)(1)(A) PTEP is decreased by \$22.5x ($\$60x \times \$30x/\$80x$). Because the entire distribution has been accounted for, the remaining PTEP groups that contain § 959(c)(2) PTEP and FC’s § 959(c)(3) E&P are not affected. Accordingly, as of December 31, 2020, FC’s E&P applicable to USP’s interest in FC are classified under the notice.

Example 2. (i) Facts. USP, a domestic corporation, wholly owns FC, a foreign corporation that has the U.S. dollar as its functional currency. Both USP and FC use the calendar year as their taxable year. At the beginning of Year 1, FC has accumulated E&P of \$50x, all of which is § 959(c)(3) E&P. In Year 1, FC has \$25x of current E&P and FC

makes no distributions. Furthermore, in Year 1, USP's income inclusion under § 951A(a) that is allocated to FC under § 951A(f)(2) and Prop. Treas. Reg. § 1.951A-6(b)(2) is \$100x.

(ii) Analysis. Before taking into account USP's income inclusions with respect to FC in Year 1, FC's current E&P for Year 1 increase FC's § 959(c)(3) E&P by \$25x to \$75x (\$50x + \$25x). The \$100x of USP's income inclusion under § 951A(a) allocated to FC results in an increase of \$100x to FC's § 951A PTEP (resulting in a balance of \$100x) and a reduction of \$100x to FC's § 959(c)(3) E&P resulting in a deficit of \$25x (\$75x - \$100x). The sum of the amounts of FC's § 959(c)(1) PTEP (\$0x), § 959(c)(2) PTEP (\$100x), and § 959(c)(3) E&P (deficit of \$25x) equals the amount of FC's E&P (\$75x).

H. Applicability Date.

1. The regulations will apply to taxable years of U.S. shareholders (and successors in interest) ending after December 14, 2018 and to taxable years of foreign corporations ending with or within such taxable years of U.S. shareholders. Before the issuance of the regulations, a shareholder may rely on the rules described in the notice if the shareholder and each person related to the shareholder under § 267(b) or 707(b) apply the rules consistently with respect to PTEP of all foreign corporations in which the shareholder or related shareholder, as the case may be, owns stock for all taxable years beginning with the shareholder's or the related shareholder's taxable year that includes the taxable year end of any such foreign corporation to which § 965 applies.

I. Observations.

1. Whatever the merits of keeping 16 § 959 PTEP accounts, § 986(c) is the 500-pound gorilla in the room. Calculating § 986(c) gains and losses with 16 annual PTEP accounts per CFC could become a career-ending job for the person delegated to do it, but one with millions, possibly hundreds of millions, of dollars at stake.
2. Section 986(c) could prove to be a bar to one of the primary executive and congressional goals in enacting the TCJA: enabling corporations to repatriate foreign earnings without suffering another level of tax. Consider for example a company whose CFCs have \$1 billion of PTEP as a result of § 965, GILTI and Subpart F. A 10% change in currency rates could result in \$100 million in taxable currency gains (or losses) if the CFCs' profits are repatriated.
3. Notice 88-71, discussed in detail above, set forth careful rules for calculating § 986(c) exchange gain or loss, which must be determined under that notice for each of the U.S. shareholder's separate § 904(d)

categories. Gain or loss is calculated using a “rolling average” approach as opposed to keeping annual accounts each with its own built-in gain or loss. Those rules also operated separately for § 956 PTEP, unless an election was made to combine §§ 954 and 956 PTEP accounts. The 1988 notice said that the regulations would provide rules regarding how to make that election.

4. As discussed above, the 2006 proposed regulations provided that for purposes of computing foreign currency gain or loss under § 986(c) and adjustments to stock basis under § 961 regarding distributions of what is now called PTEP of any foreign corporation, *in lieu of maintaining annual dollar basis accounts for PTEP*, a taxpayer could maintain an aggregate dollar basis pool that reflects the dollar basis of all of the corporation’s PTEP described in §§ 959(c)(1) and (2) and treat a pro rata portion of the dollar basis pool as attributable to distributions of that PTEP.
5. The writers of the proposed regulations seemed not to have realized that 1988 notice already provided a contrary rule as the general rule. Possibly, the authors of the 2006 regulation felt that taxpayers should be required to elect a pooling method, but that was eighteen years after taxpayers were required to use that method under Notice 88-71 without an election (other than to combine § 954 and § 956 PTEP). The 2006 proposed regulations also didn’t address § 904 baskets, § 1248, etc.
6. The new (2019) notice states that now there will be up to 16 separate PTEP accounts per year per CFC. It certainly would be helpful if taxpayers could combine –or could elect to combine– into one pool all of the PTEP that belongs in a particular § 904(d) basket and average, or pool, the PTEP in that basket on a multi-year basis for purposes of calculating § 986(c) gain or loss.
7. Further, anything that would minimize taxpayers’ dollar profit and loss exposure under § 986(c) also likely would be helpful. Treasury and the IRS have already proposed to do that in two situations under § 965. *See* Prop. Treas. Reg. § 1.986(c)-1(c).
8. Moving § 965 PTEP to the first level of priority in considering PTEP distributions is helpful regarding minimizing § 986(c) gains and losses but more is needed.

X. SECTION 245A APPLICATION LIMITED.

- A. Treasury and the IRS issued a surprising new set of § 245A temporary regulations seemingly with no corresponding support in the statute. It is not the first time they have done this in writing TCJA regulations (including the “repeal” of § 956) but it is the most surprising. The temporary regulations primary effect would override Congress’s effective date rules, and thus to that extent seem to be based

on a hypothetical technical correction that Congress might never have an interest in writing.

- B. The preamble to the new § 245A regulations says that § 245A is designed to operate residually, so that the § 245A deduction generally applies to any earnings of a CFC to the extent that they are not first subject to the Subpart F regime, the GILTI regime, or the exclusions provided in § 245A(c)(3) (and were not subject to § 965). That is, states the preamble, the text of the Subpart F and GILTI rules defines the types of income to which they apply, and § 245A applies to any remaining untaxed foreign earnings.
- C. Treasury and the IRS are concerned that a literal application of § 245A could result in the § 245A deduction applying to earnings and profits of a CFC attributable to the types of income addressed by the Subpart F or GILTI regimes – the specific types of earnings that Congress described as presenting base erosion concerns. They state that these circumstances can arise when a CFC’s fiscal year results in a mismatch between the effective date for GILTI and the final measurement date under § 965 or involve unanticipated interactions between § 245A and the rules for allocating Subpart F income and GILTI when there is a change in ownership of a CFC.
- D. They state that some taxpayers are undertaking transactions with a view to eliminating current or future taxation of all foreign earnings of a CFC, including earnings attributable to base erosion-type income, by structuring into these situations. They state that these transactions have the potential to substantially undermine the anti-base erosion framework for post-2017 foreign earnings.
- E. The new temporary regulations were issued under the authority in § 245A(g), which directs Treasury and the IRS to issue such regulations as are necessary or appropriate to carry out the provisions of § 245A, and § 7805(a), which authorizes rules and regulations made necessary by reason of changes in the tax laws. They will apply in situations in which Subpart F or tested income earned by a CFC would otherwise escape taxation to its U.S. shareholders as a result of the unanticipated interaction of § 245A and certain rules applicable to the inclusion of Subpart F income and GILTI under §§ 951(a) and 951A, respectively.
- F. The preamble states that the exemption from Subpart F income under § 954(c)(6) also can be used to avoid taxation of income that would otherwise be taxed under the Subpart F or GILTI regimes. These transactions are not dependent upon the availability of § 245A at the level of the U.S. shareholder. The preamble states that this type of concern was first generally described in Notice 2007-9, but has been exacerbated by the enactment of § 951A. This is so because (1) dividends qualifying for § 954(c)(6) generally are not treated as tested income pursuant to § 951A(c)(2)(A)(i)(IV); and (2) the same transactions used to avoid Subpart F inclusions can also be used to avoid GILTI inclusions.

G. Thus, given the authority in § 954(c)(6)(A) for Treasury and the IRS to issue regulations preventing the abuse of § 954(c)(6), the temporary regulations under § 954(c)(6) are designed to ensure that the § 954(c)(6) exception is not used to erode the U.S. tax base through certain transactions preventing the taxation of income that would otherwise be taxed under the Subpart F or GILTI regimes.

H. Limitation of Amounts Eligible for § 245A Deduction.

1. Scope. In the case of a dividend received by a domestic corporation from an a Specified 10%-Owned Foreign Corporation (“SFC”),¹⁰ Temp. Treas. § 1.245A-5T(b) limits the amount of the § 245A deduction to the portion of a dividend not constituting an “ineligible amount.” In general, the ineligible amount is the sum of (i) 50% of the portion of a dividend attributable to certain earnings and profits resulting from transactions between related parties during a period after the measurement date under § 965(a)(2) and in which the SFC was a CFC but during which § 951A did not apply to it (referred to as the “extraordinary disposition amount”) and (ii) the portion of a dividend attributable to certain earnings and profits generated during any taxable year ending after December 31, 2017 in which the domestic corporation reduces its ownership of the CFC (referred to as the “extraordinary reduction amount”).

2. Extraordinary Disposition Amount.

(a) Treasury and the IRS state that their concern relates to the TCJA effective date rules. They state there may be a gap between when § 951A first applies to the U.S. shareholders of a CFC (as of its first taxable year beginning after December 31, 2017) and the last date on which the earnings and profits of the CFC are measured for purposes of § 965, which, under § 965(a), is December 31, 2017 (termed the “disqualified period”). For example, a fiscal year CFC with a taxable year ending November 30 would have a disqualified period from January 1, 2018, the day after its final E&P measurement date under § 965, to November 30, 2018, the last date before § 951A applies to its income.

(b) Treasury and the IRS state that CFCs may have engaged in certain transactions with related parties during their disqualified period with a goal of creating stepped-up basis for the buyer, while generating earnings and profits for the seller CFC that are not subject to any current tax and may be eligible for the § 245A deduction.¹¹

¹⁰ See § 245A(b)(1).

¹¹ As a matter of “judicial notice,” have not taxpayers planned for cons regarding statutory and regulatory effective date rules? Certainly, the writers of statutes know this. In enacting the TCJA, Congress provided specific and very clear effective date rules. Those rules are in the statute. Changing the statute, if a change were necessary, is a task that belongs to Congress.

- (c) Because the transactions generally are structured to avoid creating Subpart F income and occur during the disqualified period, the income from these transactions generally is not subject to U.S. tax under the § 965 transition tax, the Subpart F regime, or the GILTI regime. The preamble states that these earnings and profits could, for example, reduce taxable gain that would otherwise be recognized on the subsequent disposition of stock of the CFC, thus potentially allowing the CFC and its future earnings to be “removed from the U.S. tax system” without the imposition of any U.S. tax.
- (d) Thus, Temp. Treas. Reg. §§ 1.245A-5T(b)(2) and (c)(1) limit the amount of the § 245A deduction allowed to a § 245A shareholder (as defined in Temp. Treas. Reg. § 1.245A-5T(i)(21)) regarding a dividend received from an SFC. Specifically, the deduction is limited to 50% of the extraordinary disposition amount, which is the portion of a dividend received by a § 245A shareholder from an SFC that is paid out of the § 245A shareholder’s “extraordinary disposition account.”
- (e) In general, this account represents the shareholder’s pro rata share of the SFC’s “extraordinary disposition E&P,” reduced by the § 245A shareholder’s prior extraordinary disposition amounts, if any. Temp. Treas. Reg. § 1.245A-5T(c)((3)(i)(C)(1)). Extraordinary disposition E&P is an amount equal to the earnings of an SFC arising from gain recognized by reason of one or more “extraordinary dispositions.” Temp. Treas. Reg. § 1.245A-5T(c)(3)(i)(C).
- (f) The § 245A deduction is limited to 50% of the extraordinary disposition amount to reflect the fact that taxpayers generally would have been eligible for a deduction under either (i) § 250(a)(1)(B) had § 951A applied to the SFC during the disqualified period or (ii) § 965(c) had the net gain been subject to the transition tax under § 965.
- (g) For a disposition by an SFC to be an extraordinary disposition, the disposition must (i) be of specified property (defined in Temp. Treas. Reg. § 1.245A-5T(c)(3)(iv) as any property other than property that produces gross income described in § 951A(c)(2)(A)(i)(I) through (V)), (ii) occur during the SFC’s disqualified period (as defined in Temp. Treas. Reg. § 1.245A-5T(c)(3)(iii)) and when the SFC was a CFC, (iii) be outside of the ordinary course of the SFC’s activities, and (iv) be to a related party. Temp. Treas. Reg. § 1.245A-5T(c)(3)(ii). For these purposes, a disposition by an SFC includes certain indirect dispositions by the SFC through a partnership or other pass-

through entity (including through ownership structures involving tiered pass-through entities).

- (h) In addition, pursuant to an exception intended to limit compliance and administrative burdens, dispositions by an SFC are not considered to be an extraordinary disposition unless they exceed a threshold of the lesser of \$50 million or 5% of the gross value of the SFC's property. Temp. Treas. Reg. § 1.245A-5T(c)(3)(ii)(E).
- (i) The temporary regulations provide a facts-and-circumstances rule for determining whether a disposition occurs outside of the ordinary course of an SFC's activities. They also provide a per se rule that a disposition is treated as outside of the ordinary course of an SFC's activities if the disposition is undertaken with a principal purpose of generating earnings and profits during the disqualified period or if the disposition is of intangible property, within the meaning of § 367(d)(4).
- (j) The temporary regulations include this latter rule because the disposition of intangible property is not an ordinary course transaction (relative to, for example, a routine sale of raw materials from one SFC to another for manufacturing); moreover, during the disqualified period taxpayers may have had a particularly strong incentive to dispose of intangible property (which often has low basis) to generate significant amounts of earnings and profits to the seller (without being subject to current tax) that may be eligible for the § 245A deduction.
- (k) The temporary regulations provide shareholder account rules to ensure that a § 245A shareholder's extraordinary disposition account is properly tracked and reduced in appropriate cases (for example, for prior extraordinary disposition amounts). Temp. Treas. Reg. § 1.245A-5T(c)(3)(i). These shareholder account rules also contain successor rules for a § 245A shareholder that acquires stock of an SFC from another § 245A shareholder regarding which there is an extraordinary disposition account and for certain § 381 transactions and distributions involving § 355 (or so much as § 356 as relates to § 355). Temp. Treas. Reg. § 1.245A-5T(c)(4).
- (l) To address cases in which the § 245A deduction might be available for an SFC held through a pass-through entity or foreign corporation, Temp. Treas. Reg. § 1.245A-5T(g)(3)(i) provides that a § 245A shareholder is treated as owning a pro rata share of stock of an SFC that is owned by a partnership, trust, or estate (domestic or foreign), or a foreign corporation in which the § 245A shareholder owns an interest or stock, as applicable.

- (m) Treasury and the IRS requested comments as to how the extraordinary disposition account rules should apply in circumstances in which an SFC is transferred to a partnership, including the extent to which principles similar to § 704(c)(1)(B) apply to prevent the use of partnerships to circumvent the purposes of the temporary regulations, such as where an SFC is subsequently transferred to a non-contributing partner.
- (n) They believe that Treas. Reg. § 1.701-2(b), as well as the judicial doctrines of economic substance, substance over form, and step transaction, prevent taxpayers from forming or availing of partnerships with a principal purpose of avoiding the application of these rules. The treatment of partnerships under § 245A will be addressed in separate guidance. It is anticipated that this guidance will provide rules ensuring that partnerships may not be formed or availed of to avoid the purposes of the temporary regulations.
- (o) Treasury and the IRS also requested comments on the treatment of consolidated groups under the temporary regulations, including for purposes of maintaining extraordinary disposition accounts. They believe that consolidated groups generally should be treated in the same manner as a single taxpayer for the purposes of Temp. Treas. Reg. § 1.245A-5T(c). Subject to any comments received, it is expected that future rules will provide that consolidated groups generally should not be advantaged or disadvantaged as a result of owning directly or indirectly stock of an SFC through multiple members relative to a standalone corporation owning the same stock.
- (p) Comments were requested regarding whether and how the rules applicable to disqualified basis under Prop. Treas. Reg. § 1.951A-2(c)(5) should be coordinated with Temp. Treas. Reg. § 1.245A-5T(c). Prop. Treas. Reg. § 1.951A-2(c)(5) provides rules for the allocation and apportionment of deductions and losses attributable to disqualified basis, *i.e.*, asset basis created in certain disqualified transfers during the disqualified period. These deductions and losses are allocated and apportioned solely to gross income that is not tested income, Subpart F income, or effectively connected income (defined as “residual CFC gross income”), thereby ensuring that such “costless” tax basis does not inappropriately reduce future tax liability.

3. Extraordinary Reduction Amount.

- (a) The transactions that concern Treasury and the IRS in this category could arise, for example, as a consequence of the application of § 951(a)(2)(B). Section 951(a)(2)(B), a longstanding provision in

the Subpart F regime, prevents double taxation of the same earnings by reducing a U.S. shareholder's pro rata share of Subpart F income (or, following the TCJA, tested income as defined in § 951A(c)(2)(A)) of a CFC by dividends received by another person regarding the same share of stock.

- (b) However, if § 245A were to apply without limitation to dividends from a CFC that reduce another U.S. shareholder's pro rata share of Subpart F income or tested income of the CFC under § 951(a)(2)(B), earnings that would otherwise be subject to the Subpart F or GILTI regimes would escape U.S. taxation to the extent of the reduction.
- (c) For example, in the case of a transfer of CFC stock from one § 245A shareholder (the transferor) to another § 245A shareholder (the transferee), a dividend (including by reason of § 1248) from the CFC to the transferor during the tax year of the transfer might both (i) be excluded from the transferor's income by reason of the § 245A deduction and (ii) reduce the transferee's pro rata share of Subpart F income or tested income of the CFC by reason of § 951(a)(2)(B).
- (d) Treasury and the IRS believe that it would be inconsistent with the residual definition of § 245A eligible earnings and the interaction of § 245A and the Subpart F and GILTI regimes, which form an integrated set of rules to tax post-2017 foreign earnings, to allow a § 245A deduction for a dividend paid out of earnings and profits attributable to Subpart F income or tested income where the dividends, by operation of § 951(a)(2)(B), and could result in double non-taxation of such income. Such a result would also be contrary to the legislative intent underlying the interaction of these provisions.
- (e) Similar results can arise in other cases where the stock of a CFC is transferred during a CFC's tax year by a U.S. shareholder to a foreign person where, after the transfer, the CFC remains a CFC but has no U.S. shareholder that owns (within the meaning of § 958(a)) stock of the CFC.
- (f) Before the TCJA, § 958(b)(4) prevented certain attribution of stock under § 318 from a foreign person to a U.S. person. However, the TCJA repealed § 958(b)(4) so that a foreign corporation can be treated as a CFC despite having no direct or indirect U.S. shareholder that owns (within the meaning of § 958(a)) stock of the CFC and that accordingly can recognize an income inclusion under § 951 or 951A.

- (g) In general, a U.S. shareholder that owns stock in a CFC on the last day within the foreign corporation's year that it is a CFC is taxable on its pro rata share of the CFC's Subpart F income or tested income for purposes of the GILTI regime. However, by reason of the TCJA's repeal of § 958(b)(4), a U.S. shareholder could transfer a CFC to a person that will not be taxed regarding an inclusion under the Subpart F or GILTI regimes without itself being subject to an inclusion.
- (h) Absent any specific limitation in these circumstances, any earnings and profits of the CFC distributed as a dividend (including by reason of § 1248) to the transferor U.S. shareholder during the CFC's taxable year might be eligible for the § 245A deduction. However, had the transfer not occurred (or had the CFC ceased to be a CFC as a result of the transfer), the earnings and profits may have been subject to tax under the Subpart F or GILTI regimes and, therefore, would not have been eligible for the § 245A deduction.
- (i) In these circumstances, § 245A would present taxpayers with a planning opportunity to completely avoid the application of the Subpart F and GILTI regimes on an annual basis. Treasury and the IRS believe that this result would undermine the integrated provisions constituting the TCJA's framework for taxing post-2017 CFC earnings and would contravene legislative intent.
- (j) To address this concern, Temp. Treas. Reg. § 1.245A-5T(b)(1) and (e) limit the amount of the § 245A deduction allowed to a "controlling § 245A shareholder" regarding a dividend from a CFC to the portion of the dividend that is paid out of earnings other than the "extraordinary reduction amount." Under Temp. Treas. Reg. § 1.245A-5T(i)(2), a controlling § 245A shareholder of a CFC is a § 245A shareholder of the CFC that, taking into account ownership of the CFC by certain other persons (such as related persons), owns more than 50% of the stock of the CFC.
- (k) For purposes of applying these rules, a controlling § 245A shareholder also includes any other shareholder that would not otherwise be a controlling § 245A shareholder but acts in concert with the controlling § 245A shareholder. This includes shareholders that sell their shares of the same CFC to the same buyer or buyers (or a related party regarding the buyer or buyers) as part of the same plan as the controlling § 245A shareholder's extraordinary reduction.
- (l) Under Temp. Treas. Reg. § 1.245A-5T(e), for an extraordinary reduction amount to exist regarding a controlling § 245A

shareholder of a CFC, an “extraordinary reduction” must occur during the CFC’s taxable year regarding the shareholder’s ownership of the CFC. An extraordinary reduction generally occurs when either (i) the controlling § 245A shareholder transfers more than 10% of its stock of the CFC (for example, an extraordinary reduction occurs if the shareholder owns 90% of the stock of the CFC and it transfers stock representing more than 9% of the stock of the CFC) or (ii) there is a greater than 10% change in the controlling § 245A shareholder’s overall ownership of the CFC (for example, if the shareholder owns 90% of the stock of the CFC and, as a result of an issuance to a foreign person, the shareholder’s ownership of the CFC is reduced so that it no longer owns at least 81% of the stock of the CFC). Temp. Treas. Reg. § 1.245A-5T(e)(2)(i)(A).

- (m) The temporary regulations include the first prong because if, for example, a § 245A shareholder of a CFC were to transfer shares of stock of the CFC to another § 245A shareholder of the CFC and the other shareholder were to transfer an equal number of similar shares to the first shareholder, neither of the shareholders’ overall ownership of the CFC would change, but the amount taken into account by each of the shareholders by reason of § 951(a)(2)(B) might be reduced as a result of dividends paid regarding shares transferred by the other.
- (n) Under Temp. Treas. Reg. § 1.245A-5T(e)(1) and (2), an extraordinary reduction amount is earnings and profits representing the amount of dividends paid by the corporation that are attributable to Subpart F income or tested income regarding a CFC, to the extent such Subpart F income or tested income (i) would have been taken into account by the controlling § 245A shareholder under § 951 or § 951A had the extraordinary reduction not occurred and (ii) is not taken into account by a domestic corporation or a citizen or resident of the U.S. (that is, a person described in § 7701(a)(30)(A) or (C)).
- (o) The limitation of the § 245A deduction in the case of an extraordinary reduction will generally result in a dividend being included in the income of the controlling § 245A shareholder and not offset by a § 245A deduction. In cases where the CFC has tested income during its taxable year that would have been subject to the GILTI regime but for the extraordinary reduction, a controlling § 245A shareholder might prefer to have an income inclusion under § 951A, potentially benefitting from the deduction available under § 250.

- (p) Therefore, Temp. Treas. Reg. § 1.245A-5T(e)(3)(i) provides an election under which a controlling § 245A shareholder is not required to reduce its § 245A deduction if it elects (and, in some cases, certain other U.S. persons also agree) to close the CFC's taxable year for all purposes of the Code on the date of the extraordinary reduction. The closing of the taxable year of the CFC results in all U.S. shareholders that own (within the meaning of § 958(a)) stock of the CFC on such date taking into account their pro rata share of Subpart F income or tested income earned by the CFC as of that date.
- (q) In addition, pursuant to an exception intended to limit compliance and administrative burdens, for a taxable year in which an extraordinary reduction occurs, no amount is considered an extraordinary reduction amount if the sum of the CFC's Subpart F income and tested income for the taxable year does not exceed the lesser of \$50 million or 5% of the CFC's total income for the year. Temp. Treas. Reg. § 1.245A-5T(e)(3)(ii).

4. Coordination Rules.

- (a) To address cases in which a dividend could qualify as either a hybrid dividend under the rules of § 245A(e) or an ineligible amount under the temporary regulations, Temp. Treas. Reg. § 1.245A-5T(g)(3)(iv) provides a coordination rule pursuant to which a dividend is first subject to the hybrid dividend rules of § 245A(e) and then, to the extent not a hybrid dividend, is subject to the temporary regulations. In future guidance relating to proposed regulations under § 245A(e) and certain other sections, Treasury and the IRS anticipate modifying those regulations to reflect this coordination rule.
- (b) In addition, to address cases in which a dividend might be either an extraordinary disposition amount under Temp. Treas. Reg. § 1.245A-5T(c) or an extraordinary reduction amount under Temp. Treas. Reg. § 1.245A-5T(e), the temporary regulations provide a coordination rule pursuant to which a dividend is first subject to the rules of Temp. Treas. Reg. § 1.245A-5T(e) and then, to the extent not an extraordinary reduction amount, is subject to the rules of Temp. Treas. Reg. § 1.245A-5T(c). Temp. Treas. Reg. § 1.245A-5T(g)(5). Because of this ordering rule, the extraordinary disposition amount regarding a dividend will not exceed the amount by which the dividend exceeds the extraordinary reduction amount regarding the dividend.

5. Transactions Described in § 964(e)(4).

- (a) The rules in the new temporary regulations for determining eligibility for the § 245A deduction also apply to deemed dividends arising by reason of § 964(e)(4), which the TCJA added to the Code. Section 964(e)(4) provides in certain cases that a sale by a CFC of stock of another foreign corporation is treated as a dividend from the target foreign corporation to the selling CFC that is, in turn, treated as Subpart F income of the selling CFC and included in the gross income of the U.S. shareholders of the selling CFC.
- (b) Pursuant to § 964(e)(4)(A)(iii), the § 245A deduction is allowed to any U.S. shareholder regarding such Subpart F income included in gross income in the same manner as if such Subpart F income were a dividend received by the shareholder from the selling CFC. Thus, according to the preamble, § 964(e)(4) presents the same concerns as a direct dividend. Absent a rule to the contrary, taxpayers might use § 964(e)(4) to avoid the results applicable to actual distributions from an upper-tier CFC to a U.S. shareholder or to constructive dividends under § 1248 that were discussed above.
- (c) Therefore, the rules in the new temporary regulations for determining eligibility for the § 245A deduction also apply to deemed dividends arising by reason of § 964(e)(4). Moreover, all U.S. shareholders of the selling CFC are deemed to act in concert for purposes of the temporary regulations regarding transactions described in § 964(e)(4).

6. Limitation of Amount Eligible for § 954(c)(6).

(a) In General.

- i. The § 954(c)(6) exception may cause dividends from one CFC to another to result in tax consequences similar to, but not dependent upon, those that can be effectuated using § 245A in conjunction with the disqualified period, § 951(a)(2)(B), or the repeal of § 958(b)(4).
- ii. To protect against avoidance of the rules for extraordinary dispositions, Temp. Treas. Reg. § 1.245A-5T(d) relies on authority under § 954(c)(6)(A) to prevent the § 954(c)(6) exception from applying in cases where a dividend from a lower-tier CFC to an upper-tier CFC would be an extraordinary disposition amount if distributed directly to the § 245A shareholders of the lower-tier CFC. In these

cases, the § 954(c)(6) exception applies only to the extent that the amount of the dividend exceeds the sum of each § 245A shareholder's extraordinary disposition account regarding the lower-tier CFC, divided by the aggregate ownership of all U.S. tax residents of the upper-tier CFC that have § 951(a) inclusions and multiplied by 50%.

- iii. The amount is divided by the aggregate ownership of these U.S. tax residents to take into account the fact that the U.S. tax residents (including individuals) will include in gross income a pro rata share of the portion of the dividend not eligible for the § 954(c)(6) exception. The amount is multiplied by 50% in order to provide similar treatment for a dividend received by a § 245A shareholder from a CFC and a dividend received by an upper-tier CFC from a lower-tier CFC. In both cases, the 50% reduction of the § 245A deduction approximates the reduced tax rate by reason of the deduction provided under § 250(a)(1)(B) regarding § 951A inclusions or § 965(c) regarding the transition tax.
- iv. Unlike the disallowance of the § 245A deduction under Temp. Treas. Reg. § 1.245A-5T(b) regarding an extraordinary disposition amount, which applies only to corporate U.S. shareholders, the limitation to the application of the § 954(c)(6) exception regarding a dividend received by an upper-tier CFC can result in a Subpart F inclusion to any U.S. shareholder, including individuals. In addition, the temporary regulations limit the § 954(c)(6) exception in these cases, rather than limiting the application of § 245A only when the lower-tier CFC earnings and profits are distributed through intervening CFCs to a section 245A shareholder. This approach prevents deferral of tax regarding the applicable Subpart F income or tested income and minimizes the administrative and compliance burdens that would be created by continuing to track the relevant earnings at the upper-tier CFC.
- v. Similarly, to prevent these inappropriate uses of the § 954(c)(6) exception to avoid the rules for extraordinary reductions, the temporary regulations apply to limit the amount of any distribution from that CFC out of earnings and profits attributable to Subpart F income or tested income that can qualify for the § 954(c)(6) exception in a taxable year in which an extraordinary reduction occurs regarding the stock of a CFC.

- vi. The limitation to the § 954(c)(6) exception regarding a dividend received by an upper-tier CFC can result in a Subpart F inclusion to any U.S. shareholder, including individuals. To the extent a CFC-to-CFC dividend otherwise satisfies the requirements of § 954(c)(6), it is eligible for the § 954(c)(6) exception only to the extent it exceeds the distributing lower-tier CFC's "tiered extraordinary reduction amount," taking into account certain prior inclusions under § 951(a). Temp. Treas. Reg. § 1.245A-5T(f)(1).
- vii. This amount is equal to the upper-tier CFC's ownership percentage in the lower-tier CFC multiplied by the lower-tier CFC's Subpart F income and tested income for the taxable year, with the resulting product reduced by four amounts. The first amount is the pro rata share of the lower-tier CFC's Subpart F income and tested income for the taxable year that is taken into account by U.S. tax residents and attributable to the shares of the lower-tier CFC owned by the upper-tier CFC.
- viii. The second amount is the amount included in an upper-tier CFC's Subpart F income resulting from prior dividends paid by the lower-tier CFC giving rise to tiered extraordinary reduction amounts or the application of § 245A(e). The third amount is for certain prior extraordinary reduction amounts regarding the lower-tier CFC arising in cases in which the lower-tier CFC was a first-tier CFC at some point in the taxable year and paid a dividend to one or more controlling § 245A shareholders at that time. The fourth amount is for Subpart F income and tested income taken into account by a U.S. tax resident as a result of an issuance of stock directly by the lower-tier CFC during the taxable year. Temp. Treas. Reg. § 1.245A-5T(f)(2).
- ix. The preamble requests comments as to whether a lower-tier CFC's tiered extraordinary reduction amount should be reduced for a pro rata portion of a dividend paid on stock of the lower-tier CFC that was held by non-U.S. shareholders before and after an extraordinary reduction. For purposes of applying Temp. Treas. Reg. § 1.245A-5T(f)(1) and (2) in taxable years of a lower-tier CFC beginning on or after January 1, 2018, and ending before June 14, 2019, a transition rule is provided so that the tiered extraordinary reduction amount of a lower-tier CFC is determined by treating the lower-tier CFC's Subpart F income for the

taxable year as if it were neither Subpart F income nor tested income. Temp. Treas. Reg. § 1.245A-5T(f)(3).

- x. The rule in Temp. Treas. Reg. § 1.245A-5T(f)(1) applies to both actual distributions and deemed distributions that occur by reason of stock dispositions subject to § 964(e)(1) but not § 964(e)(4). Dispositions subject to § 964(e)(1) but not § 964(e)(4) are treated as dividends from the target foreign corporation (or other entity whose earnings and profits gave rise to a dividend under § 964(e)(1)) to the selling CFC and, thus, must be tested for eligibility under § 954(c)(6).
- xi. Additionally, ordering and coordination rules apply regarding the rules relating to the availability of the § 954(c)(6) exception and generally mirror the rules for the § 245A deduction by giving priority to Temp. Treas. Reg. § 1.245A-5T(f) over Temp. Treas. Reg. § 1.245A-5T(d). Temp. Treas. Reg. § 1.245A-5T(g)(4)(ii). As in the rules relating to extraordinary reduction amounts, a controlling § 245A shareholder of a lower-tier CFC may elect to close the taxable year of the CFC in cases where an extraordinary reduction occurs and the CFC would have a tiered extraordinary reduction amount. Temp. Treas. Reg. § 1.245A-5T(e).
- xii. Finally, Treasury and the IRS are studying whether Temp. Treas. Reg. § 1.245A-5T(f), or a similar rule, should also apply to dividends received by an upper-tier CFC from a lower-tier CFC where the CFCs are owned by individuals and there may be a reduction in the individuals' ownership of the lower-tier CFC. Individuals are not eligible to claim deductions under § 245A and, therefore, dividends subject to § 954(c)(6) do not present the risk of permanently eliminating items of Subpart F income, investments in U.S. property taxed under § 951(a)(1)(B), or tested income from the U.S. tax base.
- xiii. At the same time, § 954(c)(6) dividends might result in a reduction of a U.S. shareholder's pro rata share of a CFC's Subpart F income or tested income, thereby resulting in deferred taxation of items that otherwise would have been taxed currently. Therefore, comments were requested as to whether Temp. Treas. Reg. § 1.245A-5T(f), or a similar rule, should be extended to CFCs owned by individuals.

(b) Dividends Received by CFCs Ineligible for § 245A Deduction.

- i. Section 245A(a), by its terms, applies only to certain dividends received by “a domestic corporation.” Treas. Reg. § 1.952-2, which sets forth rules for determining gross income and taxable income of a foreign corporation, provides that for these purposes a foreign corporation is treated as a domestic corporation. Treas. Reg. § 1.952-2(a)(1) and (b)(1). Accordingly, questions have arisen as to whether Treas. Reg. § 1.952-2 could be interpreted so that a foreign corporation could claim a § 245A deduction despite the statutory restriction in § 245A(a) expressly limiting the deduction to domestic corporations. *See* H.R. Rep. No. 115-466, at 599, fn. 1486 (2017).
- ii. Treasury and the IRS intend to address issues related to the application of Treas. Reg. § 1.952-2, taking into account various comments received in connection with the TCJA, including in connection with the proposed § 951A regulations, in a future guidance project. This guidance will clarify that, in general, any provision that is expressly limited in its application to domestic corporations does not apply to CFCs by reason of Treas. Reg. § 1.952-2. Treasury and the IRS continue to study whether, and to what extent, proposed regulations should be issued that provide that dividends received by a CFC are eligible for a § 245A deduction. They have determined, however, that in no case would any person, including a foreign corporation, be allowed a § 245A deduction directly or indirectly for the portion of a dividend paid to a CFC that is not eligible for the § 954(c)(6) exception as a result of these temporary regulations. Permitting the deduction in such a case would undermine the application of the rule that reduces the amount of the dividend eligible for the § 954(c)(6) exception.

7. Information Reporting Under § 6038.

- (a) Under § 6038(a)(1), U.S. persons that control foreign business entities must file certain information returns regarding those entities, which includes information listed in § 6038(a)(1)(A) through (a)(1)(E), as well as information that “the Secretary determines to be appropriate to carry out the provisions of this title.” Temp. Treas. Reg. § 1.6038-2T(f)(16) provides that ineligible amounts, tiered extraordinary disposition amounts, and tiered extraordinary reduction amounts must be reported on the appropriate information reporting form in accordance with § 6038.

- (b) Because transactions subject to these temporary regulations may have occurred in taxable years for which returns have been filed before the issuance of these regulations, or for which returns will be filed before revision of forms and instructions for reporting the information required by Temp. Treas. Reg. § 1.6038-2T(f)(16), the temporary regulations provide a transition rule. The transition rule mandates that taxpayers report the required information on the first return filed following the issuance of revised forms, instructions, or other guidance regarding reporting such information.
- (c) The transition rule also requires a corporation to report the information regarding a predecessor corporation (such as a lower-tier foreign corporation that distributes its assets to the corporation in a liquidation described in § 332) to ensure that all of the amounts are properly reported notwithstanding any intervening transactions.

8. Applicability Dates.

- (a) Consistent with the applicability date of § 245A, and pursuant to § 7805(b)(2), the rules in the temporary regulations relating to eligibility of distributions for the § 245A deduction apply to distributions occurring after December 31, 2017.
- (b) Pursuant to § 7805(b)(1) and (2), the rules in the temporary regulations relating to the eligibility of dividends for the § 954(c)(6) exception also apply to distributions occurring after December 31, 2017, subject to the transition rule in Temp. Treas. Reg. § 1.245A-5T(f)(3) for determining tiered extraordinary reduction amounts.

9. Good Cause.

- (a) Treasury and the IRS issued these temporary regulations without prior notice and the opportunity for public comment pursuant to § 553(b)(3)(B) of the Administrative Procedure Act (the “APA”). The preamble states that advance notice and the opportunity for public comment are not required regarding a rulemaking when an “agency for good cause finds (and incorporates the finding and a brief statement of reasons therefor in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest.”
- (b) Under the “public interest” prong of 5 U.S.C. 553(b)(3)(B), the good cause exception appropriately applies where notice-and-comment would harm, defeat, or frustrate the public interest, rather than serving it. Treasury and the IRS state they utilized the good

cause exception in § 553(d)(3) of the APA to issue the temporary regulations with an immediate effective date, rather than an effective date no earlier than 30 days after the date of publication.

- (c) Among the circumstances in which the good cause exception may be invoked for impracticability or to serve the public interest are situations where the timing and disclosure requirements of the usual procedures would defeat the purpose of the proposal, including if announcement of a proposed rule would enable or increase the sort of financial manipulation the rule sought to prevent.
- (d) Good cause may also apply where a delayed effective date would have a significant deleterious effect upon the parties to which the regulation applies. Additionally, the good cause exception may apply when the regulations are by their nature short term and there is an opportunity to comment before final rules are introduced. Finally, good cause is supported where regulations are required to be issued and effective by a certain statutory deadline, and in light of the circumstances affecting the agency and its functions leading up to that statutory deadline, the agency is unable during that timeframe to conduct a timely and fulsome notice-and-comment process. Here, states the preamble, these rationales, separately and in combination, provide good cause for Treasury and the IRS's decision to bypass the notice-and-comment and delayed effective date requirements regarding the § 245A temporary regulations.
- (e) First, good cause existed regarding these temporary regulations because any period for notice and comment, as well as a delayed effective date, would have provided taxpayers with the opportunity to engage in the transactions to which these rules relate with confidence that they achieve the intended tax avoidance results absent the applicability of the regulations. Treasury and the IRS were aware that taxpayers have considered engaging in the transactions described in these temporary regulations, but some may have been deterred from doing so because of uncertainty about the operation and interaction of the various provisions of the TCJA.
- (f) By limiting the deduction under § 245A for these transactions, the temporary regulations removed that uncertainty and – if subjected to notice-and-comment and a delayed effective date – could have emboldened some taxpayers to engage in aggressive tax planning to take advantage of the unintended interactions among TCJA's provisions with the comfort that their actions were not subject to the rules of the temporary regulations during the period of notice and comment and before the regulations' effective date.

- (g) This concern applied regarding both the extraordinary disposition and extraordinary reduction rules for an ongoing period. For the extraordinary reduction rules, both the extraordinary reduction and the associated use of § 245A can occur at any time going forward, and although the gap period for entering into extraordinary dispositions has closed, the ability to utilize the § 245A deduction for earnings generated in the extraordinary disposition would apply indefinitely absent these temporary regulations.
- (h) For example, a taxpayer who became aware of the tax effects achievable using the transactions described in the temporary regulations could, with confidence, utilize extraordinary disposition E&P or engage in an extraordinary reduction to exit the U.S. taxing jurisdiction without paying any tax during a period of notice and comment and delayed effectiveness. The proliferation of these types of transactions could have caused the regulations to exacerbate the very financial manipulation that they are intended to prevent, and accordingly, this rationale supports a finding of good cause for dispensing with pre-promulgation notice and public comment, as well as foregoing a delayed effective date, for the temporary regulations pursuant to 5 U.S.C. 553(b) and (d).
- (i) The preamble states that the second reason for a finding of good cause arises from the fact that these temporary regulations, as applied retroactively, will affect taxable years of certain taxpayers ending in 2018. As a result, the regulations can apply to taxable years for which tax returns have been or may be due during a period of comment and delayed effectiveness. Deferring the effectiveness of the temporary regulations until after such a period would have increased taxpayer compliance costs because certain taxpayers would only be able to come into compliance with the regulations by amending and refileing returns and paying additional taxes owed with interest.
- (j) Third, good cause is supported where a regulation is temporary, with public comment permitted and meaningfully considered before finalization of the temporary rule. In this regard, the temporary regulations have a fixed expiration date and are cross-referenced in a notice of proposed rulemaking published in the Proposed Rules section of the Federal Register. Comments are requested on all aspects of these rules, and specific comment requests contained in the preamble were incorporated by reference into the cross-referenced notice of proposed rulemaking. Treasury and the IRS will consider all written comments properly and timely submitted when finalizing the temporary regulations.

- (k) Finally, the preamble states that the temporary regulations are part of an effort to implement the provisions of the Act, which effected sweeping and complex statutory changes to the international tax regime. In conjunction with developing and issuing the temporary regulations, Treasury and the IRS were also tasked with issuing regulations implementing the numerous provisions enacted or modified by the TCJA, along with attendant changes to forms and other sub-regulatory guidance and attention to the orderly administration of the U.S. tax system.
- (l) Good cause existed for the issuance of temporary regulations relating to the transactions affected by these temporary regulations partially because of the statutory deadline in § 7805(b)(2), which provides (among other rules) that a regulation may be applied retroactively if it is issued within 18 months of the date of enactment of the statutory provision to which it relates. The rules in these temporary regulations relate to §§ 245A, 951A, and 965, which were enacted as part of the TCJA on December 22, 2017. Thus, to qualify for retroactivity under § 7805(b)(2), a regulation retroactive to the enactment of these provisions had to be effective no later than June 22, 2019.
- (m) The temporary regulations needed to apply retroactively from the date of the underlying statutory provisions to ensure that the international tax regime enacted by Congress in the TCJA, and its interaction with existing tax rules, functions correctly for all affected periods. Retroactivity is also required to prevent treating taxpayers comparatively advantageously if they have engaged in the types of transactions described in these temporary regulations prior to the issuance date of the temporary regulations.
- (n) The discussion of good cause regarding the temporary regulations is consistent with the Policy Statement on the Tax Regulatory Process issued on March 5, 2019 by Treasury and the IRS (the “Statement”). The Statement emphasized Treasury and the IRS’s obligation under the APA to issue interim final regulations without prior notice and comment only in conjunction with “a statement of good cause explaining the basis for that finding.” The Statement further explained that good cause for interim final regulations may exist, for example, where “such regulations may be necessary and appropriate to stop abusive practices or to immediately resolve an injurious inconsistency between existing regulations and a new statute or judicial decision.”

10. Examples.

- (a) Temp. Treas. Reg. § 1.245-5T(j) Examples Numbers 1, 2 and 3 illustrate the new temporary rules by providing the following facts and conclusions. (There are six examples in total.)

(2) Example 1. Extraordinary disposition--(i) Facts. US1 and US2 own 60% and 40%, respectively, of the single class of stock of CFC1. CFC1 owns all of the single class of stock of CFC2. CFC1 and CFC2 use the taxable year ending November 30 as their taxable year. On November 1, 2018, CFC1 sells specified property to CFC2 in exchange for \$200x of cash (the “Property Transfer”). The Property Transfer is outside of CFC1’s ordinary course of activities. The transferred property has a basis of \$100x in the hands of CFC1. CFC1 recognizes \$100x of gain as a result of the Property Transfer (\$200x - \$100x). On December 1, 2018, CFC1 distributes \$80x pro rata to US1 (\$48x) and US2 (\$32x), all of which is a dividend within the meaning of § 316 and treated as a distribution out of earnings described in § 959(c)(3). No other distributions are made by CFC1 to either US1 or US2 in CFC1’s taxable year ending November 30, 2019. For its taxable year ending on November 30, 2019, CFC1 has \$110x of earnings and profits described in § 959(c)(3), without regard to any distributions during the taxable year.

(ii) Analysis--(A) Identification of extraordinary disposition. Because CFC1 is a CFC and uses the taxable year ending on November 30, it has a disqualified period beginning on January 1, 2018, and ending on November 30, 2018. In addition, the Property Transfer is an extraordinary disposition because it (i) is a disposition of specified property by CFC1 on a date on which it was a CFC and during CFC1’s disqualified period, (ii) is to CFC2, a related party regarding CFC1, (iii) occurs outside of the ordinary course of CFC1’s activities, and (iv) is not subject to the de minimis rule.

(B) Determination of § 245A shareholders and their extraordinary disposition accounts. Because CFC1 undertook an extraordinary disposition, a portion of CFC1’s earnings and profits are extraordinary disposition E&P and, therefore, give rise to an extraordinary disposition account regarding each of CFC1’s § 245A shareholders. US1 and US2 are both § 245A shareholders regarding CFC1. The amount of the extraordinary disposition account regarding US1 is \$60x, which is equal to the product of the extraordinary disposition E&P (the amount of the net gain recognized by CFC1 as a result of the Property Transfer (\$100x)) and the extraordinary disposition ownership percentage (the

percentage of the stock of CFC1 owned directly or indirectly by US1 on January 1, 2018 (60%)), reduced by the prior extraordinary disposition amount (\$0). Similarly, the amount of the extraordinary disposition account regarding US2 is \$40x, which is equal to the product of the extraordinary disposition E&P (the net gain recognized by CFC1 as a result of the Property Transfer (\$100x)) and extraordinary disposition ownership percentage (the percentage of the stock of CFC1 owned directly or indirectly by US2 on January 1, 2018 (40%)), reduced by the prior extraordinary disposition amount (\$0).

(C) Determination of extraordinary disposition amount regarding US1. The dividend of \$48x paid to US1 on December 1, 2018, is an extraordinary disposition amount to the extent the dividend is paid out of the extraordinary disposition account regarding US1. The dividend is first considered paid out of non-extraordinary disposition E&P regarding US1, to the extent thereof. Regarding US1, \$6x of CFC1's earnings and profits is non-extraordinary disposition E&P, calculated as the excess of \$66x (the product of \$110x of earnings and profits described in § 959(c)(3), without regard to the \$80x distribution, and 60%) over \$60x (the balance of US1's extraordinary disposition account regarding CFC1, immediately before the distribution). Thus, \$6x of the dividend is considered paid out of non-extraordinary disposition E&P regarding US1. The remaining \$42x of the dividend is next considered paid out of US1's extraordinary disposition account regarding CFC1, to the extent thereof. Accordingly, \$42x of the dividend is considered paid out of the extraordinary disposition account regarding CFC1 and gives rise to \$42x of an extraordinary disposition amount. As a result, US1's prior extraordinary disposition amount is increased by \$42x, and US1's extraordinary disposition account is reduced to \$18x (\$60x - \$42x).

(D) Determination of extraordinary disposition amount regarding US2. The dividend of \$32x paid to US2, on December 1, 2018, is an extraordinary disposition amount to the extent the dividend is paid out of extraordinary disposition E&P regarding US2. The dividend is first considered paid out of non-extraordinary disposition E&P regarding US2, to the extent thereof. Regarding US2, \$4x of CFC1's earnings and profits is non-extraordinary disposition E&P, calculated as the excess of \$44x (the product of \$110x of earnings and profits described in § 959(c)(3), without regard to the \$80x distribution, and 40%) over \$40x (the balance of US2's extraordinary disposition account regarding CFC1, immediately before the distribution). Thus, \$4x of the dividend is considered paid out of non-extraordinary

disposition E&P regarding US2. The remaining \$28x of the dividend is next considered paid out of US2's extraordinary disposition account regarding CFC1, to the extent thereof. Accordingly, \$28x of the dividend is considered paid out of the extraordinary disposition account regarding US2 and gives rise to \$28x of an extraordinary disposition amount. As a result, US2's prior extraordinary disposition amount is increased by \$28x, and US2's extraordinary disposition account is reduced to \$12x (\$40x - \$28x).

(E) Determination of ineligible amount regarding US1 and US2. Regarding US1 and the dividend of \$48x, the ineligible amount is \$21x, the sum of 50% of the extraordinary disposition amount (\$42x) and extraordinary reduction amount (\$0). Therefore, regarding the dividend received by US1 of \$48x, \$27x is eligible for a § 245A deduction. Regarding US2 and the dividend of \$32x, the ineligible amount is \$14x, the sum of 50% of the extraordinary disposition amount (\$28x) and extraordinary reduction amount (\$0). Therefore, regarding the dividend received by US2 of \$32x, \$18x is eligible for a § 245A deduction.

(3) Example 2. Application of § 954(c)(6) exception with extraordinary disposition account--(i) Facts. The facts are the same as in Example 1 except that the Property Transfer is a sale by CFC2 to CFC1 instead of a sale by CFC1 to CFC2, the \$80x distribution is by CFC2 to CFC1 in a separate transaction that is unrelated to the Property Transfer, and the description of the earnings and profits of CFC1 is applied to CFC2. Additionally, absent the application of this section, § 954(c)(6) would apply to the distribution by CFC2 to CFC1. Under § 951(a)(2) and § 1.951-1(b) and (e), US1's pro rata share of any Subpart F income of CFC1 is 60% and US2's pro rata share of any Subpart F income of CFC2 is 40%.

(ii) Analysis--(A) Identification of extraordinary disposition. The Property Transfer is an extraordinary disposition under the same analysis as provided in Example 1.

(B) Determination of § 245A shareholders and their extraordinary disposition accounts. Both US1 and US2 are § 245A shareholders regarding CFC2, US1 has an extraordinary disposition account of \$60x regarding CFC2, and US2 has an extraordinary disposition account of \$40x regarding CFC2 under the same analysis as provided in Example 1.

(C) Determination of tiered extraordinary disposition amount--(1) In general. US1 and US2 each have a tiered

extraordinary disposition amount regarding the \$80x dividend paid by CFC2 to CFC1 to the extent that US1 and US2 would have an extraordinary disposition amount if each had received as a dividend its pro rata share of the dividend from CFC2. US1's pro rata share of the dividend is \$48x (60% x \$80x), that is, the increase to US1's pro rata share of the Subpart F income if the dividend were included in CFC1's foreign personal holding company income, without regard to § 952(c) and the allocation of expenses. Similarly, US2's pro rata share of the dividend is \$32x (40% x \$80x).

(2) Determination of tiered extraordinary disposition amount regarding US1. The extraordinary disposition amount regarding US1 is \$42x, under the same analysis provided in Example 1. Accordingly, the tiered extraordinary disposition amount regarding US1 is \$42x.

(3) Determination of extraordinary disposition amount regarding US2. The extraordinary disposition amount regarding US2 is \$28x, under the same analysis provided in Example 1. Accordingly, the tiered extraordinary disposition amount regarding US2 is \$28x.

(D) Limitation of § 954(c)(6) exception. The sum of US1 and US2's tiered extraordinary disposition amounts is \$70x (\$42x + \$28x). The portion of the stock of CFC1 (by value) owned (within the meaning of § 958(a)) by U.S. tax residents on the last day of CFC1's taxable year is 100%. The disqualified amount regarding the dividend is \$35x (50% x (\$70x/100%)). Accordingly, the portion of the \$80x dividend from CFC2 to CFC1 that is eligible for the exception to foreign personal holding company income under § 954(c)(6) is \$45x (\$80x - \$35x). Under § 951(a)(2) and § 1.951-1(b) and (e), US1 includes \$21x (60% x \$35x) and US2 includes \$14x (60% x \$35x) in income under § 951(a).

(E) Changes in extraordinary disposition account of US1. US1's prior extraordinary disposition amount regarding CFC2 is increased by \$42x, or 200% of \$21x, the amount US1 included in income under § 951(a) regarding CFC1. US1 has no qualified portion because all of the owners of CFC2 are § 245A shareholders with a tiered extraordinary disposition amount regarding CFC2. As a result, US1's extraordinary disposition account is reduced to \$18x (\$60x - \$42x).

(F) Changes in extraordinary disposition account of US2. US2's prior extraordinary disposition amount regarding CFC2 is

increased by \$28x, or 200% of \$14x, the amount US2 included in income under § 951(a) regarding CFC1. US2 has no qualified portion because all of the owners of CFC2 are § 245A shareholders with a tiered extraordinary disposition amount regarding CFC2. As a result, US2's extraordinary disposition account is reduced to \$12x (\$40x - \$28x).

(4) Example 3. Extraordinary reduction--(i) Facts. At the beginning of CFC1's taxable year ending on December 31, Year 2, US1 owns all of the single class of stock of CFC1, and no person transferred any CFC1 stock directly or indirectly in Year 1 pursuant to a plan to reduce the percentage of stock (by value) of CFC1 owned by US1. Also, as of the beginning of Year 2, CFC1 has no earnings and profits described in § 959(c)(1) or (2), and US1 does not have an extraordinary disposition account regarding CFC1. As of the end of Year 2, CFC1 has \$160x of tested income and no other income. CFC1 has \$160x of earnings and profits for Year 2. On October 19, Year 2, US1 sells all of its CFC1 stock to US2 for \$100x in a transaction (the "Stock Sale") in which US1 recognizes \$90x of gain. Under § 1248(a), the entire \$90x of gain is included in US1's gross income as a dividend and, pursuant to § 1248(j), the \$90x is treated as a dividend for purposes of applying § 245A. At the end of Year 2, under § 951A, US2 takes into account \$70x of tested income, calculated as \$160x (100% of the \$160x of tested income) less \$90x, the amount described in § 951(a)(2)(B). The amount described in § 951(a)(2)(B) is the lesser of \$90x, the amount of dividends received by US1 regarding the transferred stock, and \$128x, the amount of tested income attributable to the transferred stock (\$160x) multiplied by 292/365 (the ratio of the number of days in Year 2 that US2 did not own the transferred stock to the total number of days in Year 2). US1 does not make an election.

(ii) Analysis--(A) Determination of controlling § 245A shareholder and extraordinary reduction of ownership. US1 is a controlling § 245A shareholder regarding CFC1. In addition, the Stock Sale results in an extraordinary reduction regarding US1's ownership of CFC1. The extraordinary reduction occurs because during Year 2, US1 transferred 100% of the CFC1 stock it owned at the beginning of the year and such amount is more than 5% of the total value of the stock of CFC1 at the beginning of Year 2; it also occurs because on the last day of the year the percentage of stock (by value) of CFC1 that US1 owns directly or indirectly (0%) (the end of year percentage) is less than 90% of the stock (by value) of CFC1 that US1 owns directly or indirectly on the day of the taxable year when it owned the highest percentage of CFC1 stock by value (100%) (the initial percentage), no transactions

occurred in the preceding year pursuant to a plan to reduce the percentage of CFC1 stock owned by US1, and the difference between the initial percentage and the end of year percentage (100 percentage points) is at least 5 percentage points.

(B) Determination of extraordinary reduction amount. The entire \$90x dividend to US1 is an extraordinary reduction amount regarding US1 because the dividend is at least equal to US1's pre-reduction pro rata share of CFC1's Year 2 tested income, reduced by the amount of tested income taken into account by US2, a U.S. tax resident, (\$70x). C) Determination of ineligible amount. Regarding US1 and the dividend of \$90x, the ineligible amount is \$90x, the sum of 50% of the extraordinary disposition amount (\$0) and extraordinary reduction amount (\$90x). Therefore, regarding the dividend received of \$90x, no portion is eligible for the dividends received deduction allowed under § 245A(a).

(iii) Alternative facts – Election to close CFC's taxable year. The facts are the same as in Example 3, US1 elects to close CFC1's Year 2 taxable year for all purposes of the Internal Revenue Code as of the end of October 19, Year 2, the date on which the Stock Sale occurs; in addition, US1 and US2 enter into a written, binding agreement that US1 will elect to close CFC1's Year 2 taxable year. Accordingly, under § 951A(a), US1 takes into account 100% of CFC1's tested income for the taxable year beginning January 1, Year 2, and ending October 19, Year 2, and US2 takes into account 100% of CFC1's tested income for the taxable year beginning October 20, Year 2, and ending December 31, Year 2. No amount is considered an extraordinary reduction amount regarding US1.

XI. SECTION 245A(e), 267A, ETC: HYBRID ISSUES.

A. Anti-Hybrid Regulations.

1. Treasury and the IRS proposed regulations under §§ 245A(e), 267A, 1503(d), 6038, 6038A, 6038C, and 7701. Section 245A(e) denies the dividends received deduction under § 245A with respect to hybrid dividends, and § 267A denies certain interest or royalty deductions involving hybrid transactions or hybrid entities. The proposed § 245 regulations only include rules under § 245A(e). Rules addressing other aspects of § 245A, including the general eligibility requirements for the dividends received deduction under that section will be addressed in separate regulations. Section 245A, including § 245A(e), applies to distributions made after December 31, 2017. Section 267A applies to taxable years beginning after December 31, 2017 although certain rules, including those dealing with "imported mismatches," have delayed

effective dates. Other provisions of the Code, such as §§ 894(c) and 1503(d), also address certain hybrid arrangements.

B. Purpose of Anti-Hybrid Rules.

1. The preamble to the proposed regulations states that a cross-border transaction may be treated differently for U.S. and foreign tax purposes because of differences in the tax law of each country. The U.S. tax treatment of a transaction generally does not take into account foreign tax law. However, in specific cases, foreign tax law is taken into account – for example, in the context of withholdable payments to hybrid entities for which treaty benefits are claimed under § 894(c) and for dual consolidated losses subject to § 1503(d) – in order to address policy concerns resulting from the different treatment of the same transaction or arrangement under U.S. and foreign tax law.
2. In response to international concerns regarding hybrid arrangements used to achieve double non-taxation, Action 2 of the OECD’s BEPS project, and two final reports thereunder, address hybrid and branch mismatch arrangements. As we will see, these reports played an important role in Treasury’s and IRS’s hybrid mismatch regulations.
3. The TCJA’s legislative history states that § 267A is intended to be “consistent with many of the approaches to the same or similar problems [regarding hybrid arrangements] taken in the Code, the OECD BEPS project, bilateral income tax treaties, and provisions or rules of other countries.” The types of hybrid arrangements of concern are arrangements that “exploit differences in the tax treatment of a transaction or entity under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral.” Hybrid arrangements targeted by these provisions are those that rely on a hybrid element to produce these outcomes.
4. Treasury and the IRS state that these concerns also arise in the context of § 245A as a result of the enactment of a participation exemption system for taxing foreign income. Section 245A(e) generally prevents double non-taxation by disallowing the 100% dividends received deduction for dividends received from a controlled foreign corporation (“CFC”), or by mandating Subpart F inclusions for dividends received from a CFC by another CFC, if there is a corresponding deduction or other tax benefit in the foreign country.

C. § 245A(e) – Hybrid Dividends.

1. The proposed regulations under § 245A(e) address certain dividends involving hybrid arrangements. They neutralize the double non-taxation effects of these dividends by either denying the § 245A(a) dividends

received deduction with respect to the dividend or requiring an inclusion under § 951(a) with respect to the dividend, depending on whether the dividend is received by a domestic corporation or a CFC.

2. Prop. Treas. Reg. § 1.245A(e)-1(b) provides that if a domestic corporation that is a U.S. shareholder within the meaning of § 951(b) (“U.S. shareholder”) of a CFC receives a “hybrid dividend” from the CFC, then the U.S. shareholder is not allowed the § 245A(a) deduction for the hybrid dividend, and the rules of § 245A(d) (denial of foreign tax credits and deductions) apply.
3. Under Prop. Treas. Reg. §§ 1.245A(e)-1(b) and (d), a dividend is a hybrid dividend if it satisfies two conditions: (i) but for § 245A(e), the § 245A(a) deduction would be allowed, and (ii) the dividend is one for which the CFC (or a related person) is or was allowed a deduction or other tax benefit under a “relevant foreign tax law” (such a deduction or other tax benefit is termed a “hybrid deduction”).
4. The proposed regulations take into account certain deductions or other tax benefits allowed to a person related to a CFC (such as a shareholder) because, for example, certain tax benefits allowed to a shareholder of a CFC are economically equivalent to the CFC having been allowed a deduction.
5. Relevant Foreign Tax Law.
 - (a) Prop. Treas. Reg. § 1.245A(e)-1(f) defines a relevant foreign tax law as, with respect to a CFC, any regime of any foreign country or possession of the U.S. that imposes an income, war profits, or excess profits tax with respect to income of the CFC, other than a foreign anti-deferral regime under which an owner of the CFC is liable to tax. Thus, for example, a relevant foreign tax law includes the tax law of a foreign country of which the CFC is a tax resident, as well as the tax law applicable to a foreign branch of the CFC.
6. Deduction or Other Tax Benefit.
 - (a) Under Prop. Treas. Reg. § 1.245A(e)-1(d), only deductions or other tax benefits that are “allowed” under the relevant foreign tax law may constitute a hybrid deduction. Thus, for example, if the relevant foreign tax law contains hybrid mismatch rules under which a CFC is denied a deduction for an amount of interest paid with respect to a hybrid instrument to prevent a deduction/no-inclusion (“D/NI”) outcome, then the payment of the interest does not give rise to a hybrid deduction, because the deduction is not “allowed.” This prevents double-taxation that could arise if a

hybrid dividend were subject to both § 245A(e) and a hybrid mismatch rule under a relevant foreign tax law.

- (b) For a deduction or other tax benefit to be a hybrid deduction, it must relate to or result from an amount paid, accrued, or distributed with respect to an instrument of the CFC that is treated as stock for U.S. tax purposes. That is, there must be a connection between the deduction or other tax benefit under the relevant foreign tax law and the instrument that is stock for U.S. tax purposes.
- (c) Thus, a hybrid deduction includes an interest deduction under a relevant foreign tax law with respect to a hybrid instrument (stock for U.S. tax purposes, indebtedness for foreign tax purposes). It also includes dividends paid deductions and other deductions allowed on equity under a relevant foreign tax law, such as notional interest deductions (“NIDs”), which raise similar concerns as traditional hybrid instruments. However, it does not, for example, include an exemption provided to a CFC under its tax law for certain types of income (such as income attributable to a foreign branch), because there is not a connection between the tax benefit and the instrument that is stock for U.S. tax purposes.
- (d) The proposed regulations provide that deductions or other tax benefits allowed pursuant to certain integration or imputation systems do not constitute hybrid deductions. Prop. Treas. Reg. § 1.245A(e)-1(d)(2)(i)(B). However, under Prop. Treas. Reg. § 1.245A(e)-1(g)(2), Example 2, a system that has the effect of exempting earnings that fund a distribution from foreign tax at both the CFC and shareholder level gives rise to a hybrid deduction.

7. Effect of Foreign Currency Gain or Loss.

- (a) The payment of an amount by a CFC may, under a provision of foreign tax law comparable to § 988, give rise to gain or loss to the CFC that is attributable to foreign currency. Under Prop. Treas. Reg. § 1.245A(e)-1(d)(6), the foreign currency gain or loss recognized with respect to such deduction or other tax benefit is taken into account for purposes of determining hybrid deductions.

8. Tiered Hybrid Dividends.

- (a) Prop. Treas. Reg. § 1.245A(e)-1(c) sets forth rules related to hybrid dividends of tiered corporations (“tiered hybrid dividends”), as provided under § 245A(e)(2). A tiered hybrid dividend means an amount received by a CFC from another CFC to the extent that the

amount would be a hybrid dividend under Prop. Treas. Reg. § 1.245A(e)-1(b) if the receiving CFC were a domestic corporation.

- (b) Accordingly, the amount must be treated as a dividend under U.S. tax law to be treated as a tiered hybrid dividend. The treatment of the amount under the tax law in which the receiving CFC is a tax resident (or under any other foreign tax law) is irrelevant for this purpose.
- (c) If a CFC receives a tiered hybrid dividend from another CFC, and a domestic corporation is a U.S. shareholder of both CFCs, then (i) the tiered hybrid dividend is treated as Subpart F income of the receiving CFC, (ii) the U.S. shareholder must include in gross income its pro rata share of the Subpart F income, and (iii) the rules of § 245A(d) apply to the amount included in the U.S. shareholder's gross income. Prop. Treas. Reg. § 1.245A(e)-1(c)(1).
- (d) This treatment applies notwithstanding any other provision of the Code. Thus, for example, exceptions to Subpart F income such as those provided under § 954(c)(3) ("same country" exception for income received from related persons) and § 954(c)(6) (look-through rule for related CFCs) do not apply. As additional examples, the gross amount of subpart F income cannot be reduced by deductions taken into account under § 954(b)(5) and Treas. Reg. § 1.954-1(c), and is not subject to the current earnings and profits limitation under § 952(c).

9. Interaction with § 959.

- (a) Distributions of previously taxed earnings and profits ("PTEP") attributable to amounts that have been taken into account by a U.S. shareholder under § 951(a) are, in general, excluded from the gross income of the U.S. shareholder when distributed under § 959(a), and under § 959(d) are not treated as a dividend (other than to reduce earnings and profits). As a result, distributions from a CFC to its U.S. shareholder out of PTEP are not eligible for the dividends received deduction under § 245A(a), and § 245A(e) does not apply.
- (b) Similarly, distributions of PTEP from a CFC to an upper-tier CFC are excluded from the gross income of the upper-tier CFC under § 959(b), but only for the limited purpose of applying § 951(a). In addition, such amounts continue to be treated as dividends because § 959(d) does not apply to such amounts. Accordingly, distributions out of PTEP could qualify as tiered hybrid dividends

that would result in an income inclusion to a U.S. shareholder. To prevent this result, Prop. Treas. Reg. § 1.245A(e)-1(c)(2) provides that a tiered hybrid dividend does not include amounts described in § 959(b).

10. Interaction with § 964(e).

- (a) Under § 964(e)(1), gain recognized by a CFC on the sale or exchange of stock in another foreign corporation may be treated as a dividend. In certain cases, § 964(e)(4): (i) treats the dividend as subpart F income of the selling CFC; (ii) requires a U.S. shareholder of the CFC to include in its gross income its pro rata share of the subpart F income; and (iii) allows the U.S. shareholder the § 245A(a) deduction for its inclusion in gross income. As is the case with the treatment of tiered hybrid dividends, the treatment of dividends under § 964(e)(4) applies notwithstanding any other provision of the Code.
- (b) The proposed regulations coordinate the tiered hybrid dividend rules and the rules of § 964(e) by providing that, to the extent a dividend arising under § 964(e)(1) is a tiered hybrid dividend, the tiered hybrid dividend rules, rather than the rules of § 964(e)(4), apply. Thus, in such a case, a U.S. shareholder that includes an amount in its gross income under the tiered hybrid dividend rule is not allowed the § 245A(a) deduction, or foreign tax credits or deductions, for the amount. Prop. Treas. Reg. §§ 1.245A(e)-1(c)(1) and (4).

11. Hybrid Deduction Accounts.

- (a) An important new provision requires that “specified share owners” keep, and use, hybrid deduction accounts. In some cases, the actual payment by a CFC of an amount that is treated as a dividend for U.S. tax purposes will result in a corresponding hybrid deduction. In many cases, however, the dividend and the hybrid deduction may not arise pursuant to the same payment and may be recognized in different taxable years.
- (b) This could occur in the case of a hybrid instrument for which under a relevant foreign tax law the CFC is allowed deductions for accrued (but not yet paid) interest. In such a case, to the extent that an actual payment has not yet been made on the instrument, there generally would not be a dividend for U.S. tax purposes for which the § 245A(a) deduction could be disallowed under § 245A(e).
- (c) Nevertheless, because the earnings and profits of the CFC would not be reduced by the accrued interest deduction, the earnings and

profits may give rise to a dividend when subsequently distributed to the U.S. shareholder. This same result could occur in other cases, such as when a relevant foreign tax law allows deductions on equity, such as NIDs.

- (d) The disallowance of the § 245A(a) deduction under § 245A(e) should not be limited to cases in which the dividend and the hybrid deduction arise pursuant to the same payment (or in the same taxable year for U.S. tax purposes and for purposes of the relevant foreign tax law). Interpreting the provision in such a manner would result in disparate treatment for hybrid arrangements that produce the same D/NI outcome.
- (e) Accordingly, Prop. Treas. Reg. §§ 1.245A(e)-1(b) and (d) define a hybrid dividend (or tiered hybrid dividend) based, in part, on the extent of the balance of the “hybrid deduction accounts” of the domestic corporation (or CFC) receiving the dividend. This ensures that dividends are subject to § 245A(e) regardless of whether the same payment gives rise to the dividend and the hybrid deduction.
- (f) Under Prop. Treas. Reg. §§ 1.245A(e)-1(d) and (f), a hybrid deduction account must be maintained with respect to each share of stock of a CFC held by a person that, given its ownership of the CFC and the share, could be subject to § 245A upon a dividend paid by the CFC on the share.
- (g) The account, which is maintained in the functional currency of the CFC, reflects the amount of hybrid deductions of the CFC (allowed in taxable years beginning after December 31, 2017) that have been allocated to the share. A dividend paid by a CFC to a shareholder that has a hybrid deduction account with respect to the CFC is generally treated as a hybrid dividend or tiered hybrid dividend to the extent of the shareholder’s balance in all of its hybrid deduction accounts with respect to the CFC, even if the dividend is paid on a share that has not had any hybrid deductions allocated to it.
- (h) Absent such an approach, the purposes of § 245A(e) might be avoided by, for example, structuring dividend payments such that they are generally made on shares of stock to which a hybrid deduction has not been allocated (rather than on shares of stock to which a hybrid deduction has been allocated, such as a share that is a hybrid instrument).

- (i) Once an amount in a hybrid deduction account gives rise to a hybrid dividend or a tiered hybrid dividend, the account is correspondingly reduced. Prop. Treas. Reg. § 1.245A(e)-1(d).
- (j) Prop. Treas. Reg. § 1.245A(e)-1(g) Example 1(i)-(ii)(A) illustrates these rules:

Example 1. Hybrid dividend resulting from hybrid instrument--(i) Facts. US1 holds both shares of stock of FX, which have an equal value. One share is treated as indebtedness for Country X tax purposes (“Share A”), and the other is treated as equity for Country X tax purposes (“Share B”). During year 1, under Country X tax law, FX accrues \$80x of interest to US1 with respect to Share A and is allowed a deduction for the amount (the “Hybrid Instrument Deduction”). During year 2, FX distributes \$30x to US1 with respect to each of Share A and Share B.

For U.S. tax purposes, each of the \$30x distributions is treated as a dividend for which, but for § 245A(e), US1 would be allowed a deduction under § 245A(a). For Country X tax purposes, the \$30x distribution with respect to Share A represents a payment of interest for which a deduction was already allowed (and thus FX is not allowed an additional deduction for the amount), and the \$30x distribution with respect to Share B is treated as a dividend (for which no deduction is allowed).

(ii) Analysis. The entire \$30x of each dividend received by US1 from FX during year 2 is a hybrid dividend, because the sum of US1’s hybrid deduction accounts with respect to each of its shares of FX stock at the end of year 2 (\$80x) is at least equal to the amount of the dividends (\$60x). This is the case for the \$30x dividend with respect to Share B even though there are no hybrid deductions allocated to Share B. As a result, US1 is not allowed a deduction under § 245A(a) for the entire \$60x of hybrid dividends and the rules of § 245A(d) (disallowance of foreign tax credits and deductions) apply.

(A) At the end of year 1, US1’s hybrid deduction accounts with respect to Share A and Share B are \$80x and \$0, respectively, calculated as follows.

(1) The \$80x Hybrid Instrument Deduction allowed to FX under Country X tax law (a relevant foreign tax law) is a hybrid deduction of FX, because the deduction is allowed to FX and relates to or results from an amount accrued with respect to an instrument issued by FX and treated as stock for U.S. tax purposes. Thus, FX’s hybrid deductions for year 1 are \$80x.

(2) The entire \$80x Hybrid Instrument Deduction is allocated to Share A, because the deduction was accrued with respect to Share A. As there are no additional hybrid deductions of FX for year 1, there are no additional hybrid deductions to allocate to either Share A or Share B. Thus, there are no hybrid deductions allocated to Share B.

(3) At the end of year 1, US1's hybrid deduction account with respect to Share A is increased by \$80x (the amount of hybrid deductions allocated to Share A). Because FX did not pay any dividends with respect to either Share A or Share B during year 1 (and therefore did not pay any hybrid dividends or tiered hybrid dividends), no further adjustments are made. Therefore, at the end of year 1, US1's hybrid deduction accounts with respect to Share A and Share B are \$80x and \$0, respectively.

12. Transfers of Stock.

- (a) Hybrid deduction accounts are with respect to stock of a CFC. Thus, the proposed regulations include rules that take into account transfers of the stock. Prop. Treas. Reg. § 1.245A(e)-1(d)(4)(ii)(A). These rules, which are similar to the “successor” PTEP rules under § 959, ensure that § 245A(e) properly applies to dividends that give rise to a D/NI outcome in cases where the shareholder that receives the dividend is not the same shareholder that held the stock when the hybrid deduction was incurred.
- (b) These rules only apply when the stock is transferred among persons that are required to keep hybrid deduction accounts. Thus, if the stock is transferred to a person that is not required to keep a hybrid deduction account – such as an individual or a foreign corporation that is not a CFC – the account terminates (subject to the anti-avoidance rule discussed below).
- (c) The proposed regulations also include rules that take into account certain non-recognition exchanges of the stock, such as exchanges in connection with asset reorganizations, recapitalizations, and liquidations, as well as transfers and exchanges that occur mid-way through a CFC's taxable year. Prop. Treas. Reg. § 1.245A(e)-1(d)(4)(ii)(B) and (d)(5).

13. Dividends from Lower-Tier CFCs.

- (a) Prop. Treas. Reg. § 1.245A(e)-1(b)(3) provides a special rule to address earnings and profits of a lower-tier CFC that are included in a domestic corporation's income as a dividend by virtue of § 1248(c)(2). The proposed regulations treat the domestic

corporation as having certain hybrid deduction accounts with respect to the lower-tier CFC that are held and maintained by other CFCs. This ensures that, to the extent the earnings and profits of the lower-tier CFC give rise to the dividend, hybrid deduction accounts with respect to the lower-tier CFC are taken into account for purposes of the determinations under § 245A(e), even though the accounts are held indirectly by the domestic corporation. A similar rule applies with respect to gains on stock sales treated as dividends under § 964(e)(1). Prop. Treas. Reg. § 1.245A(e)-1(c)(3).

14. Anti-Avoidance Rule.

- (a) The proposed regulations, of course, include an anti-avoidance rule as do all regulations issued in this tax era. It provides that appropriate adjustments are made, including adjustments that would disregard a transaction or arrangement, if a transaction or arrangement is engaged in with a principal purpose of avoiding the purposes of Prop. Treas. Reg. § 1.245A(e)-1.

D. § 267A – Related Party Amounts Involving Hybrid Transactions and Hybrid Entities.

1. Hybrid arrangements may exploit differences under U.S. and foreign tax law between the tax characterization of an entity as transparent or opaque or differences in the treatment of financial instruments or other transactions. The proposed § 267A regulations address certain payments or accruals of interest or royalties for U.S. tax purposes (the amount of such interest or royalty, is called a “specified payment”) that involve hybrid arrangements, or similar arrangements involving branches, that produce D/NI (deduction/no inclusion) outcomes or indirect D/NI outcomes. The proposed regulations are intended to neutralize the double non-taxation effects of the arrangements by denying a deduction for the specified payment to the extent of the D/NI outcome.

2. Disallowed Deductions.

- (a) Prop. Treas. Reg. § 1.267A-1(b) generally disallows a deduction for a specified payment if and only if the payment is (i) a “disqualified hybrid amount,” meaning that it produces a D/NI outcome as a result of a hybrid or branch arrangement; (ii) a “disqualified imported mismatch amount,” meaning that it produces an indirect D/NI outcome as a result of the effects of an offshore hybrid or branch arrangement being imported into the U.S. tax system; or (iii) made pursuant to a transaction a principal purpose of which is to avoid the purposes of the regulations under § 267A and it produces a D/NI outcome.

- (b) The proposed regulations do not address D/NI outcomes that are not the result of hybridity. The proposed regulations also do not address double-deduction outcomes. Section 267A is intended to address D/NI outcomes. Transactions that produce double-deduction outcomes are addressed through other provisions (or doctrines), such as the dual consolidated loss rules (“DCL”) under § 1503(d).
- (c) The application of § 267A by its terms is not limited to any particular category of persons. The proposed regulations, however, narrow the scope of § 267A so that it applies only to deductions of “specified parties.” Deductions of persons other than specified parties are not subject to disallowance under § 267A because the deductions of those other persons generally do not have significant U.S. tax consequences. Under Prop. Treas. Reg. § 1.267A-5(a), a specified party means any of (i) a tax resident of the United States, (ii) a CFC for which there is one or more U.S. shareholders that own (within the meaning of § 958(a)) at least ten percent of the stock of the CFC, and (iii) a U.S. taxable branch (which includes a U.S. permanent establishment of a tax treaty resident).
- (d) The term generally includes a CFC because, for example, a specified payment made by a CFC to the foreign parent of the CFC’s U.S. shareholder, or a specified payment by the CFC to an unrelated party pursuant to a structured arrangement, may indirectly reduce income subject to U.S. tax. Specified payments made by a CFC to other related CFCs or to U.S. shareholders of the CFC, however, typically will not be subject to § 267A. This is because of the rules in Prop. Treas. Reg. § 1.267A-3(b) that exempt certain payments included in income of a U.S. tax resident or taken into account under the subpart F or global intangible low-tax income (“GILTI”) rules.
- (e) Similarly, the term includes a U.S. taxable branch because a payment made by the home office may be allocable to and thus reduce income subject to U.S. tax under §§ 871(b) or 882.
- (f) The term specified party does not include a partnership because a partnership generally is not liable to tax and therefore is not the person allowed a deduction. However, a partner of a partnership may be a specified party. For example, in the case of a payment made by a partnership a partner of which is a domestic corporation, the domestic corporation is a specified party and its allocable share of the deduction for the payment is subject to disallowance under § 267A.

3. Amount of a D/NI outcome.

- (a) Prop. Treas. Reg. § 1.267A-3(a) provides rules for determining the “no-inclusion” aspect of a D/NI outcome – that is, the amount of a specified payment that is or is not included in income under foreign tax law. The proposed regulations provide that only “tax residents” or “taxable branches” are considered to include an amount in income. Parties other than tax residents or taxable branches, for example, an entity that is fiscally transparent for purposes of the relevant tax laws, do not include an amount in income because such parties are not liable to tax.
- (b) Prop. Treas. Reg. § 1.267A-3(a)(1), provides that a tax resident or taxable branch includes a specified payment in income for this purpose to the extent that, under its tax law, it includes the payment in its income or tax base at the full marginal rate imposed on ordinary income, and the payment is not reduced or offset by certain items (such as an exemption or credit) particular to that type of payment.
- (c) Whether a tax resident or taxable branch includes a specified payment in income is determined without regard to any defensive or secondary rule in hybrid mismatch rules (which generally require the payee to include certain amounts in income, if the payer is not denied a deduction for the amount), if any, under the tax resident’s or taxable branch’s tax law.
- (d) Otherwise, in cases in which the relevant tax law contains a secondary response, the analysis of whether the specified payment is included in income could become circular: for example, whether the U.S. denies a deduction under § 267A may depend on whether the payee includes the specified payment in income, and whether the payee includes it in income (under a secondary response) may depend on whether the U.S. denies the deduction.
- (e) A specified payment may be considered included in income even though offset by a generally applicable deduction or other tax attribute, such as a deduction for depreciation or a net operating loss. For this purpose, a deduction may be treated as being generally applicable even if closely related to the specified payment (for example, if the deduction and payment are in connection with a back-to-back financing arrangement).
- (f) If a specified payment is taxed at a preferential rate, or if there is a partial reduction or offset particular to the type of payment, a portion of the payment is considered included in income. Under Proposed Treas. Reg. § 1.267A-3(a)(1), the portion included in

income is the amount that, taking into account the preferential rate or reduction or offset, is subject to tax at the full marginal rate applicable to ordinary income.

4. Timing Differences.

- (a) Some specified payments may never be included in income. For example, a specified payment treated as a dividend under a tax resident's tax laws may be permanently excluded from its income under a participation exemption. Permanent exclusions are always treated as giving rise to a no-inclusion. Prop. Treas. Reg. § 1.267A-3(a)(1).
- (b) Other specified payments, however, may be included in income but on a deferred basis. Some of these timing differences result from different methods of accounting between U.S. tax law and foreign tax law. For example, and subject to certain limitations such as those under §§ 163(e)(3) and 267(a) (generally applicable to payments involving related parties, but not to payments involving structured arrangements), a specified payment may be deductible for U.S. tax purposes when accrued and later included in a foreign tax resident's income when actually paid. Timing differences may also occur in cases in which all or a portion of a specified payment that is treated as interest for U.S. tax purposes is treated as a return of principal for purposes of the foreign tax law.
- (c) In some cases, timing differences reverse after a short period of time and therefore do not provide a meaningful deferral benefit. Treasury and the IRS believe that routine, short-term deferral does not give rise to the policy concerns that § 267A is intended to address. In addition, subjecting such short-term deferral to § 267A could give rise to administrability issues for both taxpayers and the IRS, because it may be challenging to determine whether the taxable period in which a specified payment is included in income matches the taxable period in which the payment is deductible.
- (d) Other timing differences, though, may provide a significant and long-term deferral benefit. Moreover, taxpayers may structure transactions that exploit these differences to achieve long-term deferral benefits. Timing differences that result in long-term deferral have an economic effect similar to a permanent exclusion and therefore give rise to policy concerns that § 267A is intended to address.
- (e) Thus, Prop. Treas. Reg. § 1.267A-3(a)(1) provides that short-term deferral, meaning inclusion during a taxable year that ends no more than 36 months after the end of the specified party's taxable

year, does not give rise to a D/NI outcome. Inclusions outside of the 36-month timeframe, however, are treated as giving rise to a D/NI outcome.

5. Hybrid and Branch Arrangements Giving Rise to Disqualified Hybrid Amounts.

6. Hybrid Transactions.

- (a) Prop. Treas. Reg. § 1.267A-2(a) addresses hybrid financial instruments and similar arrangements (collectively, “hybrid transactions”) that result in a D/NI outcome. For example, in the case of an instrument that is treated as indebtedness for purposes of the payer’s tax law and stock for purposes of the payee’s tax law, a payment on the instrument may constitute deductible interest expense of the payer and excludible dividend income of the payee (for instance, under a participation exemption).
- (b) The proposed regulations provide that a specified payment is made pursuant to a hybrid transaction if there is a mismatch in the character of the instrument or arrangement such that the payment is not treated as interest or a royalty, as applicable, under the tax law of a “specified recipient.” Examples of a specified payment include a payment that is treated as interest for U.S. tax purposes but, for purposes of a specified recipient’s tax law, is treated as a distribution on equity or a return of principal. When a specified payment is made pursuant to a hybrid transaction, it generally is a disqualified hybrid amount to the extent that the specified recipient does not include the payment in income.
- (c) Prop. Treas. Reg. § 1.267A-5(a)(19) broadly defines specified recipient as (i) any tax resident that under its tax law derives the specified payment, and (ii) any taxable branch to which under its tax law the specified payment is attributable. A specified recipient is any party that may be subject to tax on the specified payment under its tax law. There may be more than one specified recipient of a specified payment.
- (d) For example, in the case of a specified payment to an entity that is fiscally transparent for purposes of the tax law of its tax resident owners, each of the owners is a specified recipient of a share of the payment. In addition, if the entity is a tax resident of the country in which it is established or managed and controlled, then the entity is also a specified recipient. Moreover, in the case of a specified payment attributable to a taxable branch, both the taxable branch and the home office are specified recipients.

- (e) The proposed regulations deem a specified payment as made pursuant to a hybrid transaction if there is a long-term mismatch between when the specified party is allowed a deduction for the payment under U.S. tax law and when a specified recipient includes the payment in income under its tax law. This rule applies, for example, when a specified payment is made pursuant to an instrument viewed as indebtedness under both U.S. and foreign tax law and, due to a mismatch in tax accounting treatment between the U.S. and foreign tax law, results in long-term deferral. In these cases, this rule treats the long-term deferral as giving rise to a hybrid transaction. The rules in Prop. Treas. Reg. § 1.267A-3(a)(1) treat the long-term deferral as creating a D/NI outcome.
- (f) Prop. Treas. Reg. § 1.267A-2(a)(3) provides special rules to address securities lending transactions, sale-repurchase transactions, and similar transactions. In these cases, a specified payment (that is, interest consistent with the substance of the transaction) might not be regarded under a foreign tax law. As a result, there might not be a specified recipient of the specified payment under such foreign tax law, absent a special rule.
- (g) To address this situation, the proposed regulations provide that the determination of the identity of a specified recipient under the foreign tax law is made with respect to an amount connected to the specified payment and regarded under the foreign tax law – for example, a dividend consistent with the form of the transaction.

7. Disregarded Payments.

- (a) Prop. Treas. Reg. § 1.267A-2(b) provides that disregarded payments generally give rise to a D/NI outcome because they are regarded under the payer's tax law and are therefore available to offset income not taxable to the payee, but are disregarded under the payee's tax law and therefore are not included in income.
- (b) The proposed regulations define a disregarded payment as a specified payment that, under a foreign tax law, is not regarded because, for example, it is a disregarded transaction involving a single taxpayer or between consolidated group members. For example, a disregarded payment includes a specified payment made by a domestic corporation to its foreign owner if, under the foreign tax law, the domestic corporation is a disregarded entity and therefore the payment is not regarded.
- (c) It also includes a specified payment between related foreign corporations that are members of the same foreign consolidated group (or can otherwise share income or loss) if, under the foreign

tax law, payments between group members are not regarded, or give rise to a deduction or similar offset to the payer member that is available to offset the corresponding income of the recipient member.

- (d) A disregarded payment is a disqualified hybrid amount only to the extent it exceeds dual inclusion income. For example, if a domestic corporation that for foreign tax purposes is a disregarded entity of its foreign owner makes a disregarded payment to its foreign owner, the payment is a disqualified hybrid amount only to the extent it exceeds the net of the items of gross income and deductible expense taken into account in determining the domestic corporation's income for U.S. tax purposes and the foreign owner's income for foreign tax purposes.
- (e) This prevents the excess of the disregarded payment over dual inclusion income from offsetting non-dual inclusion income. Such an offset could otherwise occur, for example, through the U.S. consolidation regime, or a sale, merger, or similar transaction.
- (f) A disregarded payment could also be viewed as being made pursuant to a hybrid transaction because the payment of interest or royalty would not be viewed as interest or royalty under the foreign tax law (since the payment is disregarded). The proposed regulations address disregarded payments separately from hybrid transactions, however, because disregarded payments are more likely to offset dual inclusion income and therefore are treated as disqualified hybrid amounts only to the extent they offset non-dual inclusion income.

8. Deemed Branch Payments.

- (a) Prop. Treas. Reg. § 1.267A-2(c) addresses deemed branch payments. These payments result in a D/NI outcome when, under an income tax treaty, a deductible payment is deemed to be made by a permanent establishment to its home office and offsets income not taxable to the home office, but the payment is not taken into account under the home office's tax law.
- (b) Prop. Treas. Reg. § 1.267A-2(c)(2) defines a deemed branch payment as interest or royalty considered paid by a U.S. permanent establishment to its home office under an income tax treaty between the U.S. and the home office country. Thus, for example, a deemed branch payment includes an amount allowed as a deduction in computing the business profits of a U.S. permanent establishment with respect to the use of intellectual property developed by the home office.

- (c) When a specified payment is a deemed branch payment, it is a disqualified hybrid amount if the home office's tax law provides an exclusion or exemption for income attributable to the branch. In these cases, a deduction for the deemed branch payment would offset non-dual inclusion income and therefore give rise to a D/NI outcome. If the home office's tax law does not have an exclusion or exemption for income attributable to the branch, then, because U.S. permanent establishments cannot consolidate or otherwise share losses with U.S. taxpayers, there would generally not be an opportunity for a deduction for the deemed branch payment to offset non-dual inclusion income.

9. Reverse Hybrids.

- (a) Prop. Treas. Reg. § 1.267A-2(d) provides that a reverse hybrid is an entity that is fiscally transparent for purposes of the tax law of the country in which it is established but not for purposes of the tax law of its owner. Thus, payments to a reverse hybrid may result in a D/NI outcome because the reverse hybrid is not a tax resident of the country in which it is established, and the owner does not derive the payment under its tax law.
- (b) This D/NI outcome may occur regardless of whether the establishment country is a foreign country or the U.S. Thus, the proposed regulations provide that both foreign and domestic entities may be reverse hybrids. A domestic entity that is a reverse hybrid for this purpose therefore differs from a "domestic reverse hybrid entity" under Treas. Reg. § 1.894-1(d)(2)(i), which is defined as "a domestic entity that is treated as not fiscally transparent for U.S. tax purposes and as fiscally transparent under the laws of an interest holder's jurisdiction[.]"
- (c) For an entity to be a reverse hybrid under the proposed regulations, two requirements must be satisfied. These requirements generally implement the definition of hybrid entity in § 267A(d)(2), with certain modifications. First, the entity must be fiscally transparent under the tax law of the country in which it is established, whether or not it is a tax resident of another country. For this purpose, the determination of whether an entity is fiscally transparent with respect to an item of income is made using the principles of Treas. Reg. § 1.894-1(d)(3)(ii) (but without regard to whether there is an income tax treaty in effect between the entity's jurisdiction and the U.S.).
- (d) Second, the entity must not be fiscally transparent under the tax law of an "investor." An investor means a tax resident or taxable branch that directly or indirectly owns an interest in the entity. For

this purpose, the determination of whether an investor's tax law treats the entity as fiscally transparent with respect to an item of income is made under the principles of Treas. Reg. § 1.894-1(d)(3)(iii) (but without regard to whether there is an income tax treaty in effect between the investor's jurisdiction and the U.S.). If an investor views the entity as not fiscally transparent, the investor generally will not be currently taxed under its tax law on payments to the entity.

- (e) Thus, the non-fiscally-transparent status of the entity is determined on an investor-by-investor basis, based on the tax law of each investor. In addition, a tax resident or a taxable branch may be an investor of a reverse hybrid even if the tax resident or taxable branch indirectly owns the reverse hybrid through one or more intermediary entities that, under the tax law of the tax resident or taxable branch, are not fiscally transparent. In such a case, however, the investor's no-inclusion would not be a result of the payment being made to the reverse hybrid and therefore would not be a disqualified hybrid amount. *See* Prop. Treas. Reg. § 1.267A-6(c), Example 5 (analyzing whether a D/NI outcome with respect to an upper-tier investor is a result of the specified payment being made to the reverse hybrid).
- (f) When a specified payment is made to a reverse hybrid, it is generally a disqualified hybrid amount to the extent that an investor does not include the payment in income. For this purpose, whether an investor includes the specified payment in income is determined without regard to a subsequent distribution by the reverse hybrid. Although a subsequent distribution may be included in the investor's income, the distribution may not occur for an extended period and, when it does occur, it may be difficult to determine whether the distribution is funded from an amount comprising the specified payment.
- (g) In addition, if an investor takes a specified payment into account under an anti-deferral regime, then the investor is considered to include the payment in income to the extent provided under the general rules of Prop. Treas. Reg. § 1.267A-3(a). *See* Prop. Treas. Reg. § 1.267A-6(c), Example 5. Thus, for example, if the investor's inclusion under the anti-deferral regime is subject to tax at a preferential rate, the investor is considered to include only a portion of the specified payment in income.

10. Branch Mismatch Payments.

- (a) Prop. Treas. Reg. § 1.267A-2(e) addresses branch mismatch payments. These payments give rise to a D/NI outcome due to

differences between the home office's tax law and the branch's tax law regarding the allocation of items of income or the treatment of the branch. This could occur, for example, if the home office's tax law views a payment as attributable to the branch and exempts the branch's income, but the branch's tax law does not tax the payment.

- (b) Under the proposed regulations, a specified payment is a branch mismatch payment when two requirements are satisfied. First, under a home office's tax law, the specified payment is treated as attributable to a branch of the home office. Second, under the tax law of the branch country, either (i) the home office does not have a taxable presence in the country, or (ii) the specified payment is treated as attributable to the home office and not the branch. When a specified payment is a branch mismatch payment, it is generally a disqualified hybrid amount to the extent that the home office does not include the payment in income.

11. Link Between Hybridity and D/NI Outcome.

- (a) Under § 267A(a), a deduction for a payment is generally disallowed if (i) the payment involves a hybrid arrangement, and (ii) a D/NI outcome occurs. In certain cases, although both of these conditions are satisfied, the D/NI outcome is not a result of the hybridity. For example, in the hybrid transaction context, the D/NI outcome may be a result of the specified recipient's tax law containing a pure territorial system (and thus exempting from taxation all foreign source income) or not having a corporate income tax, or a result of the specified recipient's status as a tax-exempt entity under its tax law.
- (b) Prop. Treas. Reg. § 1.267A-2(a)(1)(ii) provides that a D/NI outcome gives rise to a disqualified hybrid amount only to the extent that the D/NI outcome is a result of hybridity.
- (c) To determine whether a D/NI outcome is a result of hybridity, the proposed regulations generally apply a test based on facts that are counter to the hybridity at issue. For example, in the hybrid transaction context, a specified recipient's no-inclusion is a result of the specified payment being made pursuant to the hybrid transaction to the extent that the no-inclusion would not occur were the payment to be treated as interest or a royalty for purposes of the specified recipient's tax law.
- (d) This test also addresses cases in which, for example, a specified payment is made to a fiscally transparent entity (such as a partnership) and owners of the entity that are specified recipients

of the payment each derive only a portion of the payment under its tax law. The test ensures that, with respect to each specified recipient, only the no-inclusion that occurs for the portion of the specified payment that it derives may give rise to a disqualified hybrid amount. In addition, as a result of the relatedness or structured arrangement limitation discussed immediately below, the no-inclusion with respect to the specified recipient is taken into account under the proposed regulations only if the specified recipient is related to the specified party or is a party to a structured arrangement pursuant to which the specified payment is made.

12. Relatedness or Structured Arrangement Limitation.

- (a) In determining whether a specified payment is made pursuant to a hybrid or branch mismatch arrangement, Prop. Treas. Reg. § 1.267A-2(f) generally only considers the tax laws of tax residents or taxable branches that are related to the specified party. For example, in general, only the tax law of a specified recipient that is related to the specified party is taken into account for purposes of determining whether the specified payment is made pursuant to a hybrid transaction. Because a deemed branch payment by its terms involves a related home office, the relatedness limitation in Prop. Treas. Reg. § 1.267A-2(f) does not apply to Prop. Treas. Reg. § 1.267A-2(c).
- (b) Prop. Treas. Reg. § 1.267A-5(a)(14) provides that related status is determined under the rules of § 954(d)(3) (involving ownership of more than 50 percent of interests) but without regard to downward attribution. In addition, to ensure that a tax resident may be considered related to a specified party even though the tax resident is a disregarded entity for U.S. tax purposes, the proposed regulations provide that such a tax resident is treated as a corporation for purposes of the relatedness test. A similar rule applies with respect to a taxable branch.
- (c) The preamble states that some hybrid arrangements involving unrelated parties are designed to give rise to a D/NI outcome and therefore present the policy concerns underlying § 267A. Furthermore, it is likely that in such cases the specified party will have, or can reasonably obtain, the information necessary to comply with § 267A.
- (d) Accordingly, Prop. Treas. Reg. § 1.267A-2(f) generally provides that the tax law of an unrelated tax resident or taxable branch is taken into account for purposes of § 267A if the tax resident or taxable branch is a party to a structured arrangement. Prop. Treas.

Reg. § 1.267A-5(a)(20) sets forth a test for when a transaction is a structured arrangement.

- (e) In addition, the proposed regulations impute an entity's participation in a structured arrangement to its investors. Thus, for example, in the case of a specified payment to a partnership that is a party to a structured arrangement pursuant to which the payment is made, a tax resident that is a partner of the partnership is also a party to the structured arrangement, even though the tax resident may not have actual knowledge of the structured arrangement.

13. Effect of Inclusion in Another Jurisdiction.

- (a) The proposed regulations provide that a specified payment is a disqualified hybrid amount if a D/NI outcome occurs as a result of hybridity in any foreign jurisdiction, even if the payment is included in income in another foreign jurisdiction. Prop. Treas. Reg. § 1.267A-6(c), Example 1. Absent such a rule, an inclusion of a specified payment in income in a jurisdiction with a (generally applicable) low rate might discharge the application of § 267A even though a D/NI outcome occurs in another jurisdiction as a result of hybridity.
- (b) For example, assume FX, a tax resident of Country X, owns US1, a domestic corporation, and FZ, a tax resident of Country Z that is fiscally transparent for Country X tax purposes. Also, assume that Country Z has a single, low-tax rate applicable to all income. Further, assume that FX holds an instrument issued by US1, a \$100x payment with respect to which is treated as interest for U.S. tax purposes and an excludible dividend for Country X tax purposes.
- (c) In an attempt to avoid US1's deduction for the \$100x payment being denied under the hybrid transaction rule, FX contributes the instrument to FZ, and, upon US1's \$100x payment, US1 asserts that, although a \$100x no-inclusion occurs with respect to FX as a result of the payment being made pursuant to the hybrid transaction, the payment is not a disqualified hybrid amount because FZ fully includes the payment in income (albeit at a low-tax rate). The proposed regulations treat the payment as a disqualified hybrid amount.
- (d) This rule only applies for inclusions under the laws of foreign jurisdictions, Prop. Treas. Reg. § 1.267A-3(b), for exceptions that apply when the payment is included or includible in a U.S. tax resident's or U.S. taxable branch's income.

14. Exceptions for Certain Amounts Included or Includible in a U.S. Tax Resident's or U.S. Taxable Branch's Income.

- (a) Prop. Treas. Reg. § 1.267A-3(b) provides rules that reduce disqualified hybrid amounts to the extent the amounts are included or includible in a U.S. tax resident's or U.S. taxable branch's income. In general, these rules ensure that a specified payment is not a disqualified hybrid amount to the extent included in the income of a tax resident of the U.S. or a U.S. taxable branch, or taken into account by a U.S. shareholder under the Subpart F or GILTI rules.
- (b) Source-based withholding tax imposed by the U.S. (or any other country) on disqualified hybrid amounts does not neutralize the D/NI outcome and therefore does not reduce or otherwise affect disqualified hybrid amounts. Withholding tax policies are unrelated to the policies underlying hybrid arrangements – for example, withholding tax can be imposed on non-hybrid payments – and, accordingly, withholding tax is not a substitute for a specified payment being included in income by a tax resident or taxable branch.
- (c) Furthermore, other jurisdictions applying the defensive or secondary rule to a payment (which generally requires the payee to include the payment in income, if the payer is not denied a deduction for the payment under the primary rule) may not treat withholding taxes as satisfying the primary rule and may therefore require the payee to include the payment in income if a deduction for the payment is not disallowed (regardless of whether withholding tax has been imposed).
- (d) Thus, the proposed regulations do not treat amounts subject to U.S. withholding taxes as reducing disqualified hybrid amounts.

15. Disqualified Imported Mismatch Amounts.

- (a) Prop. Treas. Reg. § 1.267A-4 sets forth important rules that address “imported” hybrid and branch arrangements. These rules are generally intended to prevent the effects of an “offshore” hybrid arrangement (for example, a hybrid arrangement between two foreign corporations completely outside the U.S. taxing jurisdiction) from being shifted, or “imported,” into the U.S. taxing jurisdiction through the use of a non-hybrid arrangement.
- (b) The proposed regulations disallow deductions for specified payments that are “disqualified imported mismatch amounts.” In general, a disqualified imported mismatch amount is a specified

payment: (i) that is non-hybrid in nature, such as interest paid on an instrument that is treated as indebtedness for both U.S. and foreign tax purposes, and (ii) for which the income attributable to the payment is directly or indirectly offset by a hybrid deduction of a foreign tax resident or taxable branch.

- (c) The rules address “indirect” offsets in order to take into account, for example, structures involving intermediaries where the foreign tax resident that receives the specified payment is different from the foreign tax resident that incurs the hybrid deduction.
- (d) A hybrid deduction for purposes of the imported mismatch rule is an amount for which a foreign tax resident or taxable branch is allowed an interest or royalty deduction under its tax law, to the extent the deduction would be disallowed if such tax law were to contain rules substantially similar to the § 267A proposed regulations.
- (e) For this purpose, it is not relevant whether the amount is recognized as interest or a royalty under U.S. law, or whether the amount would be allowed as a deduction under U.S. law. Thus, for example, a deduction with respect to equity (such as a NID) constitutes a hybrid deduction even though such a deduction would not be recognized (or allowed) under U.S. tax law. As another example, a royalty deduction under foreign tax law may constitute a hybrid deduction even though for U.S. tax purposes the royalty is viewed as made from a disregarded entity to its owner and therefore is not regarded.
- (f) The requirement that the deduction would be disallowed if the foreign tax law were to contain rules substantially similar to those under § 267A is intended to limit the application of the imported mismatch rule to cases in which, had the foreign-to-foreign hybrid arrangement instead involved a specified party, § 267A would have applied to disallow the deduction.
- (g) This requirement prevents the imported mismatch rule from applying to arrangements outside the general scope of § 267A, even if the arrangements are hybrid in nature and result in a D/NI (or similar) outcome. For example, in the case of a deductible payment of a foreign tax resident to a tax resident of a foreign country that does not impose an income tax, the deduction would generally not be a hybrid deduction – even though it may be made pursuant to a hybrid instrument – because the D/NI outcome would not be a result of hybridity.

- (h) Further, the proposed regulations include “ordering” and “funding” rules to determine the extent that a hybrid deduction directly or indirectly offsets income attributable to a specified payment. In addition, the proposed regulations provide that certain payments made by non-specified parties the tax laws of which contain hybrid mismatch rules are taken into account when applying the ordering and funding rules. Together, these provisions are intended to coordinate Prop. Treas. Reg. § 1.267A-4 with foreign imported mismatch rules, in order to prevent the same hybrid deduction from resulting in deductions for non-hybrid payments being disallowed under imported mismatch rules in more than one jurisdiction.
- (i) Prop. Treas. Reg. § 1.267A-6(c), Example 8, Example 9, and Example 10 illustrate these rules. They are lengthy, but need to be read to understand these broad, new “mismatch importation” rules.
- (j) Prop. Treas. Reg. § 1.267A-6(c) Example 8(i) and (ii) provide:

Example 8. Imported mismatch rule – direct offset--(i) Facts. FX holds all the interests of FW, and FW holds all the interests of US1. FX holds an instrument issued by FW that is treated as equity for Country X tax purposes and indebtedness for Country W tax purposes (the FX-FW instrument). FW holds an instrument issued by US1 that is treated as indebtedness for Country W and U.S. tax purposes (the FW-US1 instrument).

In accounting period 1, FW pays \$100x to FX pursuant to the FX-FW instrument. The amount is treated as an excludible dividend for Country X tax purposes (by reason of the Country X participation exemption) and as interest for Country W tax purposes. Also in accounting period 1, US1 pays \$100x to FW pursuant to the FW-US1 instrument. The amount is treated as interest for Country W and U.S. tax purposes and is included in FW’s income. The FX-FW instrument was not entered into pursuant to the same plan or series of related transactions pursuant to which the FW-US1 instrument was entered into.

(ii) Analysis. US1 is a specified party and thus a deduction for its \$100x specified payment is subject to disallowance under § 267A. The \$100x payment is not a disqualified hybrid amount. In addition, FW’s \$100x deduction is a hybrid deduction because it is a deduction allowed to FW that results from an amount paid that is interest under Country W tax law, and were Country X law to have rules substantially similar to those under Prop. Treas. Reg. §§ 1.267A-1 through 1.267A-3 and 1.267A-5, a deduction for the payment would be disallowed (because under those rules the

payment would be pursuant to a hybrid transaction and FX's no-inclusion would be a result of the hybrid transaction). *See* Prop. Treas. Reg. §§ 1.267A-2(a) and 1.267A-4(b).

(iii) Under Prop. Treas. Reg. § 1.267A-4(a), US1's payment is an imported mismatch payment, US1 is an imported mismatch payer, and FW (the tax resident that includes the imported mismatch payment in income) is an imported mismatch payee. The imported mismatch payment is a disqualified imported mismatch amount to the extent that the income attributable to the payment is directly or indirectly offset by the hybrid deduction incurred by FX (a tax resident that is related to US1). *See* Prop. Treas. Reg. § 1.267A-4(a).

Under Prop. Treas. Reg. § 1.267A-4(c)(1), the \$100x hybrid deduction directly or indirectly offsets the income attributable to US1's imported mismatch payment to the extent that the payment directly or indirectly funds the hybrid deduction. The entire \$100x of US1's payment directly funds the hybrid deduction because FW (the imported mismatch payee) incurs at least that amount of the hybrid deduction. *See* Prop. Treas. Reg. § 1.267A-4(c)(3)(i). Accordingly, the entire \$100x payment is a disqualified imported mismatch amount under Prop. Treas. Reg. § 1.267A-4(a) and, as a result, a deduction for the payment is disallowed under Prop. Treas. Reg. § 1.267A-1(b)(2).

- (k) Prop. Treas. Reg. § 1.267A-6(c), Example 8 (iii) deals with "long term deferral," (iv) with NIDs and (v) with a country that has its own anti-mismatch rules.
- (l) Prop. Treas. Reg. § 1.267A-6(c) Examples 9 and 10 address "indirect offsets" and "ordering rules and rule deeming certain payments to be impacted mismatch payments," respectively.

16. Definitions of Interest and Royalty.

(a) Interest.

- i. Using the principles in rulings and cases, the proposed regulations define interest broadly to include interest associated with conventional debt instruments, other amounts treated as interest under the Code, as well as transactions that are indebtedness in substance although not in form. Prop. Treas. Reg. § 1.267A-5(a)(12).
- ii. In addition, in order to address certain structured transactions, the proposed regulations apply equally to "structured payments." Prop. Treas. Reg. § 1.267A-5(b)(5)

defines structured payments to include a number of items such as an expense or loss predominately incurred in consideration of the time value of money in a transaction or series of integrated or related transactions in which a taxpayer secures the use of funds for a period of time. This approach is consistent with the rules treating such payments similarly to interest under Temp. Treas. Reg. §§ 1.861-9T and 1.954-2.

- iii. The definitions of interest and structured payments also provide for adjustments to the amount of interest expense or structured payments, as applicable, to reflect the impact of derivatives that affect the economic yield or cost of funds of a transaction involving interest or structured payments. The definitions of interest and structured payments contained in the proposed regulations apply only for purposes of § 267A.
- iv. However, solely for purposes of certain other provisions, similar definitions apply. For example, the definition of interest and structured payments under the proposed regulations is similar in scope to the definition of items treated similarly to interest under Temp. Treas. Reg. § 1.861-9T for purposes of allocating and apportioning deductions under § 861 and similar to the items treated as interest expense for purposes of § 163(j) in proposed regulations under § 163(j).
- v. Treasury and the IRS considered three options with respect to the definition of interest for purposes of § 267A. The first option considered was to not provide a definition of interest, and thus rely on general tax principles and case law to define interest for purposes of § 267A. The second option considered would have been to adopt a definition of interest but limit the scope of the definition to cover only amounts associated with conventional debt instruments and amounts that are generally treated as interest for all purposes under the Code or regulations prior to the passage of the TCJA.
- vi. The final option considered, and the one ultimately adopted in the proposed regulations, is to provide a complete definition of interest that addresses all transactions that are commonly understood to produce interest expense, as well as structured payments that may have been entered into to avoid the application of § 267A.

vii. The proposed regulations also reduce taxpayer burden by adopting definitions of interest that have already been developed and administered in Temp. Treas. Reg. § 1.861-9T and Treas. Reg. § 1.954-2 and that have been proposed for purposes of § 163(j). The definition of interest provided in the proposed regulations applies only for purposes of § 267A and not for other purposes of the Code, such as § 904(d)(3).

(b) Royalty.

i. Treasury and the IRS determined that providing a definition of royalties would provide certainty, and therefore the proposed regulations define the term royalty for purposes of § 267A to include amounts paid or accrued as consideration for the use of, or the right to use, certain intellectual property and certain information concerning industrial, commercial or scientific experience. Prop. Treas. Reg. § 1.267A-5(a)(16).

ii. The term does not include amounts paid or accrued for after-sales services, for services rendered by a seller to the purchaser under a warranty, for pure technical assistance, or for an opinion given by an engineer, lawyer or accountant. The definition of royalty provided in the proposed regulations applies only for purposes of § 267A and not for other purposes of the Code, such as § 904(d)(3).

iii. The definition of royalty is generally based on the definition used in tax treaties. This definition is also generally consistent with the language of § 861(a)(4). The proposed regulations provide certain circumstances where payments are not treated as paid or accrued in consideration for the use of information concerning industrial, commercial or scientific experience. By using definitions that have already been developed and administered in other contexts, the proposed regulations provide an approach that reduces taxpayer burdens and uncertainty.

17. Miscellaneous Issues; Effect of Foreign Currency Gain or Loss.

(a) Prop. Treas. Reg. § 1.267A-5(b)(2) provides that foreign currency gain or loss recognized under § 988 is not separately taken into account under § 267A. Rather, foreign currency gain or loss recognized with respect to a specified payment is taken into account under § 267A only to the extent that the specified payment

is in respect of accrued interest or an accrued royalty for which a deduction is disallowed under § 267A.

- (b) Thus, for example, a § 988 loss recognized with respect to a specified payment of interest is not separately taken into account under § 267A (even though under the tax law of the tax resident to which the specified payment is made the tax resident does not include in income an amount corresponding to the § 988 loss, as the specified payment is made in the tax resident's functional currency).
- (c) The preamble states that additional rules addressing the effect of different foreign currencies may be necessary. For example, a hybrid deduction for purposes of the imported mismatch rule may be denominated in a different currency than a specified payment, in which case a translation rule may be necessary to determine the amount of the specified payment that is subject to the imported mismatch rule.

18. Payments by U.S. Taxable Branches.

- (a) Certain expenses incurred by a nonresident alien or foreign corporation are allowed as deductions under §§ 873(a) and 882(c) in determining that person's effectively connected income. To the extent the deductions arise from transactions involving certain hybrid or branch arrangements, the deductions should be disallowed under § 267A.
- (b) Prop. Treas. Reg. § 1.267A-5(b)(3) does so by (i) treating a U.S. taxable branch (which includes a permanent establishment of a foreign person) as a specified party, and (ii) providing rules regarding interest or royalties considered paid or accrued by a U.S. taxable branch, solely for purposes of § 267A (and thus not for other purposes, such as chapter 3 of the Code). The effect of this approach is that interest or royalties considered paid or accrued by a U.S. taxable branch are specified payments that are subject to the rules of Prop. Treas. Reg. § 1.267A-1 through 1.267A-4; *See also* Prop. Treas. Reg. § 1.267A-6(c), Example 4.
- (c) In general, a U.S. taxable branch is considered to pay or accrue any interest or royalties allocated or apportioned to effectively connected income of the U.S. taxable branch. Prop. Treas. Reg. § 1.267A-5(b)(3)(i). However, if a U.S. taxable branch constitutes a U.S. permanent establishment of a treaty resident, then the U.S. permanent establishment is considered to pay or accrue the interest or royalties deductible in computing its business profits. Although interest paid by a U.S. taxable branch may be subject to

withholding tax as determined under § 884(f)(1)(A) and Treas. Reg. § 1.884-4, those rules are not relevant for purposes of § 267A.

- (d) Prop. Treas. Reg. § 1.267A-5(b)(3)(ii) provides rules to identify the manner in which a specified payment of a U.S. taxable branch is considered made. Absent these rules, it might be difficult to determine whether the specified payment is made pursuant to a hybrid or branch arrangement (for example, made pursuant to a hybrid transaction or to a reverse hybrid).
- (e) However, these rules regarding the manner in which a specified payment is made do not apply to interest or royalties deemed paid by a U.S. permanent establishment in connection with inter-branch transactions that are permitted to be taken into account under certain U.S. tax treaties – such payments, by definition, constitute deemed branch payments (subject to disallowance under Prop. Treas. Reg. § 1.267A-2(c)) and are therefore made pursuant to a branch arrangement.

19. Coordination with Other Provisions.

- (a) Prop. Treas. Reg. § 1.267A-5(b)(1) coordinates the application of § 267A with other provisions of the Code and regulations that affect the deductibility of interest and royalties. In general, § 267A applies after the application of other provisions of the Code and regulations. For example, a specified payment is subject to § 267A for the taxable year for which a deduction for the payment would otherwise be allowed. Thus, if a deduction for an accrued amount is deferred under § 267(a) (in certain cases, deferring a deduction for an amount accrued to a related foreign person until paid), then the deduction is tested for disallowance under § 267A for the taxable year in which the amount is paid.
- (b) Absent this rule, an accrued amount for which a deduction is deferred under § 267(a) could constitute a disqualified hybrid amount even though the amount will be included in the specified recipient's income when actually paid. This coordination rule also provides that § 267A applies to interest or royalties after taking into account provisions that could otherwise recharacterize such amounts, such as Treas. Reg. § 1.894-1(d)(2).

20. E&P Reduction. Prop. Treas. Reg. § 1.267A-5(b)(4) provides that the disallowance of a deduction under § 267A does not affect whether or when the amount paid or accrued that gave rise to the deduction reduces earnings and profits of a corporation. Thus, a corporation's earnings and profits may be reduced as a result of a specified payment for which a deduction is disallowed under § 267A.

21. De Minimis Exception. Prop. Treas. Reg. § 1.267A-1(c) provides a de minimis exception. Under this exception, a specified party is excepted from the application of § 267A for any taxable year for which the sum of its interest and royalty deductions (plus interest and royalty deductions of any related specified parties) is below \$50,000. This rule applies based on any interest or royalty deductions, regardless of whether the deductions would be disallowed under § 267A. In addition, for purposes of this rule, specified parties that are related are treated as a single specified party.
22. Interaction with Withholding Taxes and Income Tax Treaties.
- (a) The determination of whether a deduction for a specified payment is disallowed under § 267A is made without regard to whether the payment is subject to withholding under § 1441 or § 1442 or is eligible for a reduced rate of tax under an income tax treaty.
 - (b) Since the U.S. tax characterization of the payment prevails in determining the treaty rate for interest or royalties, regardless of whether the payment is made pursuant to a hybrid transaction, the proposed regulations will generally result in the disallowance of a deduction but treaty benefits may still be claimed, as long as the recipient is the beneficial owner of the payment and otherwise eligible for treaty benefits.
 - (c) On the other hand, if interest or royalties are paid to a fiscally transparent entity that is a reverse hybrid, as defined in Prop. Treas. Reg. § 1.267A-2(d), the payment generally will not be deductible under the proposed regulations if the investor does not derive the payment, and will not be eligible for treaty benefits if the interest holder under Treas. Reg. § 1.894-1(d) does not derive the payment. The proposed regulations will only apply, however, if the investor is related to the specified party, whereas the reduced rate under the treaty may be denied without regard to whether the interest holder is related to the payer of the interest or royalties.
 - (d) Certain U.S. income tax treaties also address indirectly the branch mismatch rules under Prop. Treas. Reg. § 1.267A-2(e). Special rules, generally in the limitation on benefits articles of income tax treaties, increase the tax treaty rate for interest and royalties to 15 percent (even if otherwise not taxable under the relevant treaty article) if the amount paid to a permanent establishment of the treaty resident is subject to minimal tax, and the foreign corporation that derives and beneficially owns the payment is a resident of a treaty country that excludes or otherwise exempts from gross income the profits attributable to the permanent establishment to which the payment was made.

E. Information Reporting under Sections 6038, 6038A, and 6038C.

1. Under § 6038(a)(1), U.S. persons that control foreign business entities must file certain information returns with respect to those entities, which includes information listed in §§ 6038(a)(1)(A) through (a)(1)(E), as well as information that “the Secretary determines to be appropriate to carry out the provisions of this title.” Section 6038A similarly requires 25-percent foreign-owned domestic corporations (reporting corporations) to file certain information returns with respect to those corporations, including information related to transactions between the reporting corporation and each foreign person which is a related party to the reporting corporation. Section 6038C imposes the same reporting requirements on certain foreign corporations engaged in a U.S. trade or business (also, a reporting corporation).
2. The proposed regulations provide that a specified payment for which a deduction is disallowed under § 267A, as well as hybrid dividends and tiered hybrid dividends under § 245A, must be reported on the appropriate information reporting form in accordance with §§ 6038 and 6038A. *See* Prop. Treas. Reg. §§ 1.6038-2(f)(13) and (14), 1.6038-3(g)(3), and 1.6038A-2(b)(5)(iii).

F. Sections 1503(d) and 7701 – Application to Domestic Reverse Hybrids.

1. DCL Rules.

- (a) Section 1503(d) and the regulations thereunder provide that, subject to certain exceptions, a DCL of a corporation cannot reduce the taxable income of a domestic affiliate (a “domestic use”). Section 1.1503(d)-1(b)(5) defines a DCL as a net operating loss of a dual resident corporation or the net loss attributable to a separate unit (generally defined as either a foreign branch or an interest in a hybrid entity).
- (b) The general prohibition against the domestic use of a DCL does not apply if, pursuant to a “domestic use election,” the taxpayer certifies that there has not been and will not be a “foreign use” of the DCL during a certification period. If a foreign use or other triggering event occurs during the certification period, the DCL is recaptured. A foreign use occurs when any portion of the DCL is made available to offset the income of a foreign corporation or the direct or indirect owner of a hybrid entity (generally non-dual inclusion income). Other triggering events include certain transfers of the stock or assets of a dual resident corporation, or the interests in or assets of a separate unit.

- (c) The regulations include a “mirror legislation” rule that, in general, prevents a domestic use election when a foreign jurisdiction has enacted legislation similar to § 1503(d) that denies any opportunity for a foreign use of the DCL. Treas. Reg. § 1.1503(d)-3(e). As a result, the existence of mirror legislation may prevent the DCL from being put to a domestic use (due to the domestic use limitation) or to a foreign use (due to the foreign “mirror legislation”) such that the loss becomes “stranded.” In such a case, the regulations contemplate that the taxpayer may enter into an agreement with the U.S. and the foreign country (for example, through the competent authorities) pursuant to which the losses are used in only one country. Treas. Reg. § 1.1503(d)-6(b).

2. Domestic Reverse Hybrids.

- (a) Treasury and the IRS are concerned that structures involving domestic reverse hybrids have been used to obtain double-deduction outcomes because they were not subject to limitation under current § 1503(d) regulations. A domestic reverse hybrid generally refers to a domestic business entity that elects under Treas. Reg. § 301.7701-3(c) to be treated as a corporation for U.S. tax purposes, but is treated as fiscally transparent under the tax law of its investors.
- (b) In these structures, a foreign parent corporation typically owns the majority of the interests in the domestic reverse hybrid. Domestic reverse hybrid structures can lead to double-deduction outcomes because, for example, deductions incurred by the domestic reverse hybrid can be used (i) under U.S. tax law to offset income that is not subject to tax in the foreign parent’s country, such as income of domestic corporations with which the domestic reverse hybrid files a U.S. consolidated return, and (ii) under the foreign parent’s tax law to offset income not subject to U.S. tax, such as income of the foreign parent other than the income (if any) of the domestic reverse hybrid.
- (c) The preamble states that taxpayers take the position that these structures are not subject to the current § 1503(d) regulations because the domestic reverse hybrid is neither a dual resident corporation (because it is not subject to tax on a residence basis or on its worldwide income in the foreign parent country) nor a separate unit of a domestic corporation.
- (d) Treasury and the IRS have determined that these structures are inconsistent with the principles of § 1503(d) and, as a result, raise significant policy concerns. Accordingly, the proposed regulations include rules under §§ 1503(d) and 7701 to prevent the use of these

structures to obtain a double-deduction outcome. The proposed regulations require, as a condition to a domestic entity electing to be treated as a corporation under Treas. Reg. § 301.7701-3(c), that the domestic entity consent to be treated as a dual resident corporation for purposes of § 1503(d) (such an entity, a “domestic consenting corporation”) for taxable years in which two requirements are satisfied. Prop. Treas. Reg. § 301.7701-3(c)(3).

- (e) The requirements are intended to restrict the application of § 1503(d) to cases in which it is likely that losses of the domestic consenting corporation could result in a double-deduction outcome.
- (f) Under Prop. Treas. Reg. § 1.1503(d)-1(c) the requirements are satisfied if (i) a “specified foreign tax resident” (generally, a body corporate that is a tax resident of a foreign country) under its tax law derives or incurs items of income, gain, deduction, or loss of the domestic consenting corporation, and (ii) the specified foreign tax resident is related to the domestic consenting corporation (as determined under § 267(b) or § 707(b)).
- (g) For example, the requirements are satisfied if a specified foreign tax resident directly owns all the interests in the domestic consenting corporation and the domestic consenting corporation is fiscally transparent under the specified foreign tax resident’s tax law. In addition, an item of the domestic consenting corporation for a particular taxable year is considered derived or incurred by the specified tax resident during that year even if, under the specified foreign tax resident’s tax law, the item is recognized in, and derived or incurred by the specified foreign tax resident in, a different taxable year.
- (h) Further, if a domestic entity filed an election to be treated as a corporation before December 20, 2018 so that the entity was not required to consent to be treated as a dual resident corporation, then the entity is deemed to consent to being treated as a dual resident corporation as of its first taxable year beginning on or after the end of a 12-month transition period.
- (i) This deemed consent can be avoided if the entity elects, effective before its first taxable year beginning on or after the end of the transition period, to be treated as a partnership or disregarded entity such that it ceases to be a corporation for U.S. tax purposes. For purposes of such an election, the 60-month limitation under Treas. Reg. § 301.7701-3(c)(1)(iv) is waived.

- (j) Prop. Treas. Reg. § 1.1503(d)-3(e)(3) provides that the mirror legislation rule does not apply to dual consolidated losses of a domestic consenting corporation. This exception is intended to minimize cases in which DCL's could be "stranded" when, for example, the foreign parent jurisdiction has adopted rules similar to the recommendations in the BEPS Hybrid Mismatch Report. The exception does not apply to DCL's attributable to separate units because, in such cases, the U.S. is the parent jurisdiction and the DCL rules should neutralize the double-deduction outcome.

G. Triggering Event Exception for Compulsory Transfers.

1. As noted above, certain triggering events require a DCL that is subject to a domestic use election to be recaptured and included in income. The DCL regulations also include various exceptions to these triggering events, including an exception for compulsory transfers involving foreign governments.
2. A comment regarding the 2007 final DCL regulations stated that the policies underlying the triggering event exception for compulsory transfers involving foreign governments apply equally to compulsory transfers involving the U.S. government. Accordingly, the comment requested guidance under Treas. Reg. § 1.1503(d)-3(c)(9) to provide that the exception is not limited to foreign governments.
3. Treasury and the IRS agree with this comment and, accordingly, the proposed regulations modify the compulsory transfer triggering event exception such that it will also apply with respect to the U.S. government.

H. Disregarded Payments Made to Domestic Corporations.

1. As discussed above, the proposed regulations under § 267A address D/NI outcomes resulting from actual and deemed payments of interest and royalties that are regarded for U.S. tax purposes but disregarded for foreign tax purposes. The proposed regulations under § 267A do not, however, address similar structures involving payments to domestic corporations that are regarded for foreign tax purposes but disregarded for U.S. tax purposes.
2. For example, USP, a domestic corporation that is the parent of a consolidated group, borrows from a bank to fund the acquisition of the stock of FT, a foreign corporation that is tax resident of Country X. USP contributes the loan proceeds to USS, a newly formed domestic corporation that is a member of the USP consolidated group, in exchange for all the stock of USS. USS then forms FDE, a disregarded entity that is tax resident of Country X, USS lends the loan proceeds to FDE, and FDE uses the proceeds to acquire the stock of FT.

3. For U.S. tax purposes, USP claims a deduction for interest paid on the bank loan, and USS does not recognize interest income on interest payments made to it from FDE because the payments are disregarded. For Country X tax purposes, the interest paid from FDE to USS is regarded and gives rise to a loss that can be surrendered (or otherwise used, such as through a consolidation regime) to offset the operating income of FT.
4. Under the current § 1503(d) regulations, the loan from USS to FDE does not result in a DCL attributable to USS's interest in FDE because interest paid on the loan is not regarded for U.S. tax purposes. Treas. Reg. § 1.1503(d)-7(c), Example 23. Only items that are regarded for U.S. tax purposes are taken into account for purposes of determining a DCL. In addition, the regarded interest expense of USP is not attributed to USS's interest in FDE because only regarded items of USS, the domestic owner of FDE, are taken into account for purposes of determining a DCL. The result would generally be the same, however, even if USS, rather than USP, were the borrower on the bank loan.
5. Treasury and the IRS have determined that these transactions raise significant policy concerns that are similar to those relating to the D/NI outcomes addressed by §§ 245A(e) and 267A, and the double-deduction outcomes addressed by § 1503(d). Treasury and the IRS are studying these transactions and request comments.

I. Applicability Dates.

1. Prop. Treas. Reg. § 1.245A(e)-1 applies to distributions made after December 31, 2017. Prop. Treas. Reg. §§ 1.267A-1 through 1.267A-6 generally apply to specified payments made in taxable years beginning after December 31, 2017. This applicability date is consistent with the applicability date of § 267A. Treasury and the IRS expect to finalize these provisions by June 22, 2019. However, if they finalized after June 22, 2019, then the provisions will apply only to taxable years ending on or after December 20, 2018.
2. As provided in Prop. Treas. Reg. § 1.267A-7(b), certain rules, such as the disregarded payment and deemed branch payment rules as well as the imported mismatch rule, apply to specified payments made in taxable years beginning on or after December 20, 2018.
3. Prop. Treas. Reg. §§ 1.6038-2, 1.6038-3, and 1.6038A-2, which require certain reporting regarding deductions disallowed under § 267A, as well as hybrid dividends and tiered hybrid dividends under § 245A, apply with respect to information for annual accounting periods or tax years, as applicable, beginning on or after December 20, 2018.

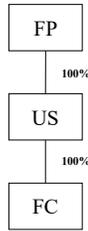
4. Prop. Treas. Reg. §§ 1.1503(d)-1 and -3, treating domestic consenting corporations as dual resident corporations, apply to taxable years ending on or after December 20, 2018.
5. Prop. Treas. Reg. § 1.1503(d)-6, amending the compulsory transfer triggering event exception, applies to transfers that occur on or after December 20, 2018, but taxpayers may apply the rules to earlier transfers. Prop. Treas. Reg. §§ 301.7701-3(a) and (c)(3) apply to a domestic eligible entity that on or after December 20, 2018 files an election to be classified as an association (regardless of whether the election is effective before December 20, 2018). These provisions also apply to certain domestic eligible entities the interests in which are transferred or issued on or after December 20, 2018.

XII. TECHNICAL CORRECTION TO TCJA.

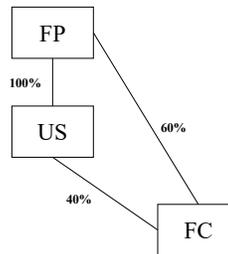
- A. Technical Corrections. Outgoing Ways and Means Committee Chairman Kevin Brady (R-Texas) released a discussion draft of the “Tax Technical and Clerical Corrections Act.” It proposes certain helpful, and in some cases, important, changes to the TCJA. It’s not clear what will happen regarding these technical corrections given the change of control in the House. The Joint Committee on Taxation prepared an explanation of these technical corrections dated January 2, 2019. JCX-1-19.
 1. Section 958(b)(4).
 - (a) The TCJA repealed § 958(b)(4), thus requiring attribution of certain stock of a foreign corporation owned by a foreign person to a related U.S. person for purposes of determining whether the related U.S. person is a U.S. shareholder of the foreign corporation and, therefore, whether the foreign corporation is a CFC. This unfortunate change created all sorts of tax problems. The intent was to address a perceived minor problem but the TCJA did it with a nuclear attack. It seriously needs fixing.
 - (b) The technical correction restores the language in § 958(b)(4) as a general rule. It also provides an exception for limited downward attributions that the JCT states is “consistent with the narrow intent of the [TCJA].” To accomplish this, the technical correction includes a new § 951B that is entitled “Amounts Included in Gross Income of Foreign Controlled United States Shareholders.”
 - (c) Section 951B provides “In the case of any *foreign controlled United States shareholder of a foreign controlled foreign corporation* this subpart (other than §§ 951A, 951(b), 957 and 965) shall be applied *with respect to such shareholder* (separately from and in addition to, the application of this subpart without

regard to this section) [italics added].... (A) by substituting ‘foreign controlled United States shareholder’ for ‘United States shareholder’ each place it appears therein and (B) by substituting ‘foreign controlled foreign corporation’ for ‘controlled foreign corporation’ each place it appears therein.”

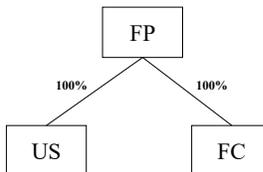
- (d) Thus, we have important new terms: “FC US SH” and “F-CFC.”
- (e) The provision continues by stating “Sections 951A and 965 shall be applied *with respect to such shareholder* [italics added] – (A) by treating each reference to ‘United States shareholder’ in such sections as including a reference to such shareholder and (B) by treating each reference to ‘controlled foreign corporation’ in such sections as including a reference to such foreign controlled foreign corporation.”
- (f) FC US SH is defined to mean with respect to any foreign corporation, any U.S. person that would be a U.S. shareholder with respect to the foreign corporation if (1) § 951(b) were applied by substituting “more than 50%” for “10% or more” and (2) § 958(b) were applied “without regard to paragraph 4 thereof.” “Paragraph 4 thereof” is the restored bar on downward attribution from a foreign person.
- (g) The term F-CFC means a foreign corporation, other than a CFC, which would be a CFC if § 957(a) were applied – (1) by substituting “foreign controlled United States shareholder” for “United States shareholders” and (2) by substituting “§ 958(b) (other than paragraph 4 thereof)” for “§ 958(b).”
- (h) Under § 951B(d) Treasury and the IRS are authorized to prescribe regulations or other guidance as may be necessary or appropriate to carry out the purposes of the new section including regulations or other guidance (1) to treat a foreign controlled United States shareholder or a foreign controlled foreign corporation as a U.S. shareholder or as a controlled foreign corporation, respectively, for purposes of this title other than this subpart and (2) to prevent the avoidance for the purposes of this section. These regulations could be important in determining reporting obligations, specifically the requirement to file Forms 5471.
- (i) We used five examples to help us with our understanding of the proposed technical correction.
- (j) FP (foreign parent) owns US 100% which owns FC 100%. No effect, no change here because FC is already a CFC. A CFC without the application of § 951B cannot become an F-CFC.



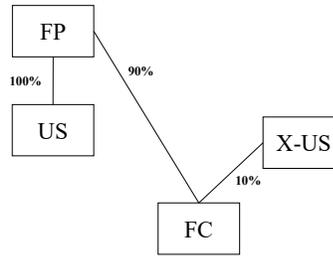
- (k) FP owns US 100% and FC 60%. US owns FC 40%. US is an FC (foreign controlled) US SH. FC is an F-CFC. This is a change from pre-2017 law. It's the same answer as under the 2017 § 958(b) change but with important new legal terms that, for example, might affect reporting, such as F-CFC. US is taxed via 958(a) on income attributable to its 40% interest in FC.



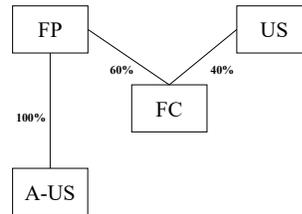
- (l) FP owns US 100% and FC 100%. US is an FC US SH. FC is an F-CFC. Same answer as under 2017 change but with different legal terms, as in #2.



- (m) An outside US Investor example: FP owns US 100% and FC 90%. X, an unrelated US corporation, owns the other 10% of FC. Under the TC, US is an FC US SH and, as to US, FC is an F-CFC. Proposed new § 951B operates “with respect to” US and FC. As to X, X is not affected by what happens to US. As to X, FC is not a CFC, and pre-2017 law is restored.



- (n) A JV example: US owns 40% of FC (a JV entity). US has no foreign ownership, so it cannot be an FC US SH. FP, simply an unrelated foreign corp in this example, owns 60% of FC (the JV entity) and 100% of A, a US Corp. Section 951B does not operate regarding US since it's not an FC US SH, so pre-2017 law is restored as to it, and as to it, FC is not a CFC or an F-CFC. Section 951B does operate regarding A, an FC US SH, and thus FC becomes an F-CFC, but only as to A.



2. Open questions include reporting (e.g., Form 5471), not for US in Example 5, but for A. However, A already has this issue today, that is, if the TC were not enacted. Presumably, the regulatory authority under § 951B(d)(1) would be used by the IRS to resolve reporting matters for A. The same issue arises in Example 4 for U.S. The IRS has already addressed this today in reasonably similar circumstances. See our column of September 3, 2018, p. 989 at 1011, so hopefully it would be easy to resolve if the TC became law.
3. The § 958(b)(4)/951B amendments are proposed to apply to the last taxable year of foreign corporations beginning before January 1, 2018, and each subsequent taxable year of such foreign corporations and taxable years of U.S. persons in which or with which those taxable years of foreign corporation's end.
4. Section 245A. TCJA provides a 100% dividends-received deduction to a domestic corporation for the foreign-source portion of dividends received from specified 10% owned foreign corporations. Three clarifications are provided regarding § 245A. They seem minor. One applies for purposes of the corporate alternative minimum tax (which TCJA repealed for taxable years beginning after December 31, 2017) as applicable to certain fiscal-year taxpayers for their 2017 taxable year. A second clarifies that a

hybrid dividend is any dividend received from a CFC for which the CFC received a deduction or other benefit. The third clarifies how the § 245A dividends received deduction works in the case of tiered foreign corporations.

5. Section 951.

- (a) In general, § 951(a) provides that a U.S. shareholder of the CFC currently includes in gross income its pro rata share of the CFC's Subpart F income. However, only shareholders that own stock (directly or indirectly) in the foreign corporation on the last day in the foreign corporation's taxable year on which the foreign corporation is a CFC are required to include those amounts. A U.S. shareholder generally includes its pro rata share of § 951(a) items for the entire portion of the year during which the foreign corporation is a CFC.
- (b) The U.S. shareholder's pro rata share is reduced, however, by dividends during the year to another owner of the same CFC stock, but only to the extent those dividends do not exceed the Subpart F income attributable on a pro rata basis to the period that the U.S. shareholder did not own the stock.
- (c) The technical correction modifies the pro rata share rules by allocating § 951(a) items in certain cases to a U.S. shareholder with respect to stock the shareholder does not hold on the last day in the foreign corporation's taxable year in which the foreign corporation is a CFC.
- (d) Specifically, the provision allocates § 951(a) items to a U.S. shareholder to the extent the U.S. shareholder received a distribution of current earnings and profits that: (1) would give rise to a deduction under § 245A(a), or (2) in the case of a dividend paid directly or indirectly to a CFC regarding stock owned by the shareholder within the meaning of § 958(a)(2) would not result in Subpart F income to the CFC by reason of § 954(b)(4), (c)(3) or (c)(6).
- (e) Consistent with prior law, the provision allocates the remaining § 951(a) items to U.S. shareholders in proportion their ownership on the last day in the foreign corporation's taxable year on which the foreign corporation is a CFC.
- (f) A new rule in § 964(e) coordinates the general rule which applies to gain recognized on the sale or exchange by CFC-1 of stock in its subsidiary, CFC-2, with § 245A. The provision clarifies that the amount included in gross income by the U.S. shareholder is treated

as a dividend to which § 245A applies, unless it constitutes a hybrid dividend under § 245A(e).

6. Section 965.

- (a) The technical corrections include a number of “clarifications” regarding § 965. Three seem more important than the others.
- (b) One provision “amends” § 965(g) to “clarify” that no credit is allowed under § 901 for foreign income taxes paid or accrued (or treated as paid or accrued) with respect to distributions of previously taxed amounts described in § 965(b)(4)(A). Treasury and the IRS addressed in proposed regulations which received some serious negative commentary. *See* Section I.A. nos. 45-53. The need to change the statute suggests that the negative commentary is perhaps correct under the statute as written, that is, that the regulation is not correct under today’s statute.
- (c) Another significant § 965 technical correction permits refunds and credits to taxpayers that elect to pay their net tax liability within the meaning of § 965(h) in installments. As a result, an electing corporation may have an overpayment for a year in which total remittances exceed tax liability for the year, exclusive of any portion of the transition tax for which the payment due date has not yet passed, the outstanding liability for future installments of the transition tax that is not satisfied by these remittances remains a liability for all other purposes, and the excess amount remitted may be refunded, credited or applied to other obligations of the taxpayer, whether or not arising in the same taxable year.
- (d) The third significant provision includes special rules for the treatment of “extraordinary E&P” of a fiscal year CFC during the disqualified period beginning after the final measurement date (December 31, 2017) applicable to that foreign corporation for determination of its accumulated post-1986 deferred foreign income under § 965 and ending with the last day of such corporation’s taxable year that immediately precedes the first taxable year to which § 951A applies.
- (e) The extraordinary E&P from extraordinary dispositions during the disqualified period are treated as additional Subpart F income of the foreign corporation of the year in which it reported its § 965 inclusion. The increased § 965 inclusion results in an additional income inclusion for U.S. shareholders that are domestic corporations. The U.S. shareholders may elect to defer assessment and payment of the net tax liability arising from the inclusion in income until the year in which a triggering event occurs.

- (f) Several triggering events, such as loss of status as a CFC, are identified in the provision, which also authorizes Treasury and the IRS to identify in published guidance additional events that warrant treatment as triggering events. The resulting increased tax liability is assessed for the year in which the triggering event occurs and may be payable in installments upon election, with certain additional conditions.
7. GILTI. A number of “clarifications” involve the GILTI rules. We will not cover them as they seem generally minor in nature.
8. FDII and GILTI.
- (a) Under the TCJA, the § 250 deduction has a taxable income limitation in order to prevent the deduction from generating losses. The deduction relates to three items: FDII, GILTI and the § 78 gross-up attributable to a GILTI inclusion. The provision clarifies that the taxable income limitation accounts for the § 78 gross-up in addition to FDII and GILTI. The provision also clarifies that the § 250 deduction cannot be negative as a result of the operation of the taxable income limitation.
 - (b) The provision also adds the following items of income to the list of items excluded in determining the deduction eligible income: any income received or accrued that is of a kind that would be foreign person holding company income (as defined in § 954(c)); any amount included under § 1293 (PFIC); and any amount included in the gross income of a corporation regarding any transaction if any amount could be excluded from gross income of the corporation as a result of the benefit for extra-territorial income.
 - (c) The technical corrections clarify that the taxable income limitation under § 613A(d) is calculated without regard to any deduction allowable under § 250.
9. Other Changes.
- (a) The TCJA modifies § 951(b) to expand the definition of U.S. shareholder to include 10% value shareholders (in addition to 10% vote shareholders). The technical correction modifies § 1248 to apply the new definition of U.S. shareholder during periods in which that definition applies.
 - (b) The technical corrections delete a reference to § 960(b) in § 78 to clarify that foreign tax credits taken by reason of withholding tax imposed on the distribution of previously taxed income do not result in an additional § 78 gross-up.

- (c) The § 78 gross-up is generally treated as a dividend, and is not intended to benefit from the § 1245A dividends received deduction. The provision providing that the § 78 gross-up is not treated as a dividend for purposes of § 245A is generally effective for taxable years of foreign corporations beginning after December 31, 2017. Section 245A, however, is effective for dividend distributions made after December 31, 2017. The technical correction clarifies that § 78 gross-up amounts are not eligible for the § 245A dividends received deduction in the case of fiscal year taxpayers for their 2017 taxable year. Treasury and the IRS addressed this in a proposed regulation, *see* Section VII. IV.(f), but obviously some government people think a statutory change is needed, not simply a regulation.
- (d) The technical corrections clarify that the § 78 gross-up, including a § 78 gross-up attributable to GILTI, should be assigned to the category to which the taxes relate.
- (e) There are three other, seemingly less important technical corrections that we will not discuss.

XIII. SECTION 482, INCLUDING TCJA CHANGES.

A. Section 482: Aggregation.

1. The Tax Act added a new third sentence to § 482 that allows aggregation and the consideration of realistic alternatives if it produces the most reliable means of valuation. The exact sentence is:

“For purposes of this section, the Secretary shall require the valuation of transfers of intangible property (including intangible property transferred with other property or services) on an aggregate basis or the valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers.”
2. An aggregation rule is also set forth in the temporary § 482 regulations. Temp. Treas. Reg. § 1.482-1T(f)(2)(i)(B) states that the combined effect of two or more interrelated transactions can be aggregated if aggregation provides the most reliable measure of an arm’s length results under the best method rule.
3. The new third sentence in § 482 and the temporary regulation require valuations on an aggregate basis only when aggregation provides the most reliable measure of an arm’s length result. If there is a reliable comparable transaction and at arm’s length in the marketplace parties do

not aggregate, then aggregation is not the most reliable means of valuation. The statute and regulations do not give the IRS unfettered discretion to apply aggregation concepts. The IRS is bound by the arm's length standard and the best method's most reliable means of valuation.

4. While the proposed and temporary regulations were issued 2 years ago, the aggregation issue is current due to the "aggregation" codification in the Tax Reform Act.
5. An IRS spokesperson said recently no further changes to the § 482 regulations will be necessary under the Tax Reform Act's § 482 change and that the Tax Act in effect simply provided explicit authority for these regulations.
6. The temporary § 482 regulations were effective September 14, 2015, and applied retroactively to tax years ending on or after that date.
7. The temporary regulations will need to be reissued as final regulations sometime this year, as they have now expired under § 7805(e). They were issued on September 14, 2015. They expired on September 13, 2018.
8. Consistent Valuation of Controlled Transactions.
 - (a) The Preamble stated that the temporary § 482 regulations apply to controlled transactions including controlled transactions that are subject in whole or in part to §§ 367 and 482. Transfers of property subject to § 367 that occur between controlled taxpayers require a consistent and coordinated application of both sections to the controlled transfer of property.
 - (b) The Preamble says that the consistent analysis and valuation of transactions subject to multiple Code and regulatory provisions is required under the best method rule described in Treas. Reg. § 1.482-1(c). A best method analysis under § 482 begins with a consideration of the facts and circumstances related to the functions performed, the resources employed, and the risks assumed in the actual transaction or transactions among the controlled taxpayers, as well as in any uncontrolled transactions used as comparables.
 - (c) For example, states the Preamble, if consideration of the facts and circumstances reveals synergies among interrelated transactions, *an aggregate evaluation under § 482 may provide a more reliable measure of an arm's length result* than a separate valuation of the transactions.
 - (d) The best method rule requires a determination of the arm's-length result in controlled transactions under the method, and particular

application of that method, that provides the most reliable measure of an arm's-length result. The Preamble also referred to the "realistic alternative transactions" rule and states that "on a risk-adjusted basis" *this may provide the basis for application of unspecified methods* to determining the most reliable measure of an arm's length result.

9. Compensation Independent of the Form or Character of Controlled Transaction.

- (a) Temp. Treas. Reg. § 1.482-1T(f)(2)(i)(A) provides that arm's-length compensation must be consistent with, and must account for all of, the value provided between parties in a controlled transaction, *without regard to the form or character of the transaction*. For this purpose, it is necessary to consider the entire arrangement between the parties, as determined by the contractual terms, whether written or imputed in accordance with the economic substance of the arrangement, in light of the actual conduct of the parties.
- (b) The Preamble says this requirement is consistent with the principles underlying the arm's length standard, which require that arm's length compensation in controlled transactions equal the compensation that would have occurred if a similar transaction had occurred between similarly situated uncontrolled taxpayers.
- (c) The parties' written contracts should not be changed, modified or ignored if they satisfy the economic substance rules of Treas. Reg. §§ 1.482-1(d)(3)(ii)(B) and 1.482-1(d)(3)(iii)(B). *See Claymont Investment v. Commissioner*, T.C. Memo 2005-254 (2005). This new regulation can hardly be reconciled with those two long-standing (20-year) prior regulations, which are still outstanding.
- (d) The Preamble also says that this analysis may provide the basis for the application of unspecified transfer pricing methods to determine the most reliable measure of an arm's length result.

10. Aggregate or Separate Analysis.

- (a) Temp. Treas. Reg. § 1.482-1T(f)(2)(i)(B) contains what was the entirety of the previous aggregation rule. It was one paragraph in length.
- (b) The temporary regulations changed (the Preamble asserts this was a "clarification") previous Treas. Reg. § 1.482-1(f)(2)(i)(A), which provided that the combined effect of two or more separate transactions (whether before, during, or after the year under review) may be considered if the transactions, taken as a whole,

are so interrelated that an aggregate analysis of these transactions provides the most reliable measure of an arm's-length result determined under the best method rule of Treas. Reg. § 1.482-1(c). The new temporary regulations also provides that the *value* provided must be considered.

(c) Temp. Treas. Reg. § 1.482-1T(f)(2)(i)(B) reads in full:

(B) *Aggregation.*—The combined effect of two or more separate transactions (whether before, during, or after the year under review), including for purposes of an analysis under multiple provisions of the Code or regulations, may be considered if the transactions, taken as a whole, are so interrelated that an aggregate analysis of the transactions provides the most reliable measure of an arm's length result determined under the best method rule of § 1.482-1(c). Whether two or more transactions are evaluated separately or in the aggregate depends on the extent to which the transactions are economically interrelated and on the relative reliability of the measure of an arm's length result provided by an aggregate analysis of the transactions as compared to a separate analysis of each transaction. For example, consideration of the combined effect of two or more transactions may be appropriate to determine whether the overall compensation in the transactions is consistent with the value provided, including any synergies among items and services provided.

(d) The temporary regulation added a new clause to provide that this aggregation principle will also apply for purposes of an analysis under multiple provisions of the Code or regulations. A new sentence elaborates on the aggregation principle by noting that consideration of the combined effect of two or more transactions may be appropriate to determine whether the overall compensation is consistent with the value provided, including any *synergies* among items and services provided.

(e) “Synergies” might have been implicit under the previous final § 482 regulation where appropriate, but under the temporary regulation, it is stated seemingly as a requirement, or at least a requirement to be considered in determining reliability of the result. Under the comparable uncontrolled transaction and other § 482 transfer pricing methods, taxpayers are directed to look to relevant comparable transactions and not simply to determine if synergies are involved.

(f) The temporary regulation also did not retain the statement in Treas. Reg. § 1.482-1(f)(2)(i)(A) that transactions generally will be

aggregated only when they involve “related products or services.” This can present a confusing element in determining when to apply the aggregation rules.

- (g) The temporary regulations also state that an analysis may be appropriate to determine if the overall compensation is consistent with the *value* provided. However, “value” may be – likely is – different from a comparable uncontrolled price. Thus, the temporary regulation muddied the waters by interposing “value” into the general § 482 transfer pricing rules.
- (h) Transfer pricing is transactional and CUTs are the gold standard. The price charged for the sales of goods and a royalty need a “value” analysis if both are supported by valid CUTs do not. Comparables are the backbone of transfer pricing. Comparables are the heart of the arm’s length standard.

11. Aggregation and Allocation for Purposes of Coordinated Analysis.

- (a) Temp. Treas. Reg. § 1.482-1T(f)(2)(i)(C) provides that, for one or more controlled transactions that are governed by one or more provisions of the Code and regulations, a coordinated best method analysis and evaluation of the transactions may be necessary to ensure that the *overall value provided* (including any synergies) is properly taken into account.

12. Allocation of Portions of an Adjustment.

- (a) Temp. Treas. Reg. § 1.482-1T(f)(2)(i)(D) provides that *in some cases it may be necessary* to allocate portions of the arm’s length result that was properly determined under a coordinated best method analysis among the interrelated transactions. An allocation must be made using the method that, under the facts and circumstances, provides the most reliable measure of an arm’s length result for each allocated amount.
- (b) It is odd that this rule applies only “in some cases.” This regulation creates uncertainty in its application.

13. Recent Tax Court Decisions Regarding Aggregation.

- (a) The Tax Court recently addressed IRS aggregation arguments in *Medtronic v. Commissioner*, T.C. Memo. 2016-112 (2016), remanded on another issue, ___ F.3d ___ (8th Cir. 2018), *Guidant v. Commissioner*, 146 T.C. No. 5 (2016), *Amazon.com, Inc. v. Commissioner*, 148 T.C. No. 8 (2017), *aff’d*, ___ F.2d ___ (9th Cir. 2019), and *Veritas Software Corp. v. Commissioner*, 133 T.C. No. 297 (2009). These cases all involved § 482

aggregation regulations as they existed before the new statutory language and the temporary regulations.

- (b) Under the IRS's view, aggregation was required in all of these cases. The Tax Court held that transactions may be aggregated if an aggregated approach produced the "most reliable means of determining the arm's length consideration for the controlled transactions." If the transactions were accounted for and priced separately in the marketplace then aggregation is not the most reliable means of valuation.
- (c) Whether the IRS abused its discretion by aggregating transactions is a question of fact. In *Medtronic*, *Guidant*, *Veritas* and *Amazon*, aggregating the transactions did not result in a reasonable determination of true taxable income.
- (d) The Tax Court has repeatedly rejected the IRS's attempt to aggregate transactions based on the fact that aggregation does not produce a reliable result. If there is a reliable CUT transaction then aggregation is not appropriate if aggregation is not done in the marketplace.
- (e) The new third sentence in § 482 and the temporary § 482 regulations retain the "most reliable means" standard and the arm's length standard should be read consistently with the Tax Court's aggregation holding in *Veritas*, *Amazon* and *Medtronic*.
- (f) Medtronic successfully argued in Tax Court that the transactions should not be aggregated and that aggregation would treat the foreign manufacturing subsidiary more like a contract manufacturer, failing to take into account its full role. The court held that the functions at issue can exist independently and that the regulations did not require that the transactions be aggregated. The Tax Court held that transactions may be aggregated under the regulations only if an aggregated approach produces the "most reliable means of determining the arm's length consideration for the controlled transactions." The court held the covered transactions are accounted for and priced separately in the marketplace and should not be aggregated. The Tax Court's holding in *Medtronic* is consistent with the new third sentence in § 482 and the temporary § 482 regulations requiring aggregation when it is the most reliable means of valuation.
- (g) In *Veritas*, the IRS argued an aggregation "akin to sale" theory for valuing cost shared intangibles. The Service argued the transfer of existing intangibles was akin to a sale of the business to the Irish subsidiary. The Service asserted that because the assets

collectively possessed synergies that imbue the whole with greater value than each asset standing alone, it is appropriate to apply the “akin to a sale” theory and aggregate the controlled transactions, rather than value each asset. The Tax Court rejected the Service’s aggregation and the “akin to sale” income method stating it was not the best or most reliable method for valuing the intangibles. The Tax Court’s holding in *Veritas* is consistent with the new third sentence in § 482 and the temporary § 482 regulations.

- (h) In *Amazon.com*, the Tax Court rejected the IRS’s attempt to relitigate the same cost-sharing transfer pricing issues the IRS lost on in *Veritas*. The IRS claimed that the transferred property had to be valued as integrated components of an operating business, in effect, treating the transfer of preexisting intangibles as economically equivalent to the sale of an entire business. The Tax Court held that aggregation did not yield a reasonable means — much less the most reliable means — of determining an arm’s-length buy-in payment because it improperly aggregates preexisting intangibles and subsequently developed intangibles. The Tax Court’s holding in *Amazon* is consistent with reliability standard in the new third sentence in § 482 and the temporary § 482 regulations.

B. Section 936(h)(3)(B).

1. The Tax Act added goodwill, going concern value and workforce-in-place, and any other item of value or potential value which is not attributable to tangible property or the services of any individual to the definition of intangibles in § 936(h)(3)(B). Specifically, Congress added:
 - “(vi) any goodwill, going concern value, or workforce in place (including its composition and terms and conditions (contractual or otherwise) of its employment); or
 - “(vii) any other item the value or potential value of which is not attributable to tangible property or the services of any individual.”
2. The language in (vii) replaced the previous flush language which stated “which has substantial value independent of the services of any individual.” Also, old (vi), which was deleted, said simply “any similar item.”
3. Section 936(h) was enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 213(a)(2), and was intended to curb the perceived abuse that taxpayers would transfer intangible property that had been developed in the U.S. to a possession corporation in order to claim a credit under § 936. Other sections of the Code that refer to the definition of intangible property in § 936(h)(3)(B)

have similar intended purposes. In this regard, it is notable that the definition of intangible property under § 936(h)(3)(B) largely was taken from the old § 482 regulations relating to the transfer or use of intangible property; thus, the intent seemed to be to cover items that could be licensed or sold in the marketplace to unrelated purchasers.

4. The change in the definition of intangible in § 936 would seem not to impact the cost sharing regulations in § 1.482-7 which has its own definition of intangible property and platform contributions. Under the cost sharing regulations, a cost shared intangible is any intangible, within the meaning of § 1.482-4(b). Treas. Reg. § 1.482-7(j). Under § 1.482-4(b) an intangible is an asset that is one of the listed assets (patent, copyrights, trademarks, etc.) and other similar items if they have value independent of the services of an individual. A platform contribution, however, is stated to include “any resource, capability, or right ... that is reasonably anticipated to contribute to developing cost shared intangibles.”
5. The Tax Act change does not change what cost-sharing anticipated benefits are (defined in the regulations as increased income and decreased expenses) and does not change what costs are R&D costs that must be shared.
6. The inclusion of these items in the statutory definition could affect the way the IRS argues cost-sharing buy-in cases in the future, however. *See Amazon, infra*, at E.5. (d) and (e). This assumes, of course, that corporations’ commence buy-ins after the statutory change’s effective date. However, these items are still items that, as the Tax Court stated, “cannot be bought and sold independently” and they still are “an inseparable component of an enterprise’s residual business value.” They also “do not derive their value from their intellectual content or other intangible properties.” The IRS nonetheless asserts in its appeal that the statutory changes somehow help its case (*i.e.*, a “bootstrap” argument).
7. While § 367(d) references § 936(h)(3)(B), the § 367 regulations that were finalized last year already added goodwill and going concern. The revised § 367 regulations required taxpayers to elect § 367(d) for foreign goodwill and going concern to avoid being taxed on the fair market value of the assets in the year of the transfer. Section 367 itself, of course, was materially changed, as discussed in Section I (above) at p. 4. As a result, the treatment under § 367(d) is no longer elective or optional.

C. Altera.

1. The Ninth Circuit issued a new opinion in *Altera v. Commissioner*, No. ____ F.2d ____ (9th Cir. 2019), holding that Treasury and the IRS complied with the Administrative Procedure Act (“APA”) and that the

cost sharing regulations requiring parties to share stock-based compensation are valid. The 2-1 decision opinion reaches the same conclusion as the withdrawn July 2018 majority opinion, but is more narrowly drafted to the APA issue and stock-based compensation. Judge Kathleen M. O'Malley wrote a very strong dissent addressing and rejecting all of the arguments raised in the majority opinion. O'Malley's dissent in the new opinion is even stronger than her dissent in the withdrawn opinion.

2. Majority Opinion.

- (a) The Ninth Circuit Court states that the issue is “relatively straightforward.” The court states that under the governing § 482 tax statute, the “arm’s length” standard applies. Altera argued that a comparability analysis using comparable transactions between unrelated business entities is the method that is required to meet the arm’s length standard. The government disagreed that the arm’s length standard requires the specific comparability method in all cases and asserted that an arm’s length result can be achieved by applying a purely internal method of allocations, distributing the costs of employee stock options in proportion to the income enjoyed by each related taxpayer.
- (b) The holding marks a change in the Tax Law regarding the importance of comparables to establish arm’s length dealings.
- (c) The Court said that its task is not to assess the better tax policy, nor the wisdom of either approach, but rather to examine whether Treasury’s regulations are permitted under the statute. The Ninth Circuit opinion focused on the APA. It concluded that the regulations withstood scrutiny and reversed the Tax Court judgement. The Court’s holding and conclusion have seriously taken away interested parties protections under the APA.
- (d) In reaching its decision the Ninth Circuit relied on *Frank v. Int’l Canadian Corp.*, 308 F.2d 520, 528-29 (9th Cir. 1962), applying a “fair and reasonable,” standard in transfer pricing under § 482. The Court admitted that *Frank* had later been limited to situations in which “it would have been difficult for the Court to hypothesize an arm’s-length transaction.” *Oil Base, Inc. v. Comm’r*, 362 F.2d 212, 214 n.5 (9th Cir. 1966). However, the Ninth Circuit stated that “*Frank’s* central point remained: the arm’s length standard based on comparable transactions was not the *sole* basis of reallocating costs and income under the statute.” These were both Ninth Circuit cases, of course.

- (e) The court also cited the White Paper, “A Study of Intercompany Pricing Under Section 482 of the Code,” I.R.S. Notice 88-123, 1988-2 C.B. 458, and stated that the White Paper signaled a shift in the interpretation of the arm’s length standard and advanced a new allocation method, the “basic arm’s length return method” That would “apply only in the absence of comparable transactions.”
- (f) In addition, the Ninth Circuit stated that the 1994 and 1995 § 482 regulations defined the arm’s length standard as result-oriented, “meaning that the goal is parity in *taxable income* rather than parity in the method of allocation itself...[h]owever, the arm’s length standard remained ‘the standard to be applied in every case.’”
- (g) The Court noted that the Tax Court’s decision in *Altera v. Commissioner*, 125 T.C. No. 4 (2005), “rested largely on its own opinion in *Xilinx*, in which it determined that the arm’s length standard mandates a comparability analysis.”
- (h) The Ninth Circuit evaluated the validity of the cost sharing regulations under the APA based on both *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984) and *Motor Vehicle Manufacturers Ass’n of the United States, Inc. v. State Farm Mutual Automobile Insurance Co.*, 462 U.S. 29 (1983).
- (i) The Court stated there is no question that the § 482 statute remains ambiguous regarding the method by which Treasury is to make allocations based on stock-based compensation satisfying step one under *Chevron*.
- (j) Under step one of *Chevron*, *Altera* argued that the statute, by its terms, cannot apply to stock-based compensation. “According to *Altera*, stock-based compensation is not ‘transferred’ between parties because only preexisting intangibles can be transferred” and that Treasury exceeded the delegation of authority apparent from the plain text of the statute.
- (k) The Court was not persuaded and stated that when parties enter into cost sharing they are *transferring* future distribution rights to intangibles.
- (l) After concluding that the statute is ambiguous the Ninth Circuit stated that under *Chevron* step two, deference is given to the agency so long as the agency’s interpretation is based on a permissible construction of the statute. The Court considered whether Treasury’s interpretation of § 482 as to the allocation of employee stock option costs is permissible.

- (m) It relied on the statutory addition of the commensurate with income standard sentence to support the interpretation that employee stock option costs is permissible under the statute.
- (n) The Court stated that Treasury reasonably understood § 482 as an authorization to require internal allocation methods, provided that the costs and income allocated are proportionate to the economic activity of the related parties and that these internal allocation methods are reasonable methods for reaching the arm's length results.
- (o) According to the Court, Altera's narrow reading of the commensurate with income clause would render it "meaningless except in two circumstances: (1) to allow the Commissioner periodically to adjust prices initially assigned following a comparability analysis; and (2) to reflect a party's contribution of existing intangible property or "buy-in" to a cost-sharing arrangement."
- (p) It also stated there is no evidence that treaty obligations require the use of comparable transactions, and that Treasury's conclusion that it could require parties to share all costs was a reasonable. The refusal to consider "irrelevant" comments was reasonable, since the comments had no bearing on "relevant factors" to the rulemaking, nor any bearing on the final rule. The Court stated that data that stock-based compensation was not a cost, provided little guidance because it did not concern parties to a cost sharing agreement developing high-profit intangibles.
- (q) Its conclusion is that it was clear that, "in implementing the commensurate with income amendment, Treasury was moving away from a purely method-based, comparable-transaction view of the arm's length standard in attempting to achieve tax parity."
- (r) The Court found that the arm's length standard allows the IRS to allocate costs between related parties without a comparability analysis and therefore there was no policy change, merely a clarification of the same policy and that the policy change was occasioned by the congressional addition of the "commensurate with income" sentence.

3. Dissent.

- (a) The dissent stated that Treasury has "consistently asserted that a comparability analysis is the only way to determine the arm's length standard; indeed, Treasury made clear that a comparability analysis is the cornerstone of the arm's length standard. Despite

these consistent practices and declarations, in its preamble to § 1.482-7A(d)(2), Treasury stated, for the first time and with no explanation, that it may, *instead*, employ the ‘commensurate with income’ standard to reach the required arm’s length result.”

- (b) Treasury’s resort to the commensurate with income standard to jettison the arm’s length standard altogether is “a justification Treasury never provided and one which does not withstand careful scrutiny.” Thus, the majority, “suppl[ies] a reasoned basis for the agency’s action that the agency itself has not given,” *Motor Vehicle Mfrs. Ass’n of U.S., Inc. v. State Farm Mut. Auto, Ins. Co.*, 463 U.S. 29, 43 (1983) (citing *SEC v. Chenery Corp.* (“*Chenery IP*”), 332 U.S. 194, 196 (1947)).
- (c) The dissent agreed with the Tax Court “that Treasury’s explanation of its rule (to the extent any was provided) failed to satisfy the *State Farm* standard, that Treasury did not provide adequate notice of its intent to change its longstanding practice of employing the arm’s length standard and using a comparability analysis to get there, and that its new rule is invalid as arbitrary and capricious.”
- (d) The dissent stated that “The majority attempts to water down the text of Treasury’s own regulations at the time ... and uses *Frank* to support its position.” However, “the parties in *Frank* had stipulated to applying a standard other than the arm’s length standard.”
- (e) “There really can be no doubt that, prior to the 1986 amendment, this Circuit believed that an arm’s length standard based on comparable transactions was the sole basis for allocating costs and income under the statute in all but the narrow circumstances outlined in *Frank* – including the presence of the stipulation therein. The majority’s attempt to breathe life back into *Frank* is, simply, unpersuasive.”
- (f) The dissent further stated “[t]he plain text of the statute limits the application of the commensurate with income standard to only *transfers* or *licenses* of intangible property.” The commensurate with income standard “did not grant Treasury the flexibility to depart from a comparability analysis whenever it sees fit; rather, it permitted a departure in the limited context of any transfer (or license) of intangible property because it had found that comparable transactions in such cases are frequently unrealistic.”
- (g) The White Paper stated that, even in the context of transfers or licenses of intangible property, the “intangible income must be allocated on the basis of comparable transactions if comparables

exist.” Only “in situations in which comparables do not exist” would the commensurate with income standard apply.

- (h) In the Tax Court, the IRS argued that they could apply the commensurate with income test because it could find no comparable transaction and that stock-based compensation “was actually *consistent* with the arm’s length standard.” However, on Appeal the government argued that what they were “*actually* saying is that § 482 no longer requires a comparability analysis when Treasury concludes that any comparable transactions are imperfect and that the methodology for arriving at an arm’s length result is, and always has been fluid.”
- (i) The dissent stated that “(1) Treasury’s rule is procedurally invalid and the majority’s attempt to recreate the record surrounding its adoption cannot cure that flaw; (2) Treasury’s purported interpretation of § 482 is wrong; and (3) related companies may not be required to share the cost of stock-based compensation under current law because comparable uncontrolled taxpayers would not do so.”
- (j) The Tax Court found that Treasury “failed to provide a reasoned basis” for its “belief that unrelated parties entering into QCSAs would generally share stock-based compensation costs.” “On appeal, the Commissioner does not meaningfully dispute the Tax Court’s determination that Treasury’s analysis under the arm’s length standard was inadequate and unsupported. In its opening brief, it contends, instead, ‘that, in the context of a QCSA, the arm’s-length standard does *not* require an analysis of what unrelated entities do under comparable circumstances’...In its supplemental brief, the Commissioner reiterates that—despite its own earlier machinations to the contrary—one should not conflate comparability analysis with the arm’s length standard.”
- (k) The dissent said, “The majority accepts the latest of the Commissioner’s ever-evolving post-hoc rationalizations and then, amazingly, goes even further to justify what Treasury did here.”
- (l) The dissent stated “Treasury may well have thought that QCSAs involving the development of high-profit intangibles constitute transfers of intellectual property under the second sentence of § 482. It may also have believed that, given the fundamental characteristics of stock-based compensation in QCSAs and what the majority here calls the ‘fluid’ definition of the arm’s length standard, it could dispense with a comparability analysis entirely, regardless of whether QCSAs constitute transfers. *Cf. Xilinx II*, 598 F.3d at 1197 (Fisher, J., concurring) (hypothesizing why

unrelated companies may not share stock-based compensation costs). It may—despite never taking this position before rehearing in this appeal—have even believed that the arm’s length standard was not required at all in these circumstances by virtue of the second sentence of § 482. But the APA required Treasury to *say* that it was taking these positions, which depart starkly from Treasury’s previous regulations. *See FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 515 (2009) (‘[T]he requirement that an agency provide reasoned explanation for its action would ordinarily demand that it display awareness that it *is* changing position.’)”

- (m) Judge O’Malley stated that Treasury’s notice of proposed rulemaking ran afoul of these safeguards by failing to put the public on notice of its intention to depart from a traditional arm’s length analysis. She stated that “Even if Treasury did not err procedurally, it would still find that the regulations are impermissible under *Chevron*.”
- (n) Congress added the commensurate with income sentence to address specific cases. “Congress did not leave a gap in the statute allowing Treasury to choose when one methodology displaces the other.”
- (o) The dissent said, “Here, Treasury’s only justification for eschewing the comparability analysis was its insistence that the legislative history allows it to disregard comparable transactions that it deems imperfect. This rationale is inconsistent with the plain text of that statute and thus, is impermissible under *Chevron*.”
- (p) Even if Treasury could dispense with a comparability analysis whenever it believed no comparables exists, that interpretation would still fail step two of *Chevron* because uncontrolled comparable transactions do not exist here. The majority acknowledges Treasury’s view that a different methodology may only be applied “*when comparable transactions do not exist*.” The arm’s length standard of § 482 does not require perfectly identical transactions—only comparable ones. Related parties, by virtue of common ownership, are always positioned differently from unrelated parties.
- (q) The dissent said, “Even if Treasury were correct that no comparable transactions exist, Treasury’s reasoning would still fail. The absence of evidence is not evidence of absence.”

D. Medtronic.

1. The Eighth Circuit vacated the Tax Court’s decision in *Medtronic v. Commissioner*, ___ F.3d ___ (8th Cir. 2018), and remanded the case back to the Tax Court for a comparability assessment.
2. Medtronic used the comparable uncontrolled transactions (“CUT”) transfer pricing method to determine the royalty rates paid on its intercompany licenses. To resolve a 2002 audit, Medtronic and the IRS entered into a Memorandum of Understanding (“MOU”) on the royalty rates and agreed to apply the royalty rates in future years “as long as there [were] no significant changes in any underlying facts.”
3. In 2005 and 2006, the IRS asserted that the comparable profits method – not the CUT method – was the best way to determine an arm’s length price for Medtronic’s intercompany licensing agreements for those two years resulting in tax deficiencies.
4. Medtronic filed in Tax Court, arguing that the CUT method, not the comparable profits method, was the best method for determining an arm’s length price for the intercompany licenses. The Tax Court found that the comparable profits method downplayed Medtronic Puerto Rico’s role in ensuring the quality that it did not reasonably attribute a royalty rate to Medtronic’s profits, that it used an incorrect return on assets approach, that it improperly aggregated the transactions, and that it ignored the value of licensed intangibles. Similarly, the Tax Court concluded that Medtronic’s CUT method did not produce an accurate arm’s length adjustment because it did not distinguish between devices and leads and therefore produced a result that was unconvincing and overly broad.
5. The Tax Court then engaged in its own valuation analysis. It ultimately decided that Medtronic’s CUT method was the best way to determine an arm’s length royalty rate for intercompany agreements, but made a number of adjustments.
6. The Eighth Circuit reviewed the Tax Court’s de novo for legal conclusions and mixed questions of law and fact and reviewed factual findings under the clear error standard.
7. The Tax Court applied the Pacesetter agreement as the best CUT to calculate the arm’s length result for intangible property. The Pacesetter agreement was entered into by Pacesetter’s parent company and Medtronic US in 1992 in an effort to settle several lawsuits regarding patent and license use. As part of the agreement, the parties cross-licensed their pacemaker and patent portfolios.
8. The Tax Court determined that the Pacesetter agreement was an appropriate CUT because it involved similar intangible property and had

similar circumstances regarding licensing. The Eighth Circuit concluded that the Tax Court's factual findings are insufficient to enable the Eighth Circuit to conduct an evaluation of that determination.

9. The Eighth Circuit stated that the Tax Court did not address in sufficient detail whether the circumstances of the settlement were comparable to the licensing agreement.
10. Additionally, the Eighth Circuit stated that the Tax Court did not analyze the degree of comparability of the contractual terms.
11. The Eighth Circuit stated that the Tax Court also did not evaluate how the different treatment of intangibles affected the comparability. The Pacesetter agreement was limited to patents and excluded all other intangibles, including "any technical know-how or design information, manufacturing, marketing, and/or processing information or know-how, designs, drawings, specifications, software source code or other documents directly or indirectly pertinent to the use of the Licensed patents." The Medtronic Puerto Rico licensing agreement on the other hand, did not exclude such intangibles.
12. The Tax Court made a 7% adjustment of the "know how" that Medtronic Puerto Rico received from Medtronic, as well as a 2.5% adjustment to account for the differences in licensed products, however, the Eighth Circuit stated it could not determine that appropriateness of using the Pacesetter agreement as a CUT without additional findings regarding the comparability of the remaining intangibles.
13. Finally, the Eighth Circuit stated that the Tax Court did not decide the amount of risk and product liability expense that should be allocated between Medtronic US and Medtronic Puerto Rico.

E. Amazon Appeal.

1. Ninth Circuit Affirms Tax Court Decision in Favor of Amazon.
 - (a) The Ninth Circuit Court of Appeals issued a unanimous decision on August 16, 2019 affirming the Tax Court decision in favor of Amazon.
 - (b) The Ninth Circuit concluded that the definition of intangible assets in the transfer pricing cost sharing regulations does not include residual-business assets. The drafting history of the regulations shows that "intangible" was understood to be limited to independently transferrable assets. The Ninth Circuit stated that regulatory definition of intangible is not broad enough to include all intangible assets of value, even the more nebulous ones that the Commissioner referred to as "residual-business assets" (*i.e.*

Amazon’s culture of innovation, the value of workforce in place, going concern value, goodwill, and growth options).

- (c) The issue involved the 1994/1995 cost sharing regulations and whether the “buy-in” required for “pre-existing intangible property” must include compensation for residual-business assets. The Court considered the regulatory definition of an “intangible,” the overall transfer pricing regulatory framework, the rulemaking history of the regulations, and whether the Commissioner’s position is entitled to deference under *Auer v. Robbins*, 519 U.S. 452 (1997).
- (d) The regulation defines an “intangible” as an asset that both “has substantial value independent of the services of any individual” and is an item listed in subsection (b)(1)-(6). Treas. Reg. § 1.482-4(b). Each of the 28 specific items listed is independently transferrable—none is a residual-business asset. The Commissioner relied on the catchall provision for “[o]ther similar items.” “[A]n item is considered similar” to the other items in the subsection “if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.”
- (e) Reading the catchall provision together with the introductory language of the definition, residual-business assets are intangibles if they (1) have substantial value independent of the services of any individual and (2) derive their value from intellectual content or other intangible properties.
- (f) Amazon argued that the Commissioner’s interpretation of the catchall provision was too sweeping for several reasons. The central argument was that to qualify as an “intangible” under the regulation, an item must be capable of being bought and sold independently of the business—and residual-business assets are inseparable from the business. The Tax Court agreed. The Ninth Circuit stated that the Commissioner clearly disagrees with *Veritas* on this point, but did not explain why the Tax Court’s analysis is wrong.
- (g) The Ninth Circuit stated that the problem is that residual-business assets, such as “growth options” and a “culture of innovation,” are amorphous, and it’s not self-evident whether such assets have “substantial value independent of the services of any individual.” It said that Amazon raised legitimate concerns about the regulation’s catchall being stretched too far, and those concerns likely bear on which party has the more reasonable view of the regulatory definition.

- (h) The Commissioner also argued that the definition of an “intangible” includes residual-business assets because an uncontrolled party would pay for access to those assets in an arm’s length transaction. The Ninth Circuit said that the government’s argument missed the mark. Under the regulations, the arm’s length standard governs the *valuation* of intangibles; it doesn’t answer whether an item *is* an intangible. The definition of an “intangible” is provided in § 1.482-4(b). The government pointed to no language in the statute or regulations suggesting that the definition of what constitutes an intangible is determined by asking whether an uncontrolled party would pay for it.
- (i) The Ninth Circuit held that the government’s argument that residual-business assets should be paid for “if they are made ‘available’ to the cost-sharing participants” even though such assets generally cannot be transferred independently from the business based on § 1.482-7A(g)(1) *presupposes* the very point he attempts to prove—that residual-business assets are “intangible property” within the meaning of the regulations. The “makes...available” language provides no meaningful insight into the regulatory definition of an “intangible.”
- (j) The Court stated that the drafting history of the transfer pricing regulations did not support the government’s argument that the definition of an “intangible” covered residual-business assets. The only references in the drafting history to any residual-business assets suggest that such items were excluded from the definition of intangible assets.
- (k) The IRS’s 1988 White Paper proposed including “going concern value” of a research facility in the buy-in, but Treasury and the IRS’s 1994/1995 regulations kept essentially the same definition as before without referring to “going concern value” or any other residual-business asset.
- (l) The Court said that two key statements by Treasury in the drafting history rendered the position untenable. First, in 1993, Treasury confirmed that the then-existing definition of “intangible” did *not* include residual-business assets when it asked for comments on whether the definition of intangibles “should be *expanded* to include items not normally considered to be items of intellectual property, such as work force in place, goodwill or going concern value.” Second, a year later after opting against such an expansion, and instead retaining the same essential definition from before (including the same list of 28 items), Treasury and the IRS explained that the final (1994) rule merely “clarified” when an

item would be deemed similar to the 28 items listed in the definition.

- (m) The Ninth Circuit stated that the government’s argument stretched “clarification” beyond its commonly understood meaning of merely clearing up what was previously ambiguous or otherwise restating a standard consistent with what was previously intended.
- (n) Amazon and *amici curiae* argued that if the Commissioner were correct that the non-specific “clarify[cation]” of § 1.482-4(b)’s catchall substantively expanded the definition of an “intangible,” then Treasury/IRS violated the Administrative Procedures Act. The Ninth Circuit did not address this argument because it rejected the Commissioner’s post hoc interpretation of the changes to the regulatory definition.
- (o) Amazon pointed to other Treasury regulations that define certain covered property by incorporating the definition of intangible property under § 936(h)(3)(B) and then adding goodwill and going concern value. The Ninth Circuit stated that these regulations also show that Treasury “clearly knew how to write its regulations” to include goodwill and other residual-business assets.
- (p) The Court stated that it shared the sentiment reflected in the concurring opinion in *Xilinx*:
- (q) The court said it was troubled by the complex, theoretical nature of many of the Commissioner’s arguments trying to reconcile the two regulations. Not only does this make it difficult for the court to navigate the regulatory framework, it shows that taxpayers have not been given clear, fair notice of how the regulations will affect them.
- (r) The Ninth Circuit stated that it appears that the government’s court briefs presented Treasury’s “first announce[ment of] its view,” that the definition of intangible in § 1.482-4(b) embraced residual-business assets. No statement from Treasury in the drafting history of the 1994/1995 regulations expressed the position the government advanced in the case. Treasury’s contemporaneous explanations of the regulations were to the contrary to the regulatory framework and history. Treasury appeared to have changed its position on the meaning of the regulation after Amazon entered into their cost sharing arrangement. Amazon and other taxpayers were thus not given fair warning of Treasury and the IRS’s current interpretation of the regulatory definition of an “intangible.” Thus, the Court held that interpretation was not entitled to deference.

F. Coca Cola.

1. In *Coca-Cola Co. et al v. Commissioner*, T.C. Dkt. 31,183-15, the Tax Court denied the IRS's Motion for Partial Summary Judgment on September 7, 2017. The case is calendared for trial beginning on March 5, 2018. The IRS made transfer-pricing adjustments under § 482 that produced aggregate deficiencies in excess of \$3.3 billion for Coca-Cola's 2007-2009 taxable years. In the Summary Judgment Motion the IRS unsuccessfully asked the Court to hold as a matter of law that a 1996 closing agreement had no conceivable relevance to any issue before the court.
2. In the closing agreement, the parties agreed to a methodology (the "10-50-50 method") for calculating profits to foreign affiliates. Under this method the foreign affiliates would retain 10% of gross revenues as a routine return, and the residual operating income (after certain adjustments) would be split 50%-50%. The closing agreement covered Coca-Cola's tax years up to and including 1995.
3. The closing agreement also provided penalty protection both during the term of the agreement and for tax years after 1995. The closing agreement provided that, if Coca-Cola continued to calculate royalties in accordance with the 10-50-50 method or another method to which the parties subsequently agreed, then Coca-Cola would be deemed to have met the "reasonable cause and good faith" exception to the penalties in §§ 6662(e)(3)(D) and 6664(c).
4. Coca-Cola continued to use the 10-50-50 method to compute product royalties through 2009. For 1996-2006, the IRS accepted Coca-Cola's application of the 10-50-50 method and (with one exception) made no § 482 adjustments to the product royalties. However, during the 2007-2009 examination, the IRS determined that the transfer prices using the 10-50-50 method were not arm's-length.
5. The Tax Court held that the execution of the closing agreement was a historical fact and provides the obvious starting point for any narrative of the events leading up to the 2007-2009 audit. The Tax Court stated that 10-50-50 method prescribed by the closing agreement is the method that Coca-Cola used when computing its taxable income for the years at issue and this alone gives the closing agreement relevance.
6. The closing agreement also had relevance in addressing an issue involving the creditability of a Mexican tax on the profits of a Mexican branch. The branch's income was based on the methodology set forth in the closing agreement.

7. The Tax Court stated that the IRS's summary judgment motion to exclude the closing agreement was "odd." The IRS did not file a motion in limine seeking to exclude the closing agreement from evidence on relevance grounds. Rather, the IRS filed a Motion for Partial Summary Judgment seeking a ruling that a historical fact, as a matter of law, can have no conceivable relevance to any issue before the Court.
8. The Tax Court doubted that this was a proper subject for summary judgment because the IRS did not seek summary adjudication in its favor on one or more of the "legal issues in controversy." The Tax Court stated that it would be imprudent for a court to grant a summary judgment motion of this sort six months before hearing any evidence at trial. While the Tax Court questioned whether the IRS's Motion for Summary Judgment was proper it still denied the motion on its merits.
9. The issue and the IRS's position bears a striking conceptual similarity to three prior cases in which the court seemingly followed a prior transfer pricing agreement between the taxpayer and the IRS that the IRS decided it no longer liked. In *Eaton v. Commissioner*, T.C. Memo. 2017-147 (2017), the Tax Court criticized the IRS for cancelling APAs retroactively stating that the IRS's desire to change the underlying agreed upon transfer pricing method was an abuse of discretion. In *Medtronic Inc. v. Commissioner*, T.C. Memo. 2016-112 (2016, on appeal) and *Eli Lilly v. Commissioner*, 856 F.3rd 855 (7th Cir. 1988), there also were prior transfer pricing-agreements between the taxpayer and the IRS that the IRS subsequently decided it no longer liked and instead asserted large tax deficiencies.
10. In all three cases the IRS lost when it deviated from its prior agreement with the taxpayer. In all three cases the Courts' transfer-pricing conclusions were basically those to which the parties had previously agreed, with slight modifications. While the case in *Coca-Cola* has not reached its ultimate conclusion, the Court does seem interested in the parties' prior agreement.
11. The IRS undoubtedly is concerned that the Tax Court will take an approach similar to that which it took in the prior cases involving taxpayer-IRS agreements, and thus it tried unsuccessfully to have the Court exclude the prior agreement as a matter of law.
12. Situations where something that once seemed like a good deal no longer looks so good to one of the parties to an agreement are sometimes described as involving "seller's remorse" or "buyer's remorse." However, for this to happen repeatedly¹² and with such drastic changes in the IRS's

¹² We have experienced this same situation in cases subsequently resolved in Appeals.

position (multi-million and billion dollar adjustments) suggests a much greater problem than simply “seller’s/buyer’s remorse.”

G. Peking Investment: § 482 “Control.”

1. *Peking Investment Fund LLC v. Commissioner*, T.C. Dkt. No. 12772-09 (Order 2018), involved the Service’s disallowance of a partnership’s loss stemming from the exchange of an interest in one portfolio of nonperforming loans for another. We will address only the Service’s assertion that § 482 applied. This issue previously was addressed in *Austin Investment Fund LLC v. United States*, ____ F. Supp. ____ (D.D.C. 2015).
2. In *Austin*, a district court granted the government’s motion for summary judgement disallowing a similar loss on the basis of § 482. The court held in *Austin* that a transaction that took place in China between two entities there was subject to § 482 because § 482 by its terms applies to entities “whether or not organized in the United States.” It applied to transactions between the Bank of China and another company, China Orient, even though neither party was organized in the United States and neither was before the court.
3. In *Peking Investment Fund*, disposing of the motion for summary judgment did not require a resolution of the legal issue as to whether § 482’s reach extends to transactions between “non-taxpayers,” because the IRS had not established that the entities in China were under common ownership or control when the relevant portfolio exchange took place. The IRS argued that the taxpayer did not dispute that the two entities in China were both owned by the Chinese government. To the contrary, the taxpayer claimed that an affidavit that it submitted that the two entities were not co-owned by the Chinese government as a matter of fact.
4. While the court did not read that affidavit as establishing the point for which the taxpayer invoked it, the court nonetheless took the taxpayer’s claim as an indication that it did not concede that the entities were under common ownership within the meaning of § 482 at the time of the transaction between them. Common ownership, for this purpose, can be either direct or indirect, but the ownership, in either case, should be clear.
5. The court was unconvinced that the “amorphous” common ownership was sufficient to authorize the IRS to make adjustments under § 482. The court cited a previous case (*Southgate Master Fund LLC v. United States*, 651 F. Supp 596 (N.D. Tex 2009), *aff’d* on other grounds, 659 F.3d 466 (5th Cir. 2011)) recognizing the entities’ ownership by the Chinese government but reasoning that the “bright line between state ownership and enterprise management” allowed each entity to treat its property and assets as its own. Thus, the Tax Court denied the IRS’s motion for partial

summary judgment that § 482 allowed the Service to disallow the loss in question.

H. Broadwood Investment: § 482 “Control.”

1. In *Broadwood Investment Fund LLC v. United States*; No. 8:08-cv-00295, the court denied the government partial summary judgment on § 482 adjustments that limited partnerships’ inside basis in portfolios of Chinese nonperforming loans. This is the issue that also was addressed in *Peking Investment Fund LLC v. Commissioner*, T.C. Dkt. No. 12772-09 (Order 2018) and *Austin Investment Fund LLC v. United States*, ____ F. Supp. ____ (D.D.C. 2015).
2. At least four courts have now addressed the question of whether the Chinese government had common ownership or control over China’s Banks under § 482. In *Southgate Master Fund LLC v. United States*, 651 F. Supp. 2d 596, 647 (N.D. Tex. 2009), *aff’d on other grounds*, 659 F.3d 466 (5th Cir. 2011), the district court held that they were not “commonly controlled entities” for the purposes of § 482.
3. In the second case, *Austin*, the district court reached a contrary result, granting summary judgment in favor of the government holding they were under common ownership of the Chinese government for purposes of § 482.
4. In *Peking*, the courts disposed of the motion for summary judgment. The Tax Court was unconvinced that the “amorphous” common ownership was sufficient to authorize the IRS to make adjustments under § 482.
5. In this new *Broadwood* case the district court held that given the factually intensive and far-reaching questions involved in the common control inquiry at hand, it would be premature to resolve this issue at summary judgment.

I. Transfer Pricing Guidance.

1. The IRS Large Business & International Division issued new guidance on the Transfer Pricing Examination Process (“TPEP”) providing best practices and insights about what can be expected during an examination. With the issuance of the TPEP, the Transfer Pricing Roadmap is retired.
2. The guide will be provided at the start of a transfer pricing examination and serve as a framework and guide. The IRS stated that the TPEP is not a checklist or a one-size fit all tool. It is only a guide – not a set of required steps.
3. The TPEP states that transfer pricing examinations are factually intensive and require a thorough analysis of functions, assets, and risks along with

an accurate understating of relevant financial information. To ensure resources are applied effectively, LB&I is using data analytics to identify issues for examination that have the most significant risk for non-compliance. In addition, it recommends that teams continually assess the merits of issues during an examination and continually assess opportunities for issue resolution with taxpayers during the examination process.

4. Hopefully, the TPEP will encourage exam teams to better assess the merits of transfer pricing cases, including considering recent court case decisions, and work better than the Transfer Pricing Roadmap, but that may be over optimistic since the TPEP is only a guide and not a set of required procedures.
5. The TPEP stresses the importance of collaboration and coordination in the planning phase and also the use of practice units as reference tools.
6. In the initial transfer pricing risk assessment phase, the TPEP states that the exam team needs to review prior year workpapers and income tax returns. Exam is also instructed to analyze the country-by-country report as a tool to provide useful information to analyze high level transfer pricing risk, Base Erosion and Profit Splitting (“BEPS”) related risk, and when appropriate, conduct further economic and statistical analysis. Before analyzing the CbC report, the exam team members are required to complete CbC training.
7. In the planning phase, exam is instructed to compute key financial ratio analysis for multiple years, make industry comparisons, and consider whether there is potential cross border income shifting. The TPEP states that this may be useful as a diagnostic tool; however, is not a definitive indication of the arm’s length nature of controlled transactions.
8. In order to understand the history, background, overall core business operations, and profit drivers, the TPEP recommends reviewing the company website, Securities and Exchange Commission (“SEC”) filings, and search the company’s name on the internet. It is important for companies to be aware of what is stated in filings and on the internet.
9. In terms of developing a working hypothesis, the TPEP cautions that unadjusted industry average returns should only be used to assess transfer pricing risk and on their own should not be used to make a transfer pricing adjustment.
10. For planning meetings, the TPEP recommends general agenda items including timeframes, key milestones, and topics specific to the transfer pricing examination. The TPEP states that exam teams should conduct weekly or bi-weekly discussions with the taxpayer to support

communication and ensure common expectations regarding the audit, progress, IDRs, and timelines.

11. The execution phase includes determining the facts, applying the law to those facts, and understanding the various tax implications of the issue. In the execution phase the exam team should conduct interactive discussions, including using the IDR process. Every effort should be made to resolve any factual differences. Open communication and continuous reassessment should continue throughout the execution phase. This was encouraged in the Transfer Pricing Roadmap as well.
12. In terms, risk assessment, the exam team will review and analyze the § 6662(e) documentation prior to the orientation meetings and note areas that require further development, confirmation, or inquiry and whether the conclusions can be considered reasonable.
13. In the execution phase, the exam team will prepare and issue an IDR requesting a transfer pricing and a supply chain orientation meeting. The exam team will also request any additional information not obtained during the planning phase and issue IDRs or summonses for factual development, including requests for interviews, plant tours, and site visits. The exam team is also instructed to review intercompany agreements and conduct functional analysis.
14. The exam team is encouraged to work with the economist to perform an economic analysis. The TPEP states that penalties should be considered whenever adjustments are made. This is consistent with the IRS's new directive on Transfer Pricing penalties.
15. The TPEP states that an acknowledgement of facts IDR should be issued for all transfer pricing issues (whether potentially agreed or unagreed). Exam should revise the Economist's Report and NOPA based on additional taxpayer input, as appropriate.
16. The goal of the resolution phase is to reach agreement, if possible. The resolution phase section discusses case closing, appeals, and competent authority.

XIV. SUBPART F.

A. Proposed Regulations: Stock Ownership: Domestic Partnerships.

1. Historical Treatment.

- (a) Since the enactment of Subpart F, domestic partnerships have generally been treated as entities, rather than as aggregates of their partners, for purposes of determining whether U.S. shareholders own more than 50% of the stock (by voting power or value) of a

foreign corporation and thus whether a foreign corporation is a CFC. Treas. Reg. § 1.701-2(f), Example 3 (a foreign corporation wholly owned by a domestic partnership is a CFC for purposes of applying the look-through rules of § 904(d)(3)). Domestic partnerships have also generally been treated as entities for purposes of treating a domestic partnership as the U.S. shareholder that has the Subpart F inclusion regarding a foreign corporation.¹³ If a domestic partnership is treated as the U.S. shareholder with a Subpart F inclusion, then each partner of the partnership has a distributive share of the partnership's Subpart F inclusion, regardless of whether the partner itself is a U.S. shareholder. § 702.

- (b) The preamble states that this entity treatment is consistent with the inclusion of a domestic partnership in the definition of a U.S. person in § 7701(a)(30), which term is used in the definition of U.S. shareholder by reference to § 957(c). It is also consistent with the legislative history of § 951, which describes domestic partnerships as being included within the definition of a U.S. person and, therefore, a U.S. shareholder. Furthermore, entity treatment is consistent with §§ 958(b) and 318(a)(3)(A), which treat a partnership (including a domestic partnership) as owning the stock owned by its partners for purposes of determining whether the foreign corporation is owned more than 50% by U.S. shareholders.
- (c) In contrast to this treatment of domestic partnerships as entities for purposes of Subpart F, foreign partnerships are generally treated as aggregates of their partners for purposes of determining stock ownership under § 958(a). § 958(a)(2). Accordingly, whether a foreign corporation owned by a foreign partnership is a CFC is determined based on the proportionate amount of stock owned by domestic partners of the partnership and, if the foreign corporation is a CFC, partners that are U.S. shareholders have the Subpart F inclusion regarding the CFC.

2. Section 951A.

- (a) Section 951A requires a U.S. shareholder of any CFC for any taxable year to include in gross income the shareholder's global intangible low-taxed income ("GILTI inclusion") for such taxable year in a manner similar to a Subpart F inclusion for many purposes of the Code. Similar to a Subpart F inclusion, the

¹³ Except for Prop. Treas. Reg. §§ 1.951-1(h) and 1.965-1(e) which treat certain domestic partnerships owned by CFCs as foreign partnerships for purposes of determining the U.S. shareholder that has the Subpart F inclusion regarding CFCs owned by such domestic partnerships.

determination of a U.S. shareholder's GILTI inclusion begins with the calculation of relevant items – such as tested income, tested loss, and qualified business asset investment – of each CFC owned by the shareholder (“tested items”). § 951A(c)(2) and (d) and Treas. Reg. §§ 1.951A-2 through -4. A U.S. shareholder then determines its pro rata share of each of these CFC-level tested items in a manner similar to a U.S. shareholder's pro rata share of Subpart F income under § 951(a)(2). *See* § 951A(e)(1) and Treas. Reg. § 1.951A-1(d).

- (b) In contrast to a Subpart F inclusion, however, a U.S. shareholder's pro rata shares of the tested items of a CFC are not amounts included in gross income, but rather are amounts taken into account by the U.S. shareholder in determining the amount of its GILTI inclusion for the taxable year. Section 951A(b) and Treas. Reg. § 1.951A-1(c). Thus, a U.S. shareholder does not compute a separate GILTI inclusion amount under § 951A(a) regarding each CFC for a taxable year, but rather computes a single GILTI inclusion amount by reference to all of its CFCs.
- (c) Section 951A itself does not contain specific rules regarding the treatment of domestic partnerships and their partners for purposes of GILTI. However, proposed regulations under § 951A that were published October 2018 reflected a hybrid approach that would treat a domestic partnership that is a U.S. shareholder regarding a CFC (“U.S. shareholder partnership”) as an entity regarding some partners but as an aggregate of its partners regarding others.
- (d) Under this hybrid approach, regarding partners that are not U.S. shareholders of a CFC owned by a domestic partnership, a U.S. shareholder partnership calculates a GILTI inclusion amount and its partners have a distributive share of such amount (if any). Prop. Treas. Reg. § 1.951A-5(b)(1). However, regarding partners that are themselves U.S. shareholders of a CFC owned by a domestic partnership (“U.S. shareholder partners”), the partnership is treated in the same manner as a foreign partnership, with the result that the U.S. shareholder partners are treated as proportionately owning, within the meaning of § 958(a), stock owned by the domestic partnership for purposes of determining their own GILTI inclusion amounts. Prop. Treas. Reg. § 1.951A-5(c).
- (e) Treasury and the IRS received a number of comments regarding this hybrid approach in the GILTI proposed regulations. The comments generally advised against adopting such an approach due primarily to concerns with complexity and administrability arising from the treatment of a partnership as an entity regarding some partners but as an aggregate regarding others.

- (f) The comments also generally advised against adopting a pure entity approach because such an approach would result in different treatment for similarly situated taxpayers depending on whether a U.S. shareholder owned stock of a foreign corporation through a domestic partnership or a foreign partnership, which is treated as an aggregate of its partners for purposes of determining CFC status and § 958(a) ownership. The majority of comments recommended at least some form of aggregate approach for domestic partnerships for purposes of the GILTI regime. Some suggested that an aggregate approach was supported by analogy to other situations where regulations apply an aggregate approach to partnerships.
- (g) In response to these comments, final regulations under § 951A treat stock owned by a domestic partnership as owned within the meaning of § 958(a) by its partners for purposes of determining a partner's GILTI inclusion amount under § 951A. Treasury and the IRS believe that applying an aggregate approach for purposes of determining a partner's GILTI inclusion amount under § 951A is necessary to ensure that, consistent with the purpose and operation of § 951A, a single GILTI inclusion amount is determined for each taxpayer based on its economic interests in all of its CFCs. The GILTI final regulations apply to taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.
- (h) Some comments also recommended adopting an aggregate approach for purposes of § 951, especially if the GILTI final regulations adopt an aggregate approach. These comments generally asserted that there is insufficient policy justification for treating domestic partnerships differently from foreign partnerships for purposes of U.S. shareholder and CFC determinations because the choice of law under which a partnership is organized should be irrelevant.
- (i) These comments criticized entity treatment of domestic partnerships because it results in each partner including in income its distributive share of a domestic partnership's Subpart F inclusion regarding a CFC, even if that partner is not a U.S. shareholder itself and thus would not have had a Subpart F inclusion regarding the CFC if the domestic partnership were instead foreign.

3. Aggregate Treatment for Purposes of § 951.

- (a) Treasury and the IRS believe that, to be consistent with the treatment of domestic partnerships under § 951A, a domestic

partnership should also generally be treated as an aggregate of its partners in determining stock owned under § 958(a) for purposes of § 951. Therefore, Prop. Treas. Reg. § 1.958-1(d)(1) provides that, for purposes of §§ 951 and 951A, and for purposes of any provision that applies by reference to §§ 951 and 951A (for example, §§ 959, 960, and 961), a domestic partnership is not treated as owning stock of a foreign corporation within the meaning of § 958(a).

- (b) This rule does not apply, however, for purposes of determining whether any U.S. person is a U.S. shareholder, whether a U.S. shareholder is a controlling domestic shareholder (as defined in Treas. Reg. § 1.964-1(c)(5)), or whether a foreign corporation is a CFC. Prop. Treas. Reg. § 1.958-1(d)(2).
- (c) Thus, under the proposed regulations, a domestic partnership that owns a foreign corporation is treated as an entity for purposes of determining whether the partnership and its partners are U.S. shareholders, whether the partnership is a controlling domestic shareholder, and whether the foreign corporation is a CFC, but the partnership is treated as an aggregate of its partners for purposes of determining whether, and to what extent, its partners have inclusions under §§ 951 and 951A and for purposes of any other provision that applies by reference to §§ 951 and 951A.
- (d) The GILTI final regulations adopt the same approach for purposes of § 951A. Treas. Reg. § 1.951A-1(e). As a result, under the proposed regulations, stock owned directly or indirectly by or for a domestic partnership will generally be treated as owned proportionately by its partners for purposes of §§ 951(a) and 951A and any provision that applies by reference to §§ 951 and 951A.
- (e) Treasury and the IRS believe that, as a result of the enactment of the GILTI regime, it is no longer appropriate to treat domestic partnerships as entities that are separate from their owners for purposes of determining whether, and to what extent, a partner has an inclusion under § 951. Congress intended for the Subpart F and GILTI regimes to work in tandem by providing that both regimes apply to U.S. shareholders of CFCs, that GILTI is included in a U.S. shareholder's gross income in a manner similar to a Subpart F inclusion for many purposes of the Code, and that gross income taken into account in determining the Subpart F income of a CFC is not taken into account in determining the tested income of such CFC (and, therefore, in determining the GILTI inclusion amount of a U.S. shareholder of such CFC). As a result, treating domestic partnerships inconsistently for Subpart F and GILTI purposes would not be appropriate.

- (f) Inconsistent approaches to the treatment of domestic partnerships for purposes of Subpart F and GILTI also would introduce substantial complexity and uncertainty, particularly regarding foreign tax credits, previously taxed earnings and profits (“PTEP”) and related basis rules, or any other provision the application of which turns on the owner of stock under § 958(a) and, thus, the U.S. person that has the relevant inclusion. For example, if a domestic partnership were treated as an aggregate of its partners for purposes of GILTI but as an entity for purposes of Subpart F, regulations would need to address separately the maintenance of PTEP accounts at the domestic partnership level for Subpart F and the maintenance of PTEP accounts at the partner level for GILTI.
- (g) Similarly, regulations would need to provide separate rules for basis adjustments under § 961 regarding a domestic partnership and its CFCs depending on whether an amount was included under § 951 or § 951A. The increased complexity of regulations resulting from treating domestic partnerships differently for purposes of Subpart F and GILTI would, in turn, increase the burden on taxpayers to comply with, and on the IRS to administer, such regulations.
- (h) Conversely, aggregate treatment of domestic partnerships in determining § 958(a) stock ownership for purposes of determining a partner’s inclusion under both the GILTI and Subpart F regimes will result in substantial simplification, as compared to disparate treatment, and will harmonize the two regimes.
- (i) Treasury and the IRS also considered extending aggregate treatment for all purposes of Subpart F, including for purposes of determining whether a foreign corporation is a CFC under § 957(a). However, they believe that an approach that treats a domestic partnership as an aggregate for purposes of determining CFC status would be inconsistent with relevant statutory provisions. The Code clearly contemplates that a domestic partnership can be a U.S. shareholder under § 951(b), including by attribution from its partners. §§ 7701(a)(30), 957(c), 951(b), 958(b), 318(a)(2)(A), and 318(a)(3)(A). An approach that treats a domestic partnership as an aggregate for purposes of determining CFC status would not give effect to the statutory treatment of a domestic partnership as a U.S. shareholder.
- (j) By contrast, neither § 958(a) nor any other provision of the Code specifies whether and to what extent a domestic partnership should be treated as an entity or an aggregate for purposes of determining stock ownership under § 958(a) for purposes of §§ 951 and 951A. In light of the changes adopted in the TCJA (including the

introduction of the GILTI regime), it is consistent with the intent of the TCJA to provide that domestic partnerships are treated in the same manner as foreign partnerships under § 958(a)(2) for purposes of §§ 951(a) and 951A and any provision that applies by reference to §§ 951 and 951A.

- (k) A domestic partnership may be treated as an aggregate of its partners or as an entity separate from its partners for purposes of a provision, depending on which characterization is more appropriate to carry out the purpose of the provision. Treasury and the IRS believe that treating a domestic partnership as an aggregate for purposes of §§ 951 and 951A is appropriate because the partners of the partnership generally are the ultimate taxable owners of the CFC and thus their inclusions under §§ 951 and 951A are properly computed at the partner level regardless of whether the partnership is foreign or domestic.
- (l) Thus, they believe that a domestic partnership should be treated consistently as an aggregate of its partners in determining the ownership of stock within the meaning of § 958(a) for purposes of §§ 951 and 951A, and any provision that applies by reference to § 951 or § 951A, except for purposes of determining whether a U.S. person is a U.S. shareholder, whether a U.S. shareholder is a controlling domestic shareholder (as defined in Treas. Reg. § 1.964-1(c)(5)), and whether a foreign corporation is a CFC. *See* Prop. Treas. Reg. § 1.958-1(d).
- (m) This aggregate treatment does not apply for any other purposes of the Code, including for purposes of § 1248.
- (n) Treasury and the IRS request comments on other provisions in the Code that apply by reference to ownership within the meaning of § 958(a) for which aggregate treatment for domestic partnerships would be appropriate. They also request comments on whether, and for which purposes, the aggregate treatment for domestic partnerships should be extended to the determination of the controlling domestic shareholders (as defined in Treas. Reg. § 1.964-1(c)(5)) of a CFC, such that some or all of the partners who are U.S. shareholders of the CFC, rather than the partnership, make any elections applicable to the CFC for purposes of §§ 951 and 951A.

4. Applicability Date and Comment Request regarding Transition.

- (a) These regulations are proposed to apply to taxable years of foreign corporations beginning on or after the date of publication of the Treasury decision adopting these rules as final regulations in the

Federal Register (the “finalization date”), and to taxable years of a U.S. person in which or with which such taxable years of foreign corporations end. Prop. Treas. Reg. § 1.958-1(d)(4).

- (b) Regarding taxable years of foreign corporations beginning before the finalization date, the proposed regulations provide that a domestic partnership may apply Treas. Reg. § 1.958-1(d), as included in the final regulations, for taxable years of a foreign corporation beginning after December 31, 2017, and for taxable years of a domestic partnership in which or with which such taxable years of the foreign corporation end (the “applicable years”), provided that the partnership, domestic partnerships that are related (within the meaning of § 267 or 707) to the partnership, and certain partners consistently apply Treas. Reg. § 1.958-1(d) regarding all foreign corporations whose stock they own within the meaning of § 958(a) (generally determined without regard to Treas. Reg. § 1.958-1(d)). Prop. Treas. Reg. § 1.958-1(d)(4).
- (c) A domestic partnership may rely on Prop. Treas. Reg. § 1.958-1(d) regarding taxable years beginning after December 31, 2017, and beginning before the date that these regulations are published as final regulations in the Federal Register, provided that the partnership, domestic partnerships that are related (within the meaning of § 267 or 707) to the partnership, and certain partners consistently apply Prop. Treas. Reg. § 1.958-1(d) regarding all foreign corporations whose stock they own within the meaning of § 958(a) (generally determined without regard to Prop. Treas. Reg. § 1.958-1(d)).
- (d) Once Prop. Treas. Reg. § 1.958-1(d) applies as a final regulation, Treas. Reg. § 1.951A-1(e) and Treas. Reg. § 1.951-1(h) (providing an aggregate treatment of domestic partnerships, but only for purposes of § 951A and limited Subpart F purposes, respectively) would be unnecessary because the scope of those regulations would effectively be subsumed by Treas. Reg. § 1.958-1(d). Therefore, the proposed regulations would revise the applicability dates of Treas. Reg. § 1.951A-1(e) and Treas. Reg. § 1.951-1(h), so that those provisions do not apply once the final regulations under § 958 apply.
- (e) Historically, domestic partnerships have been treated as owning stock within the meaning of § 958(a) for purposes of determining their Subpart F inclusions, and thus PTEP accounts were maintained, and related basis adjustments were made, at the partnership level. When the proposed regulations are finalized, domestic partnerships will cease to be treated as owning stock of foreign corporations under § 958(a) for purposes of determining a

Subpart F inclusion, and instead their partners will be treated as owning stock under § 958(a).

- (f) Treasury and the IRS request comments on appropriate rules for the transition to the aggregate approach to domestic partnerships described in the proposed regulations. Comments are specifically requested as to necessary adjustments to PTEP and related basis amounts and capital accounts after finalization. Comments are also requested as to whether aggregate treatment of domestic partnerships should be extended to other “pass-through” entities, such as certain trusts or estates.
- (g) In addition, comments are requested regarding the application of the PFIC regime after finalization, and whether elections (including elections under §§ 1295 and 1296) and income inclusions under the PFIC rules are more appropriately made at the level of the domestic partnership or at the level of the partners. Specifically, Treasury and the IRS are considering the operation of the PFIC regime where U.S. persons are partners of a domestic partnership that owns stock of a foreign corporation that is a PFIC, some of those partners might themselves be U.S. shareholders of the foreign corporation, and the foreign corporation might not be treated as a PFIC regarding these U.S. shareholders under § 1297(d) if the foreign corporation is also a CFC. Comments should consider how any recommended approach would interact with the determinations of a partner’s basis in its interest and capital accounts determined and maintained in accordance with Treas. Reg. § 1.704-1(b)(2).

5. Examples.

The following examples illustrate the application of these rules.

Example 1--(A) Facts. USP, a domestic corporation, and Individual A, a U.S. citizen unrelated to USP, own 95% and 5%, respectively, of PRS, a domestic partnership. PRS owns 100% of the single class of stock of FC, a foreign corporation.

(B) Analysis--(1) CFC and U.S. shareholder determinations. The determination of whether PRS, USP, and Individual A (each a U.S. person) are U.S. shareholders of FC and whether FC is a controlled foreign corporation is made without regard to the partnership “aggregate” rules. PRS, a U.S. person, owns 100% of the total combined voting power or value of the FC stock within the meaning of § 958(a). Accordingly, PRS is a U.S. shareholder under § 951(b), and FC is a controlled foreign corporation under § 957(a). USP is a U.S. shareholder of FC because it owns 95% of the total combined voting power or value of the FC stock

under §§ 958(b) and 318(a)(2)(A). Individual A, however, is not a U.S. shareholder of FC because Individual A owns only 5% of the total combined voting power or value of the FC stock under §§ 958(b) and 318(a)(2)(A).

(2) Application of §§ 951 and 951A. For purposes of §§ 951 and 951A, PRS is not treated as owning (within the meaning of § 958(a)) the FC stock; instead, PRS is treated in the same manner as a foreign partnership for purposes of determining the FC stock owned by USP and Individual A under § 958(a)(2). Therefore, for purposes of §§ 951 and 951A, USP is treated as owning 95% of the FC stock under § 958(a), and Individual A is treated as owning 5% of the FC stock under § 958(a). USP is a U.S. shareholder of FC, and therefore USP determines its income inclusions under §§ 951 and 951A based on its ownership of FC stock under § 958(a). However, because Individual A is not a U.S. shareholder of FC, Individual A does not have an income inclusion under § 951 regarding FC or a pro rata share of any amount of FC for purposes of § 951A.

Example 2--(A) Facts. USP, a domestic corporation, and Individual A, a U.S. citizen, own 90% and 10%, respectively, of PRS1, a domestic partnership. PRS1 and Individual B, a nonresident alien individual, own 90% and 10%, respectively, of PRS2, a domestic partnership. PRS2 owns 100% of the single class of stock of FC, a foreign corporation. USP, Individual A, and Individual B are unrelated to each other.

(B) Analysis--(1) CFC and U.S. shareholder determination. The determination of whether PRS1, PRS2, USP, and Individual A (each a U.S. person) are U.S. shareholders of FC and whether FC is a controlled foreign corporation is made without regard to the partnership “aggregate” rules. PRS2 owns 100% of the total combined voting power or value of the FC stock within the meaning of § 958(a). Accordingly, PRS2 is a U.S. shareholder under § 951(b), and FC is a controlled foreign corporation under § 957(a). Under §§ 958(b) and 318(a)(2)(A), PRS1 is treated as owning 90% of the FC stock owned by PRS2. Accordingly, PRS1 is a U.S. shareholder under § 951(b). Further, under § 958(b)(2), PRS1 is treated as owning 100% of the FC stock for purposes of determining the FC stock treated as owned by USP and Individual A under § 318(a)(2)(A). Therefore, USP is treated as owning 90% of the FC stock under § 958(b) (100% x 100% x 90%), and Individual A is treated as owning 10% of the FC stock under § 958(b) (100% x 100% x 10%). Accordingly, both USP and Individual A are U.S. shareholders of FC under § 951(b).

(2) Application of §§ 951 and 951A. For purposes of §§ 951 and 951A, PRS1 and PRS2 are not treated as owning (within the meaning of § 958(a)) the FC stock; instead, PRS1 and PRS2 are treated in the same

manner as foreign partnerships for purposes of determining the FC stock owned by USP and Individual A under § 958(a)(2). Therefore, for purposes of determining the amount included in gross income under §§ 951 and 951A, USP is treated as owning 81% (100% x 90% x 90%) of the FC stock under § 958(a), and Individual A is treated as owning 9% (100% x 90% x 10%) of the FC stock under § 958(a). Because USP and Individual A are both U.S. shareholders of FC, USP and Individual A determine their respective inclusions under §§ 951 and 951A based on their ownership of FC stock under § 958(a).

B. Repeal of § 958(b)(4).

1. Effective for the last taxable year of foreign corporations beginning before January 1, 2018, and each subsequent year, and for the taxable years of United States shareholders in which or with which such taxable years of the foreign corporations and the Tax Act repealed § 958(b)(4). Before repeal, § 958(b)(4) provided that subparagraphs (A), (B), and (C) of § 318(a)(3) were not to be applied to consider a United States person to own stock which is owned by a person who is not a United States person. The subparagraphs of § 318(a)(3) generally attribute stock owned by a person to a partnership, estate, trust, or corporation in which such person has an interest (so-called “downward” attribution).
2. Multiple comments requested guidance be issued addressing the repeal of § 958(b)(4). Treasury and the IRS said that this issue was beyond the scope of the § 965 proposed regulations, discussed in Section I.A. no. 68 above.
3. However, consistent with § 5.02 of Notice 2018-13, the preamble to the proposed § 965 regulations states that the instructions to Form 5471 will be amended to provide an exception from certain filing requirements for a United States person that is a United States shareholder with respect to a CFC or other specified foreign corporation if no United States shareholder (including the United States person) owns, within the meaning of § 958(a), stock of the CFC or other specified foreign corporation, and the foreign corporation is a CFC or specified foreign corporation solely because a United States person is considered to own the stock of the CFC or other specified foreign corporation owned by a foreign person under § 318(a)(3).
4. Consistent with § 6 of Notice 2018-13 and § 7 of Notice 2018-26, taxpayers may rely on this exception with respect to the last taxable year of a foreign corporation beginning before January 1, 2018, and each subsequent year of the foreign corporation, and for the taxable years of a United States shareholder in which or with which these taxable years of the foreign corporation end.

5. A Technical Corrections discussion draft (accompanied by a 1-2-19 JCT Explanation) would retroactively restore § 958(b)(4) but by adding a new § 951B. *See* Section XI.

C. Section 956: Repealed by a Regulation?

1. Treasury and the IRS finalized the § 956 regulations which affect certain domestic corporations that own, or are treated as owning, stock in foreign corporations. The regulations finalize the proposed regulations published on November 5, 2018 with certain changes.
2. The preamble to the proposed regulations states that Treasury and the IRS have determined that under the participation exemption system, the application of § 956 to corporate U.S. shareholders would be inconsistent with the purposes of § 956 and the scope of transactions it is intended to address.
3. The final regulations, like the proposed regulations, exclude corporate U.S. shareholders from the application of § 956 to maintain symmetry between the taxation of actual repatriations and the taxation of effective repatriations. To achieve this result, the regulations provide that the § 956 amount is reduced to the extent that the U.S. shareholder would be allowed a deduction under § 245A if they had received a distribution from the CFC in an amount equal to the tentative § 956 amount (the “hypothetical distribution”).
4. In general, under § 245A and the final regulations, neither an actual dividend to a corporate U.S. shareholder, nor such a shareholder’s tentative § 956 amount, will result in additional U.S. tax.
5. Published commentary on the proposed regulations raised concerns regarding how the proposed rules apply in the case of a CFC that has prior year earnings and profits (“E&P”) described in § 959(c)(1) and current-year E&P described in § 959(c)(3) that do not result in an inclusion under § 951 or § 951A. Even though a dividend of the current-year E&P would potentially be eligible for a deduction under § 245A, a distribution by the CFC would not qualify for a § 245A deduction, because under § 959(c), the distribution would be allocated to the prior-year E&P described in § 959(c)(1) first. To address this issue, the final regulations include an ordering rule treating a hypothetical distribution as attributable first to E&P described in § 959(c)(2), then to E&P described in § 959(c)(3), consistent with the allocation of an amount determined under § 956 pursuant to § 959(f)(1). This rule is illustrated in a new example in § 1.956-1(a)(3)(iii).

Example: USP owns FC. FC has an obligation of USP with an adjusted basis of \$120. FC’s applicable earnings are \$100. FC has \$200

of undistributed earnings, which constitute undistributed foreign earnings as defined in § 245A(c)(3), of which \$100 are described in § 959(c)(1)(A) and \$100 are described in § 959(c)(3).

USP's aggregate tentative § 956 amount is \$20, the lesser of (i) \$20 (\$120) over the earnings and profits described in § 959(c)(1)(A) (\$100), and (ii) FC's applicable earnings (\$100). USP would be allowed a \$20 hypothetical distribution which is treated as attributable to the earnings and profits of FC described in § 959(c)(3) despite the fact that FC has \$100 of earnings and profits described in § 959(c)(1)(A) that would otherwise be distributed before earnings and profits described in § 959(c)(3). Accordingly, under the ordering rule in the regulation, the § 956 amount with respect to FC is \$0, its aggregate tentative § 956 amount of (\$20) reduced by the deduction of \$20 that USP would have been allowed under § 245A with respect to the hypothetical distribution.

6. In terms of partnerships, the final regulations provide that the tentative § 956 amount with respect to a domestic partnership is reduced to the extent that one or more domestic corporate partners would be entitled to a § 245A deduction if the partnership received such amount as a distribution, and any remaining amount of the domestic partnership's inclusion under §§ 951(a)(1)(B) and 956 is allocated to the partners in the same proportion as net income would result to the partners upon a hypothetical distribution (that is, a distribution from the CFC to the domestic partnership). *See* § 1.956-1(a)(2)(i) and (iii).
7. The final regulations also update certain examples in the regulations under § 956 to reflect that § 956 may no longer apply in the case of corporate U.S. shareholders.
8. The final regulations apply to taxable years of a CFC beginning on or after May 23, 2019, and to taxable years of a U.S. shareholder in which or with which such taxable years of the CFC end. Taxpayers may apply the final regulations for taxable years of a CFC beginning after December 31, 2017, and for taxable years of a U.S. shareholder in which or with which such taxable years of the CFC end, provided the taxpayer consistently apply the regulations with respect to all CFCs in which they are U.S. shareholders for taxable years of the CFCs beginning after December 31, 2017.

D. New Subpart F Regulations: Related Person; Active Rents.

1. Background.

- (a) Section 954(a) defines foreign base company income (FBCI), which is a category of Subpart F income. Subpart F income generally is income earned by a CFC that is taken into account in computing the amount that a U.S. shareholder (as defined in

§ 951(b)) of the CFC must include in income under § 951(a)(1)(A). FBCI includes foreign personal holding company income, as defined in § 954(c), as well as certain types of income from sales and services.

- (b) The determination of whether certain types of sales and services income constitute FBCI depends, in part, on whether the income is earned from a transaction that involves a related person, as defined under § 954(d)(3). *See* § 954(d) and (e). The definition of related person under § 954(d)(3) is also relevant in determining whether certain income qualifies for an exception to FPHCI. *See*, for example, §§ 954(c)(2)(A), 954(c)(3), and 954(c)(6).
- (c) Subpart F income also includes insurance income (as defined under § 953), and the rules in § 953 similarly reference the definition of related person in § 954(d)(3). The definition of related person under § 954(d)(3) is also relevant in determining whether an exception to the definition of U.S. property applies for purposes of § 956. *See* § 956(c)(2)(L)(ii)(II). Additionally, certain provisions outside of Subpart F reference the definition of related person in § 954(d)(3). *See*, for example, §§ 267A, 904(d)(2)(I), 988(a)(3)(C), 1297(b)(2), and 1471(e)(2).
- (d) Section 954(d)(3) provides that a person is a related person with respect to a CFC if the person is (i) an individual who controls the CFC; (ii) a corporation, a partnership, a trust, or an estate that controls or is controlled by the CFC; or (iii) a corporation, a partnership, a trust, or an estate that is controlled by the same person or persons that control the CFC. Regarding a corporation, control means the ownership, directly or indirectly, of stock possessing more than 50% of (i) the total voting power of all classes of stock entitled to vote or (ii) the total value of stock of the corporation. Regarding a partnership, trust, or estate, control means the ownership, directly or indirectly, of more than 50% (by value) of the beneficial interests in the partnership, trust, or estate. Section 954(d)(3) states that “rules similar to the rules of section 958 shall apply” for purposes of determining ownership.
- (e) Section 958 provides rules for determining direct, indirect, and constructive stock ownership and states that such rules “shall apply” for purposes of § 954(d)(3) to the extent that the effect is to treat a person as a related person within the meaning of § 954(d)(3). *See* § 958(b). Sections 954(d)(3) and 958 were added to the Code in 1962, as part of the legislation that enacted the Subpart F regime, and § 954(d)(3) provided as originally enacted that “the rules for determining ownership of stock prescribed by section 958 shall apply.” The change in the language of

§ 954(d)(3) to provide for the application of rules “similar to the rules of” § 958 was made in 1986, but no corresponding change was made to the language in § 958.

- (f) Final regulations issued in 1964 cross-referenced § 958 and the regulations thereunder for purposes of determining ownership under § 954(d)(3) as then in effect. Final regulations published in 1995 revised the regulations, in part to provide that the principles of § 958, modified to apply to domestic as well as foreign entities, applied for purposes of determining direct and indirect ownership under § 954(d)(3).
- (g) Thus, under current Treas. Reg. § 1.954-1(f)(2)(iv), the principles of § 958(a) and (b) apply, without regard to whether an entity is foreign or domestic, to determine direct and indirect ownership for § 954(d)(3) purposes. The existing regulations do not provide any additional guidance beyond this general statement.
- (h) The newly proposed regulations would revise the existing regulations under § 954(d)(3) to provide some specific guidance on the application of principles similar to the constructive ownership rules in § 958(b).
- (i) FPHCI, as defined in § 954(c), generally includes rents. § 954(c)(1)(A). However, rents are excluded from FPHCI if they are received from a person other than a related person and derived in the active conduct of a trade or business within the meaning of § 954(c)(2)(A) and Treas. Reg. § 1.954-2(c) (the active rents exception).
- (j) The new regulations propose to revise the rules under § 954(c) to provide guidance on the treatment of amounts (including royalties) paid or incurred by a CFC in connection with the CFC’s rental income for purposes of the active rents exception.

2. Definition of Related Person in § 954(d)(3).

- (a) Treas. Reg. § 1.954-1(f)(1), like § 954(d)(3), provides that a person is a related person with respect to a CFC if the person is (i) an individual who controls the CFC; (ii) a corporation, a partnership, a trust, or an estate that controls or is controlled by the CFC; or (iii) a corporation, a partnership, a trust, or an estate that is controlled by the same person or persons that control the CFC. Treas. Reg. § 1.954-1(f)(2) provides that, regarding a corporation, control means the ownership, directly or indirectly, of stock possessing more than 50% of the total voting power of all classes of stock entitled to vote or the total value of stock of the

corporation. Regarding a trust or estate, control means the ownership, directly or indirectly, of more than 50% (by value) of the beneficial interests of the trust or estate. Regarding a partnership, control means the ownership, directly or indirectly, of more than 50% (by value) of the capital or profits interest in the partnership.

- (b) Section 954(d)(3) provides that rules similar to the rules of § 958 apply for purposes of determining whether a person is a related person. Similarly, current Treas. Reg. § 1.954-1(f)(2)(iv) states that the principles of § 958 apply to determine direct or indirect ownership for purposes of Treas. Reg. § 1.954-1(f) and further provides that the principles of § 958 apply without regard to whether a corporation, partnership, trust, or estate is foreign or domestic or whether an individual is a citizen or resident of the U.S.
- (c) Under § 958(a)(1), stock is considered owned by a person if it is owned directly or indirectly through certain foreign entities under § 958(a)(2). In relevant part, § 958(b) provides that § 318(a) (relating to the constructive ownership of stock) applies for purposes of § 954(d)(3), subject to certain modifications, to the extent that the effect is to treat a person as a related person within the meaning of § 954(d)(3). Treas. Reg. § 1.958-2 sets forth the rules in § 318(a) as modified by § 958(b).
- (d) Section 318 provides rules that attribute the ownership of stock to certain family members, between certain entities and their owners, and to holders of options to acquire stock. Section 318(a)(1) provides rules attributing stock ownership among members of a family, and § 318(a)(2) provides rules attributing stock ownership “upward” from an entity to the owner of an entity. In addition, § 318(a)(3) provides specific rules that attribute the ownership of stock “downward” from the owner of an entity to the entity.
- (e) In particular, § 318(a)(3)(A) provides that stock owned, directly or indirectly, by or for a partner in a partnership or a beneficiary of an estate is considered owned by the partnership or estate. This provision applies to all partners and beneficiaries without regard to the size of their interest in the partnership or estate. *See also* Treas. Reg. § 1.958-2(d)(1)(i).
- (f) Section 318(a)(3)(B) similarly provides, subject to certain exceptions, that stock owned, directly or indirectly, by or for a beneficiary of a trust (or a person who is considered an owner of a trust) is considered owned by the trust. *See also* Treas. Reg. § 1.958-2(d)(1)(ii). In comparison, § 318(a)(3)(C) attributes stock

owned, directly or indirectly, by or for a person to a corporation only if 50% or more in value of the stock in the corporation is owned, directly or indirectly, by the person. *See also* Treas. Reg. § 1.958-2(d)(1)(iii). Section 318(a)(4) provides that a person that has an option to acquire stock is considered to own the stock. *See also* Treas. Reg. § 1.958-2(e).

- (g) Treasury and the IRS are concerned that, in certain situations, the application of the § 318(a)(3)(A) and (B) constructive ownership rules, if incorporated into Treas. Reg. § 1.954-1(f) by the reference to § 958, could produce inappropriate results when defining related person for purposes of § 954(d)(3). For example, if two otherwise unrelated domestic corporations each owned interests in a partnership, the partnership would be treated under § 318(a)(3)(A) as owning any stock owned directly or indirectly by the unrelated domestic corporations. Thus, for purposes of § 954(d)(3), the partnership would be treated as controlling any corporations, including CFCs, in which one of the domestic corporations owned more than 50% of the stock, regardless of the size of the domestic corporation's ownership interest in the partnership, such that a CFC of one of the domestic corporations would be treated as related to a CFC of the other domestic corporation.
- (h) Treatment of the domestic corporations' CFCs as related persons regarding one another under § 954(d)(3) could be relied upon by taxpayers, for example, to treat payments of interest between the otherwise unrelated CFCs as interest that is eligible for the exception from FPHCI in § 954(c)(6). Similarly, a sale of personal property between a CFC of one domestic corporation and a CFC of the other domestic corporation could give rise to foreign base company sales income under § 954(d).
- (i) Treasury and the IRS do not believe that either of these results is appropriate when the domestic corporations each own 50% or less of the partnership because the domestic corporations (and thus their CFCs) do not have a significant relationship to each other, for purposes of § 954(d)(3), which itself refers to ownership of "more than 50%" of stock or other ownership interests, and Subpart F more generally.
- (j) Similarly, when two unrelated domestic corporations each own exactly 50% of the stock of a joint venture corporation, that joint venture corporation would be treated under § 318(a)(3)(C) as owning other stock owned by the domestic corporations (including stock of CFCs) and, accordingly, could be treated as controlling the domestic corporations' CFCs, such that a CFC of one of the

domestic corporations would be treated as related to a CFC of the other domestic corporation.

- (k) Treasury and the IRS do not believe that § 954(d)(3) was intended to treat the CFCs of the domestic corporations as related persons with respect to each other or with respect to the joint venture corporation in these circumstances, given that no person owns more than 50% of both the joint venture corporation and one of the CFCs directly or indirectly, as directly or indirectly would commonly be understood. Accordingly, Treasury and the IRS interpret § 954(d)(3) to qualify the application of the constructive ownership rules in § 318(a)(3).
- (l) Concerns about the application of the downward attribution rules of § 318(a)(3) were raised in connection with proposed regulations under § 385 published by Treasury and the IRS in 2016. Accordingly, the § 385 final regulations revised the rules in the § 385 proposed regulations concerning the definition of an expanded group to provide that § 318(a)(3) generally does not apply for such purpose. *See* Treas. Reg. § 1.385-1(c)(4)(iii)(A).
- (m) Until 1986, § 954(d)(3) and § 958(b) both provided for the rules in § 958(b) to apply for purposes of § 954(d)(3). Although § 958(b) was not changed in 1986, when § 954(d)(3) was amended to provide that rules “similar to” those in § 958 would apply, the preamble states that the change to § 954(d)(3) indicates that Congress intended for Treasury and the IRS to prescribe rules regarding the incorporation of § 958(b) into the definition of a related person under § 954(d)(3) with such modifications as may be appropriate.
- (n) For these reasons, and consistent with the § 385 final regulations, Treasury and the IRS propose, pursuant to the grant of regulatory authority under § 7805(a), to revise Treas. Reg. § 1.954-1(f) to provide that the rules of § 318(a)(3) and Treas. Reg. § 1.958-2(d) do not apply for purposes of § 954(d)(3) and Treas. Reg. § 1.954-1(f). Treas. Reg. § 1.958-2 is also proposed to be revised to cross-reference the limitations on its applicability in Treas. Reg. § 1.954-1(f).
- (o) However, the revision to Treas. Reg. § 1.954-1(f) does not preclude a corporation, partnership, trust, or estate from being treated as controlled by the same person or persons that control the CFC under the other rules that remain applicable for purposes of § 954(d)(3) and Treas. Reg. § 1.954-1(f). For example, if one domestic corporation (USP1) held 51% of the stock of a joint venture corporation, while an unrelated domestic corporation

(USP2) held 49% of its stock, the joint venture corporation would continue to be a related person with respect to a CFC in which USP1 owned 51% of the stock (CFC1) as a result of USP1's direct ownership of more than 50% of both entities, notwithstanding the fact that the joint venture corporation would no longer be treated as owning the stock of CFC1 owned by USP1.

- (p) Treasury and the IRS also are concerned that the application of the option attribution rule in § 318(a)(4) in the context of § 954(d)(3) could lead to inappropriate results. If, for example, two otherwise unrelated domestic corporations owned 51% and 49%, respectively, of the total value of the stock of a joint venture CFC, and the 49% owner also held an option to acquire an additional 2% of the corporation, the 49% owner could take the position that it, as well as the 51% owner, controlled the CFC for purposes of § 954(d)(3).
- (q) Based on this position, payments of interest between the joint venture CFC and another CFC of the 49% owner would be eligible for the exception from FPHCI in § 954(c)(6). Treasury and the IRS believe that it would be inappropriate to allow taxpayers to effectively elect related person status using options in this manner.
- (r) Accordingly, the new proposed regulations provide that § 318(a)(4) does not apply to treat a person that has an option to acquire stock or an equity interest, or an interest similar to such an option, as owning the stock or equity interest for purposes of the § 954(d) related person definition if a principal purpose for the use of the option or similar interest is to cause a person to be treated as a related person regarding a CFC (the option anti-abuse rule).
- (s) Section 7(d) of Notice 2007-9, 2007-1 C.B. 401, stated that regulations containing a similar rule would be issued, providing that if a principal purpose for the use of the option or similar interest is to qualify dividends, interest, rents, or royalties paid by a foreign corporation for the § 954(c)(6) exception, the dividends, interest, rents, or royalties received or accrued from such foreign corporation will not be treated as being received or accrued from a CFC payor and, therefore, will not be eligible for the § 954(c)(6) exception.
- (t) Notice 2007-9 indicated that § 7(d) would be effective for taxable years of foreign corporations beginning after December 31, 2006. Accordingly, these proposed regulations also contain, pursuant to the grant of regulatory authority under § 954(c)(6), the rule described in Notice 2007-9 (the Notice 2007-9 option anti-abuse rule), which is proposed to apply for taxable years of CFCs

beginning after December 31, 2006, and ending before the date of publication in the Federal Register of the Treasury decision adopting these new rules as final regulations, and for the taxable years of U.S. shareholders in which or with which such years end. Section 7(d) of Notice 2007-9 will be obsoleted upon finalization of these proposed regulations.

- (u) Comments with respect to the § 385 proposed regulations also raised concerns regarding the application of § 318(a)(4) to options in a joint venture corporation. The § 385 final regulations address those comments by providing that § 318(a)(4) applies only to options that are reasonably certain to be exercised as described in Treas. Reg. § 1.1504-4(g). *See* Treas. Reg. § 1.385-1(c)(4)(iii)(C). Comments are requested as to whether the concerns of Treasury and the IRS concerning the application of § 318(a)(4) for purposes of the definition of related person in § 954(d)(3) would be better addressed by the proposed option anti-abuse rule or a rule similar to Treas. Reg. § 1.385-1(c)(4)(iii)(C).

3. Active Rent Exception to FPHCI.

- (a) Although rents generally are included in FPHCI under § 954(c)(1)(A), rents derived in the active conduct of a trade or business and received from a person that is not a related person are excluded from FPHCI under the active rents exception in § 954(c)(2)(A) and Treas. Reg. § 1.954-2(b)(6). The § 954 regulations provide the exclusive rules for determining whether rents are derived in the active conduct of a trade or business for purposes of § 954(c)(2)(A).
- (b) Specifically, Treas. Reg. § 1.954-2(c) provides four alternative ways for rents to be derived in the active conduct of a trade or business, one of which applies to rents derived by a CFC from leasing property as a result of performing marketing activities. Under this rule, the CFC derives rents in the active conduct of a trade or business when the CFC satisfies an “active marketing” test, which, among other things, requires the CFC to operate in a foreign country or countries an organization that is regularly engaged in the business of marketing, or marketing and servicing, the leased property, and that is “substantial” in relation to the amount of rents derived from the property. *See* Treas. Reg. § 1.954-2(c)(1)(iv).
- (c) Pursuant to a safe harbor in the regulations, an organization is “substantial” if its active leasing expenses equal or exceed 25% of the adjusted leasing profit. *See* Treas. Reg. § 1.954-2(c)(2)(ii). The regulations generally define active leasing expenses to mean,

subject to certain exceptions, deductions that are properly allocable to rental income and that would be allowable under § 162 if the CFC were a domestic corporation. *See* Treas. Reg. § 1.954-2(c)(2)(iii). The regulations generally define adjusted leasing profit to mean the gross income of the lessor from rents, reduced by certain items. *See* Treas. Reg. § 1.954-2(c)(2)(iv).

- (d) A CFC may derive rent from leasing property that it does not own. In that case, the CFC likely will make payments to the owner of the property, which may be characterized as rent. For purposes of applying the safe harbor, the regulations provide that rents paid or incurred by the CFC with respect to the rental income (i) are not taken into account in determining active leasing expenses (in other words, are excluded from the definition of active leasing expenses); and (ii) are taken into account for purposes of determining adjusted leasing profit (in other words, reduce the CFC's gross income for purposes of determining adjusted leasing profit). Treas. Reg. § 1.954-2(c)(2)(iii)(B) and (iv)(A).
- (e) These rules reflect the principle that when a lessor CFC derives rents from property that it does not own, the substantiality of the CFC's marketing organization should be determined under the safe harbor on the basis of the CFC's income and expenses net of any payments that it makes for the use of the property.
- (f) Treasury and the IRS state they are aware that in cases in which a lessor CFC derives rent from leasing property that it does not own, the CFC may make payments to the owner of the property that are characterized as royalties rather than rent. For purposes of the safe harbor, there is no reason to distinguish between payments made by the CFC for the use of property based on their characterization as rents or royalties.
- (g) For example, if a CFC pays \$100 for the transfer of a computer program, and in turn transfers the computer program to an unrelated person for \$150 in a transaction that is treated as a lease under Treas. Reg. § 1.861-18, the determination of whether the CFC satisfies the safe harbor in Treas. Reg. § 1.954-2(c)(2)(ii) should not depend on whether the transaction pursuant to which the CFC received the computer program is characterized under Treas. Reg. § 1.861-18 as a license, under which the CFC pays royalties, or a lease, under which the CFC pays rents.
- (h) In both cases, the CFC's \$100 payment for use of the computer program should be excluded from active leasing expenses and reduce the CFC's adjusted leasing profit, in order to ensure that

only expenses related to the marketing organization are taken into account in assessing its substantiality.

- (i) Accordingly, Treasury and the IRS propose to revise Treas. Reg. § 1.954-2(c)(2)(iii)(B) and Treas. Reg. § 1.954-2(c)(2)(iv)(A) to apply generally to amounts paid or incurred, including both rents and royalties, by the lessor CFC for the right to use the property (or a component thereof) that generated the rental income.

4. Proposed Applicability Dates.

- (a) These regulations generally are proposed to apply for taxable years of CFCs ending on or after the date of publication in the Federal Register of the Treasury decision adopting these rules as final regulations, and for the taxable years of U.S. shareholders in which or with which such taxable year's end. However, pursuant to the authority under § 7805(b)(1)(C), the Notice 2007-9 option anti-abuse rule is proposed to apply for taxable years of CFCs beginning after December 31, 2006, and ending before the date of publication in the Federal Register of the Treasury decision adopting these rules as final regulations, and for the taxable years of U.S. shareholders in which or with which such years end.
- (b) Furthermore, pursuant to the authority under § 7805(b)(1)(B), the rules in Prop. Treas. Reg. § 1.954-1(f)(2)(iv)(B)(1) and (3) will apply to taxable years of CFCs ending on or after May 17, 2019, and to taxable years of U.S. shareholders in which or with which such taxable years end, with respect to amounts that are received or accrued by a CFC on or after May 17, 2019 to the extent the amounts are received or accrued by the CFC in advance of the period to which such amounts are attributable with a principal purpose of avoiding the application of Treas. Reg. § 1.954-1(f)(2)(iv)(B)(1) or (3) with respect to such amounts.
- (c) These rules would prevent taxpayers from effectively electing related person status in inappropriate situations, including to qualify payments for the exception from FPHCI in § 954(c)(6). Accordingly, Treasury and the IRS have determined that an immediate applicability date for these rules is appropriate to address the possibility of acceleration of payments to a period before these rules are adopted as final regulations. Until the effective date of the final regulations, CFCs may rely on the rules in Prop. Treas. Reg. § 1.954-1(f)(2)(iv) for taxable years ending on or after May 17, 2019, provided that they consistently apply the rules in Treas. Reg. §§ 1.954-1(f)(2)(iv) and 1.958-2(d) and (e) for all such taxable years.

XV. DOWNWARD ATTRIBUTION.

- A. The IRS and Treasury issued proposed regulations relating to the modification of ownership attribution under § 958. Before its repeal in the Tax Cuts and Jobs Act (“TCJA”), § 958(b)(4) provided that downward attribution did not apply to consider a U.S. person as owning stock owned by a foreign person. Section 958(b)(4) provided rules for determining the constructive stock ownership of a foreign corporation for Subpart F purposes, however, the rules impact many Code provisions based on ownership, not just Subpart F.
- B. Now that § 958(b)(4) has been repealed, stock of a foreign corporation owned by a foreign person can be attributed to a U.S. person under § 318(a)(3) for purposes of determining whether a U.S. person is a U.S. shareholder of the foreign corporation and, therefore, whether the foreign corporation is a controlled foreign corporation (“CFC”). This resulted in a number of unintended consequences and collateral damage. U.S. persons that were not previously treated as U.S. shareholders may be treated as U.S. shareholders, and foreign corporations that were not previously treated CFCs may be treated as CFCs. The repeal of § 958(b)(4) creates many CFC issues.
- C. Rather than reinstate § 958(b)(4), the proposed regulations turn off downward attribution in certain situations, including § 267 deductions for payments to related foreign persons, § 332 holding company liquidations, § 367(a) triggering events exception for gain recognition agreements, § 672 trust rules, § 706 partnership taxable year, § 863 space and ocean income and international communications income, § 904 look-through rules and active rents and royalties exception, § 1297 passive foreign investment company (“PFIC”) asset test, and § 6949 reporting provisions.
- D. There was a technical correction draft bill that was proposed, as discussed elsewhere in this outline. The Technical Correction restored the language in § 958(b)(4) and provide a limited exception consistent with the intent to TCJA. Congress has taken no action on the technical corrections draft bill. The new regulations appear to capture most of the numerous unintended consequences of the repeal of § 958(b)(4). However, the proposed regulations do not provide relief to a foreign-controlled CFC that is ineligible for the portfolio interest exception with respect to interest received from a related U.S. borrower solely as a result of downward attribution. The proposed regulations would apply on or after October 1, 2019, but can be consistently relied on prior to finalization.
- E. Section 267: Deduction for Certain Payments to Foreign Related Persons.
1. Section 267(a)(2) provides a matching rule that governs the time at which an otherwise deductible amount owed to a related person may be deducted. The purpose of the matching principle in § 267(a)(2) is to align the timing of a deduction with the inclusion of the item in income. If an amount is owed to a CFC that has no § 958(a) U.S. shareholders and the

CFC is exempt from U.S. tax on the amount owed due to a treaty, it is unnecessary to not allow a taxpayer to take the deduction.

2. Accordingly, the proposed regulations in Treas. Reg. § 1.267(a)-3(c)(4) provide that an amount (other than interest) that is income of a related foreign person that is exempt from U.S. taxation pursuant to a treaty is exempt from the application of § 267(a)(3)(B)(i) if the related foreign person is a CFC that does not have any § 958(a) U.S. shareholders.

F. Section 332: Liquidation of Applicable Holding Company.

1. Section 332(a) provides a general rule that no gain or loss is recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation. Section 332(d) was enacted to disallow the nonrecognition of gain to a foreign corporation through the complete liquidation of certain domestic holding companies, which could avoid the imposition of withholding tax that would otherwise apply to a § 301 distribution from these holding companies.
2. The repeal of § 958(b)(4) broadened the application of § 332(d)(3) to foreign corporations that are CFCs because of downward attribution from a foreign person. Thus, Prop. Treas. Reg. § 1.332-8(a) modifies the definition of a CFC (so as to use the definition of a CFC in effect immediately before the repeal of § 958(b)(4)) for purposes of applying § 332(d)(3).

G. Section 367(a): Triggering Events Exception for Other Dispositions or Events Under Treas. Reg. § 1.367(a)-8(k)(14).

1. In general, a U.S. transferor subject to a § 367(a) gain recognition agreement (“GRA”) must recognize gain if a triggering event (as defined in Treas. Reg. § 1.367(a)-8(j)) occurs during the term of a GRA. In particular, Treas. Reg. § 1.367(a)-8(k)(14) generally provides that a disposition or other event is not a triggering event if immediately after the U.S. transferor retains a direct or indirect interest in the transferred stock or in substantially all of the assets of the transferred corporation. The exception applies only if the U.S. transferor owns at least five percent (applying the attribution rules of § 318, as modified by § 958(b) of the total voting power and the total value of the outstanding stock of such foreign corporation.
2. The proposed regulations revise Treas. Reg. § 1.367(a)-8(k)(14) to apply § 958(b) without regard to the repeal of § 958(b)(4). The preamble to the proposed regulations state that a U.S. transferor’s constructive ownership interest should not include an interest that is treated as owned as a result of downward attribution as it would inappropriately treat the U.S. transferor

as owning an interest it would not have owned under the rules in effect when Treas. Reg. § 1.367(a)-8(k)(14) was added.

H. Section 706: Taxable Year of Partnership.

1. Section 706 provides rules for determining the taxable year of a partnership and its partners. Treas. Reg. § 1.706-1(b)(6)(ii) defines a foreign partner as a partner that is not a U.S. person (as defined in § 7701(a)(30)), but provides that CFCs are not treated as foreign partners.
2. As a result of the repeal of § 958(b)(4), a foreign corporation that is a CFC solely by reason of downward attribution from a foreign person may now be taken into account for purposes of determining the taxable year of such partnership. This would include a foreign corporation that is a CFC even if the CFC does not have a U.S. shareholder who owns stock of the foreign corporation within the meaning of § 958(a) and is required to include amounts in income under § 951(a). Accordingly, the proposed regulations in Treas. Reg. § 1.706-1(b)(6)(ii) exclude from the definition of foreign partner only CFCs with respect to which a U.S. shareholder owns stock within the meaning of § 958(a) for purposes of determining a partnership taxable year.

I. Section 904: Look-Through Rules and Active Rents and Royalties Exception to Categorization as Passive Category Income.

1. The IRS and Treasury stated that the formulation of the CFC look-through rule and the affiliated group rules in both the § 904 active rents and royalties exception and the financial services income rules was premised on the assumption that income of CFCs (including affiliated group members meeting the active conduct requirement of the financial services entity requirement) would be subject to U.S. tax under § 951(a) or on a distribution of earnings and profits generated by such income, and that foreign corporations to which the rules applied would be directly or indirectly controlled by U.S. persons able to obtain information concerning their activities, income, and expenses.
2. The preamble states that treating foreign corporations as CFCs or U.S. persons as U.S. shareholders by reason of downward attribution from foreign persons for purposes of the CFC look-through rule and the affiliated group rules would be inconsistent with the intended scope of the rules.
3. Accordingly, the regulations under § 904 are revised to limit the applications of the affiliated group rules in the § 904 active rents and royalties exception and the financial services income rule, as well as the CFC look-through rule, to foreign corporations that are CFCs without regard to downward attribution from foreign persons. Further, the CFC

look-through rule is further revised to apply only to U.S. shareholders that are U.S. shareholders without regard to downward attribution from foreign persons. Treasury and the IRS request comments on these proposed revisions to the regulations under § 904.

- J. Section 1297: PFIC Asset Test. Shareholders of a foreign corporation that became a CFC as a result of the repeal of § 958(b)(4) have to determine whether the average percentage of assets that produce passive income is at least 50% using adjusted basis. The rule imposes a burden on taxpayers that own stock in foreign corporations that became CFCs solely by reason of the repeal of § 958(b)(4). Thus, the proposed regulations in Treas. Reg. § 1.1297-1(d)(1)(iii)(A) modify the definition of a CFC for purposes of § 1297(e) to disregard downward attribution from foreign person.
- K. Section 6049: Reporting. The revision to the § 6049 regulations provides that foreign-controlled CFCs will not be treated as U.S. taxpayers and, therefore, are exempted from Form 1099 reporting and backup withholding with respect to such entity.
- L. Rev. Proc. 2019-40. The repeal of § 958(b)(4) also created significant reporting and compliance burdens. Rev. Proc. 2019-40 was issued at the same time as the proposed regulations and provides safe harbors to reduce the reporting issues. The revenue procedure states that Treasury and the IRS are aware that, in certain circumstances, taxpayers are required to include the gross income amounts under §§ 951 (“Subpart F inclusion amounts”) and 951A (“GILTI inclusion amounts”) attributable to, and report amounts with respect to, foreign corporations that are CFCs solely because of the repeal of § 958(b)(4), even though those taxpayers may have limited ability to determine whether such foreign corporations are CFCs and to obtain the information necessary to accurately determine these amounts.
- M. Safe Harbor.
 - 1. The revenue procedure provides a safe harbor under which the IRS will accept a U.S. person’s determination that a foreign corporation does not meet the § 957 ownership requirements and, therefore, that the foreign corporation is not a CFC with respect to the U.S. person if certain conditions are satisfied. The safe harbor only applies to a foreign controlled CFC and does not apply to a U.S.-controlled CFC. A foreign controlled CFC is a CFC that became a CFC as a result of downward attribution arising from the repeal of § 958(b)(4).
 - 2. In order to satisfy the safe-harbor conditions that the foreign corporation is not a CFC, the U.S. person cannot have actual knowledge, statements received, and/or reliable publicly available information sufficient for the U.S. person to determine that the § 957 ownership requirements are met.

3. The safe harbor is very helpful in addressing the concern that in a joint venture (“JV”) situation, after the repeal of § 958(b)(4), the U.S. JV partner could have a CFC based on the JV partner’s ownership interest and there was no way to get that information. However, the safe harbor only applies when there is no actual knowledge of the CFC.

N. Alternative Information.

1. Even if the CFC status is known, there can still be information reporting issues to determine Subpart F inclusions or inclusions under GILTI, since the U.S. shareholder of a CFC needs to know gross and taxable income, qualified business asset investment, and the E&P of the CFC.
2. Treasury and the IRS recognize that certain U.S. shareholders may be unable to obtain information necessary for the U.S. shareholder to calculate a Subpart F inclusion amount or GILTI inclusion amount or report amounts on Form 5471. Accordingly, taxpayers can choose to use alternative information .
3. Alternative information includes audited or unaudited separate financial statements prepared according to U.S. generally accepted accounting principles U.S. GAAP, or international financial reporting standards, or local country GAAP or separate entity records used by the foreign corporation for tax reporting or internal management controls. The alternative information provision is tiered, with priority given to audited statements and U.S. GAAP.
4. Nothing in the revenue procedure affects the application of the requirements for determining the foreign income taxes paid or accrued by a foreign-controlled CFC for purposes of applying § 960 (relating to deemed paid foreign income taxes). Accordingly, a taxpayer that uses alternative information must determine if amounts paid or accrued are “foreign income taxes,” as defined under Treas. Reg. § 1.960-1(b)(5) and satisfy the evidentiary and other requirements of Treas. Reg. § 1.905-2.

O. Safe Harbor for Using Alternative Information for Determining § 965 Amounts.

1. Treasury and the IRS also recognize that certain U.S. shareholders may have been unable to obtain information necessary for the U.S. shareholder to calculate an amount included under § 951 by reason of § 965 or a deduction under § 965(c) (each a “§ 965 amount”) and thus may use alternative information.
2. A taxpayer that uses alternative information must determine if amounts paid or accrued are “foreign income taxes,” as provided under §§ 902 and 960 (as in effect on December 21, 2017) and applicable regulations, and satisfy the evidentiary and other requirements of Treas. Reg. § 1.905-2, and the extent to which a credit is disallowed for such amounts.

3. Treasury and the IRS intend to revise the instructions for Form 5471 to provide that if information satisfying the requirements of § 964 and the regulations thereunder is not readily available to an unrelated § 958(a) U.S. shareholder or an unrelated constructive U.S. shareholder, an amount reported on a Form 5471 may be determined by the unrelated § 958(a) U.S. shareholder or the unrelated constructive U.S. shareholder, as applicable, on the basis of alternative information.

P. Penalties.

1. Taking into account that the IRS will accept taxpayers' positions based on the revenue procedure and the availability of reasonable cause relief, penalties under §§ 6038 and 6662 will not be applied to the extent such penalties would be attributable to:
 - (a) A U.S. person determining that a foreign corporation does not meet the § 957 ownership requirements,
 - (b) A U.S. person determining a Subpart F inclusion amount or GILTI inclusion amount, an amount in a record required to be maintained under § 964(c), Treas. Reg. § 1.964-3, or Treas. Reg. § 1.964-4, or an amount reported on a Form 5471 on the basis of alternative information, or
 - (c) A U.S. person determining a § 965 amount on the basis of alternative information.

Q. Form 5471.

1. Treasury and the IRS understand that, even as modified, the Form 5471 filing requirements may result in a significant undertaking for certain U.S. shareholders with limited access to information with respect to a foreign-controlled CFC. Accordingly, Treasury and the IRS intend to further limit the Form 5471 filing requirements.
2. The IRS intends to revise the instructions for Form 5471 to provide that a Category 5 filer is generally only required to file the identifying information on page 1 of Form 5471 above Schedule A, as well as Schedule I, Schedule I-1, and Schedule P, with respect to a foreign-controlled CFC if the Category 5 filer is an unrelated § 958(a) U.S. shareholder with respect to the foreign-controlled CFC.
3. If, however, the Category 5 filer claims under § 960 to be deemed to have paid foreign income taxes of the foreign-controlled CFC for the Category 5 filer's taxable year, Schedule E and Schedule E-1 are also required to be filed. Therefore, a Category 5 filer that is an unrelated § 958(a) U.S. shareholder with respect to a foreign-controlled CFC will no longer have

to file Part II of Schedule B, Schedule G, Schedule H, or Schedule J with respect to the foreign-controlled CFC.

4. The IRS intends to revise the instructions for Form 5471 to provide that a Category 5 filer is generally only required to file the identifying information on page 1 of Form 5471 above Schedule A, as well as Part II of Schedule B, Schedule E, Schedule G, and Schedule I-1, with respect to a foreign-controlled CFC if the Category 5 filer is a related constructive U.S. shareholder with respect to the foreign-controlled CFC. Therefore, a Category 5 filer that is related constructive U.S. Shareholder with respect to a foreign-controlled CFC will no longer have to file Schedule E-1, Schedule H, Schedule I, Schedule J, or Schedule P with respect to the foreign-controlled CFC.
5. The IRS intends to revise the instructions for Form 5471 to provide that a Category 5 filer is not required to file a Form 5471 with respect to a foreign-controlled CFC if it is an unrelated constructive U.S. shareholder with respect to the foreign-controlled CFC.

R. Examples.

1. Example 3

In 2020, USP, a domestic corporation, and FP, a foreign corporation, invest in FJV, a newly formed foreign corporation. USP receives 10% of the single class of stock of FJV, and FP receives the remaining 90% of the stock of FJV. FP is not a related person of USP. FP has no U.S. shareholders. FP owns 5% of the interests in a domestic partnership, DPS, the remainder of the interests in which are held by persons unrelated to USP and FP.

DPS as an unrelated constructive U.S. shareholder. Because FP is a partner in DPS, DPS is considered to own, pursuant to § 958(b) and section 318(a)(3)(A), the 90% of the single class of stock of FJV owned by FP. Accordingly, DPS is a U.S. shareholder of FJV. Because DPS does not own (within the meaning of § 958(a)) any stock of FJV, DPS is not a § 958(a) U.S. shareholder of FJV. Accordingly, DPS is a constructive U.S. shareholder of FJV. Because DPS is not a related person of FJV, relying on Treas. Reg. § 1.954-1(f)(2)(iv), as proposed to be revised. DPS is an unrelated constructive U.S. shareholder of FJV.

FJV as a foreign-controlled CFC. Because more than 50% of the single class of stock of FJV is considered owned under § 958(b) by DPS, a U.S. shareholder of FJV, FJV is a CFC. If, however, § 318(a)(3)(A) did not apply to treat DPS as owning the FJV stock owned by FP, FJV would not be a CFC, because the only stock of FJV owned (within the meaning of § 958(a)) or considered owned under § 958(b) by U.S. shareholders

would be the 10% of the FJV stock owned by USP. Accordingly, FJV is a foreign-controlled CFC.

USP as an unrelated § 958(a) U.S. shareholder. Because USP owns (within the meaning of § 958(a)) 10% of the stock of FJV, USP is a § 958(a) U.S. shareholder of FJV. Because USP is not a related person of FJV, USP is an unrelated § 958(a) U.S. shareholder of FJV.

2. Example 4

The facts are the same as in Example 3. USP inquired of FJV whether FJV met the § 957 ownership requirements, and FJV did not report that it met the § 957 ownership requirements. There is no reliable publicly available information that would indicate that FJV is a CFC. USP has not received a statement indicating that FJV is a CFC. Furthermore, after making the inquiry of FJV, USP does not know that FJV is a CFC.

Because FJV is not a U.S.-controlled CFC and FP is not a related person with respect to USP, for purposes of determining if FJV meets the § 957 ownership requirements, USP may rely on the safe harbor without inquiring of FP whether FP owns directly or indirectly (determined under the principles of § 958(a)(2)) or constructively owns (determined under the principles of § 958(b)) stock of, or an interest in, a domestic entity. Because there is no reliable publicly available information that would indicate that FJV is a CFC, USP has not received a statement indicating that FJV is a CFC, and, after making an inquiry of FJV, USP does not know that FJV is a CFC, USP may treat FJV as not meeting the § 957 ownership requirements.

XVI. PFIC REGULATIONS.

- A. The newly proposed PFIC regulations provide guidance regarding a number of issues that are not specifically addressed in the current regulations and that are intended to resolve some of the complexities that arise in the determination of the ownership of a PFIC and in the application of the Income Test and Asset Test in cases in which the look-through rules of § 1297(c) applies to a Tested Foreign Corporation.
- B. They provide guidance on the application of the corporate attribution rules when a partnership indirectly holds a Tested Foreign Corporation through a corporation that is not a PFIC. These regulations also are intended to clarify the scope of the § 1297(b)(1) cross-reference to § 954(c) for purposes of defining passive income, and they set forth rules that address certain computational and characterization issues that arise in applying the Asset Test. They also provide additional new rules.

C. Determination of Ownership and Attribution Through Partnerships.

1. Section 1298(a) contain attribution rules that apply to the extent that their effect is to treat stock of a PFIC as owned by a U.S. person. Except as provided in regulations, the attribution rules do not apply to treat stock owned or treated as owned by a U.S. person as owned by any other person.
2. Section 1298(a)(2)(A) provides that if 50% or more in value of the stock of a corporation is owned, directly or indirectly, by or for any person, that person is considered to own the stock owned directly or indirectly by or for the corporation in proportion to the person's ownership of the corporation. Under § 1298(a)(2)(B), the 50% ownership threshold does not apply in the case of stock held through a PFIC or a corporation that would be a PFIC if it were not a CFC within the meaning of § 957(a) ("CFC"). Section 1298(a)(3) provides that stock owned, directly or indirectly, by a partnership, estate, or trust is considered owned proportionately by its partners or beneficiaries. The current rules in Treas. Reg. § 1.1291-1(b)(8) are consistent with these statutory provisions.
3. Comments have inquired whether the attribution rules are intended to be applied to a tiered ownership structure on a "top-down" basis, by starting with a U.S. person and determining what stock is considered owned at each successive lower tier on a proportionate basis. Alternatively, the rules could be applied on a "bottom-up" basis, by starting with a PFIC and attributing ownership of its stock upwards to each successive upper tier until the U.S. person whose ownership in the PFIC is being tested is reached.
4. The two approaches can have different ownership consequences when a partnership indirectly owns stock of a Tested Foreign Corporation through a corporation that is not a PFIC. A U.S. person not treated as a shareholder of PFIC stock indirectly held by a partnership through a non-PFIC corporation under a "top-down" approach may be treated as a shareholder under a "bottom-up" approach as a result of the application of § 1298(a)(3) and Treas. Reg. § 1.1291-1(b)(8)(iii), which provide that holders of interests in a pass-through entity are considered to proportionately own stock owned directly or indirectly by the pass-through entity.
5. Consider, for example, the following fact pattern. A, a U.S. citizen, owns 50% of the interests in FP, a foreign partnership, the remainder of which is owned by an unrelated foreign person. FP owns 100% of the stock of FC1 and 50% of the stock of FC2, the remainder of which is owned by an unrelated foreign person. Both FC1 and FC2 are foreign corporations that are not PFICs (determined without applying § 1297(d)). FC1 and FC2 each own 50% of the stock of FC3, a foreign corporation that is a PFIC.

Under a “bottom-up” approach, FP could be treated as owning 75% of the stock of FC3 indirectly through FC1 and FC2, and accordingly, A could be treated as owning 37.5% of the stock of FC3. Under a “top-down” approach, however, A would be treated as owning 50% of the stock of FC1 and 25% of the stock of FC2, and the only stock of FC3 that would be attributed to A would be the 25% of the FC3 stock treated as indirectly owned by A through FC1.

6. Comments have noted that a “top-down” approach produces the same result as if the partnership were disregarded and partners were treated as if they directly or indirectly owned a partnership’s direct and indirect interests in a non-PFIC foreign corporation. Thus, it could thus be viewed as consistent with an aggregate theory of partnerships.
7. Under the proposed regulations, the attribution rules apply consistently whether a U.S. person owns stock of a non-PFIC foreign corporation through a partnership or directly, as they would under the “top-down” approach. This ensures that ownership of a foreign corporation that is a PFIC through a partnership will not change the amount of the stock of the PFIC that the U.S. person is treated as owning.
8. Accordingly, under the proposed regulations, for purposes of determining whether a partner, S corporation shareholder, or beneficiary in a partnership, S corporation, estate, or nongrantor trust is considered under Treas. Reg. § 1.1291-1(b)(8)(ii)(A) to own a portion of stock of a PFIC owned indirectly by the partnership, S corporation, estate, or trust through a non-PFIC foreign corporation, the partner, shareholder, or beneficiary will be considered to own 50% or more in value of the stock of the non-PFIC foreign corporation through the partnership, estate, or trust only if the partner, shareholder, or beneficiary directly or indirectly owns 50% or more of the ownership interests in the partnership, estate, or trust. Prop. Treas. Reg. § 1.1291-1(b)(8)(iii).
9. If, in this example, FP were replaced with another foreign corporation, FC4, the proposed regulations would not apply. It may seem less appropriate for the amount of FC3 stock that is treated as owned by A to be limited to the 25% of FC3 indirectly owned by A through FC4 and FC1. Instead, FC4 could be treated as owning 25% of the stock of FC3 indirectly through FC2, and thus A could be treated as owning 12.5% of the stock of FC3 indirectly through FC4 and FC2 in addition to the 25% owned indirectly through FC4 and FC1.
10. Treasury and the IRS request comments as to whether a “top- down” attribution analysis or some alternative analysis should apply under § 1298(a) in a purely corporate structure such as this one, such that A would not be treated as owning any stock of FC3 indirectly through FC4 and FC2.

D. Income Test.

1. In General.

- (a) In the 1988 Tax Act (“TAMRA”), Congress amended § 1297(b)(1) to define the term passive income generally as any income of a kind that would constitute FPHCI under § 954(c). FPHCI, and thus passive income, includes interest income that would be tax-exempt under § 103. Treas. Reg. §§ 1.954-2(b)(3), 1.952-2(c)(1). Neither the rules under Subpart F nor rules under § 1297, however, address the treatment for purposes of FPHCI or the Income Test of other types of income that are otherwise excluded from gross income, such as intercompany dividends that are excluded from the income of a recipient under the consolidated return regulations. Treas. Reg. § 1.1502-13(f)(2)(ii).
- (b) A Tested Foreign Corporation may be treated under § 1297(c) as receiving directly income received by a 25-percent-owned subsidiary, including a domestic corporation. A Tested Foreign Corporation could own a second domestic corporation through a 25-percent-owned domestic corporate subsidiary and could thus be treated under §§ 1297(c) and 1298(b)(7) as receiving intercompany dividends from the lower-tier domestic corporation that would be excluded from the income of the upper-tier domestic corporation under the consolidated return regulations. Accordingly, the operation of the statutory rules under §§ 1297 and 1298 indicate that the Income Test is intended to take into account all income of a Tested Foreign Corporation, without regard to reductions or exclusions that might apply for purposes of determining the U.S. Federal income tax imposed on such income.
- (c) Consistent with those rules, Treasury and the IRS believe that intercompany dividends received by a corporation from a member of its consolidated group and treated as received under § 1297(c) by a Tested Foreign Corporation that directly or indirectly owns stock in the corporation should be taken into account for purposes of the Income Test.
- (d) Thus, the proposed regulations indicate that income for purposes of the Income Test includes all dividend income, including dividends that are excluded from gross income under § 1502 and Treas. Reg. § 1.1502-13. Prop. Treas. Reg. § 1.1297-1(b).

2. Exceptions from Passive Income.

- (a) There are a number of exceptions to the definition of FPHCI in § 954(c), as well as in § 954(h) and (i), and special rules and

definitions in § 954(c) that affect the determination of FPHCI. Specifically, in addition to the exceptions contained within the general definition of FPHCI in § 954(c)(1), § 954(c)(2) provides three exceptions: (i) an active rents and royalties exception; (ii) an export financing exception; and (iii) a dealer exception. Section 954(c)(3) provides two additional exceptions: (i) a related person, same country dividend and interest exception; and (ii) a related person, same country rents and royalty exception.

- (b) In addition, for taxable years of foreign corporations beginning after December 31, 2005, and before January 1, 2020, § 954(c)(6) excludes from FPHCI certain dividends, interest, rents, and royalties received or accrued from a related corporation that is a CFC. Moreover, § 954(h) provides rules that apply for purposes of § 954(c)(1) pursuant to which income derived in an active banking or financing business is excluded from FPHCI. Additionally, under § 954(i), income from an active insurance business is excluded from FPHCI for purposes of § 954(c)(1). Finally, § 954(c)(4) contains a look-through rule that applies in the case of a sale of certain partnership interests, and § 954(c)(5) contains definitions and special rules applicable to commodity transactions.
- (c) Separately, § 1297(b)(2) provides explicit exclusions to the general definition of passive income set forth in § 1297(b)(1). Specifically, § 1297(b)(2) provides four exceptions: (i) an active banking exception; (ii) an active insurance business exception; (iii) a related person interest, dividends, rents, and royalties exception; and (iv) an export trade financing exception.
- (d) Questions have arisen regarding the scope of the cross-reference to § 954(c) in § 1297(b)(1) for purposes of defining passive income for PFIC purposes. Comments have inquired whether the § 954(c) reference in § 1297(b) incorporates all of the exceptions to FPHCI that are in § 954(c). In addition, by their terms, certain exceptions to FPHCI apply only to a foreign corporation that is a CFC. If these exceptions apply for PFIC purposes, the comments also question whether a Tested Foreign Corporation must also be a CFC in order to benefit from the exceptions.
- (e) Treasury and the IRS believe that Congress did not intend for all of the exceptions in § 954(c) to apply for purposes of determining passive income under the PFIC provisions. In particular, the exceptions in § 954(c)(3) (relating to certain income received from related persons) and 954(c)(6) (relating to certain income received from related CFCs) were not meant to be taken into account for PFIC purposes. The legislative history indicates that Congress intended for the § 1297(c) look-through rules or the

§ 1297(b)(2)(C) exception to apply to income items that otherwise would be entitled to the § 954(c)(3) exception.

- (f) Thus, the proposed regulations do not incorporate the § 954(c)(3) exception for purposes of determining passive income for PFIC purposes. Similarly, under the proposed regulations, the § 954(c)(6) exception also does not apply for determining PFIC status because the § 1297(b)(2)(C) related-person exception is intended to be the sole related-person exception applicable for determining passive income under the PFIC rules.
- (g) The preamble says that additional questions are raised regarding the FPHCI exceptions for active banking, financing, and insurance income because § 1297(b) does not specifically cross-reference § 954(h) and (i).
- (h) Treasury and the IRS state that, as with § 1297(b)(2)(C), it is possible that §§ 1297(b)(2)(A) and (B) were intended to be the sole exceptions for active banking, financing, and insurance income applicable for determining passive income under the PFIC rules because § 1297(b) has specific exceptions for active banking, financing, and insurance income. Alternatively, the § 1297(b) cross-reference to § 954(c) could be read to include the exceptions provided in § 954(h) and (i), which apply for purposes of § 954(c) by their terms.
- (i) It may be appropriate for income that satisfies the requirements in § 954(h) and (i) to be excluded from passive income because Congress generally defined passive income by reference to FPHCI, and when § 954(h) and (i) were enacted, each with a cross-reference to § 954(c), Congress did not provide that § 954(h) or (i) should not apply for PFIC purposes. Moreover, states the preamble, the fact that the PFIC provisions are more generally not intended to apply to foreign corporations engaged in active businesses supports the application of rules excluding active banking, financing, and insurance income from the definition of passive income.
- (j) However, regarding § 954(i), Congress recently amended the exclusion for income derived in the active conduct of an insurance business in § 1297(b)(2)(B) to require that income be earned by a QIC. Given this statutory change and the tests contained in the definition of QIC in § 1297(f), Treasury and the IRS believe that the exception for insurance income in § 954(i) should not apply in addition to the newly modified exception in § 1297(b)(2)(B).

- (k) Accordingly, the proposed regulations provide that the § 954(i) exception to FPHCI does not apply in addition to the PFIC exception. Prop. Treas. Reg. § 1.1297-1(c)(1)(i)(B). By contrast, given that no final regulations under the PFIC regime provide rules concerning an exclusion of active banking and financing income, the proposed regulations provide that the FPHCI exception for banking and financing income under § 954(h) applies for purposes of determining PFIC status. Prop. Treas. Reg. § 1.1297-1(c)(1)(i)(A). The application of § 954(h) is in addition to the PFIC exception.
- (l) Comments have said that the application of § 954(c) for PFIC purposes can be uncertain when a Tested Foreign Corporation is not also a CFC. For instance, the application of § 954(h) for PFIC purposes could be interpreted to apply only to amounts received by a Tested Foreign Corporation that also is a CFC. Passive income for PFIC purposes is defined by cross-reference to § 954(c) because the income items that comprise FPHCI are generally passive in nature.
- (m) The preamble states that the CFC status of the recipient of an item of FPHCI does not affect the passive nature of the item, and thus is not relevant for purposes of determining whether an item is passive under the PFIC rules. Therefore, Treasury and the IRS believe that it is appropriate for income derived by any Tested Foreign Corporation, and not just Tested Foreign Corporations that also are CFCs, to be eligible for the exceptions to FPHCI, including the § 954(h) exception.
- (n) The proposed regulations provide that for purposes of § 1297(b)(1), passive income is determined by reference to the items of income listed in § 954(c)(1), subject only to the exceptions found in § 954(c)(1), § 954(c)(2)(A) (relating to active rents and royalties), § 954(c)(2)(B) (relating to certain export financing interest), § 954(c)(2)(C) (relating to dealers), and § 954(h) (relating to entities engaged in the active conduct of a banking, financing, or similar business). Prop. Treas. Reg. § 1.1297-1(c)(1)(i) and (c)(1)(i)(A).
- (o) In addition, the rules in § 954(c)(4) (relating to sales of certain partnership interests) and 954(c)(5) (relating to certain commodity hedging transactions) apply for PFIC purposes. Prop. Treas. Reg. § 1.1297-1(c)(1)(i)(C). However, the exceptions in § 954(c)(3) (relating to certain income received from related persons), § 954(c)(6) (relating to certain amounts received from related controlled foreign corporations), and § 954(i) (relating to entities engaged in the active conduct of an insurance business) are not

taken into account for purposes of § 1297(b)(1). Prop. Treas. Reg. § 1.1297-1(c)(1)(i)(B).

- (p) Prop. Treas. Reg. § 1.1297-1(c)(1)(i)(D) provides that an entity is treated as a CFC for purposes of applying an exception to FPHCI and for purposes of determining whether a person is a related person with respect to the entity.

3. Income and Gains from Certain Transactions.

- (a) The Income Test is computed based on a Tested Foreign Corporation's gross income. However, pursuant to § 954(c), certain categories of income are FPHCI only to the extent that gains exceed losses with respect to the category. For instance, under § 954(c)(1)(B) only "the excess of gains over losses from the sale or exchange" of certain property is treated as FPHCI. Similar rules apply to income from commodities transactions under § 954(c)(1)(C), foreign currency gains under § 954(c)(1)(D), and income from notional principal contracts under § 954(c)(1)(F).
- (b) Prop. Treas. Reg. § 1.1297-1(c)(1)(ii) provides that for purposes of the Income Test, items of income under § 954(c) that are determined by netting gains against losses are taken into account by a corporation on that net basis, so that only net gains in a particular category of FPHCI are taken into account. However, the net amount of income in each category of FPHCI is determined separately for each relevant corporation, such that net gains or losses of a corporation, at least 25% of the value of stock of which is owned, directly or indirectly, by a Tested Foreign Corporation ("Look-Through Subsidiary") may not be netted against net losses or gains of another Look-Through Subsidiary or of a Tested Foreign Corporation.

4. Income Earned Through Partnerships.

- (a) Treasury and the IRS believe that income earned by a Tested Foreign Corporation through a partnership should be treated similarly to income earned through a corporate subsidiary. If a Tested Foreign Corporation owns a Look-Through Subsidiary, the Tested Foreign Corporation is treated as if it directly received its proportionate share of the income of the Look-Through Subsidiary, and certain items of income received from the Look-Through Subsidiary are proportionately eliminated.
- (b) If a corporation is not a Look-Through Subsidiary, income received from the corporation is characterized in accordance with the general rules, under which dividends generally will be passive.

Accordingly, the proposed regulations provide that a Tested Foreign Corporation's distributive share of any item of income of a partnership is treated as income received directly by the Tested Foreign Corporation, provided the Tested Foreign Corporation owns, directly or indirectly, at least 25% of the value of the partnership, in which case the partnership is referred to as a "Look-Through Partnership," and income elimination rules similar to those for Look-Through Subsidiaries apply. Prop. Treas. Reg. § 1.1297-1(c)(2)(i).

- (c) If the Tested Foreign Corporation owns less than 25% of the value of a partnership, the corporation's distributive share of any item of income of the partnership is passive income. Prop. Treas. Reg. § 1.1297-1(c)(2)(ii).
- (d) As a result of these rules, in cases in which the Tested Foreign Corporation owns at least 25% of the value of the partnership, the exceptions to passive income contained in § 1297(b)(2) and the relevant exceptions to foreign personal holding company income in § 954(c) and (h) that are based on whether income is derived in the active conduct of a business generally apply if, and only if, the partnership engages in the relevant business activities. The focus on partnership activities is consistent with the principles applicable to partnership interests under the regulations under Subpart F. Treas. Reg. § 1.954-2(a)(5)(ii)(A); Treas. Reg. § 1.954-3(a)(6).
- (e) However, the proposed regulations also include rules that, in certain circumstances, allow the character of income to be determined at the level of the Tested Foreign Corporation, taking into account activities performed by the Tested Foreign Corporation and certain subsidiaries of the Tested Foreign Corporation, whether such subsidiaries are in corporate or partnership form.
- (f) Although the Subpart F regulations provide rules concerning the classification of a CFC's distributive share of partnership income that, absent these proposed regulations, would generally be applicable by virtue of § 1297's adoption of FPHCI as the basis for passive income, Treasury and the IRS believe that the differing policies of the Subpart F and PFIC regimes warrant different rules for partnerships.
- (g) Specifically, Treasury and the IRS believe that it is appropriate to generally characterize a corporation's distributive share of partnership income as passive when the corporation owns less than 25% of the value of the partnership, consistent with the treatment of Look-Through Subsidiary income, notwithstanding the fact that

under the Subpart F regulations, such income could have been excluded from FPHCI by virtue of the partnership's activities regardless of the corporation's level of ownership.

- (h) The preamble states that this different treatment is warranted because of the flexibility that entities have in their characterization for U.S. Federal income tax purposes under Treas. Reg. § 301.7701-3 and because of the fact that treating a subsidiary as a partnership may not have U.S. income tax consequences for a Tested Foreign Corporation, as it could for a CFC. However, Treasury and the IRS requested comments as to whether a 25% threshold for the Tested Foreign Corporation's percentage ownership in the partnership is the appropriate threshold for distinguishing between a distributive share of partnership income that is automatically treated as passive and a distributive share that is characterized in accordance with the activities undertaken by the partnership (or, as applicable under the rules described in the Tested Foreign Corporation and certain subsidiaries of the Tested Foreign Corporation). They ask whether an alternative threshold should be considered.

5. Income from a Related Person.

- (a) Prop. Treas. Reg. § 1.1297-1(c)(3)(iv) provides additional guidance on the application of the § 1297(b)(2)(C) related-person exception to dividends, interest, rents, and royalties. It provides that the determination of whether the payor of an item of income is a related person should be made on the date of receipt or accrual, as applicable based on the recipient's method of accounting, of the item of income.
- (b) Under Treas. Reg. § 1.904-5(c)(2)(ii)(C) (the preamble calls this the "cream-skimming rule"), interest paid to a related person is treated as passive income to the payee to the extent that the payor has passive income. Under this rule, if a foreign corporation had \$200 of passive gross income and \$200 of non-passive gross income, and that foreign corporation made an interest payment of \$100 to a related foreign corporation, for purposes of determining the nature of the interest income in the hands of the payee foreign corporation, the entire \$100 of interest would be treated as passive income rather than as ratably allocable between passive and non-passive income.
- (c) Although Treasury and the IRS considered applying a so-called cream-skimming rule for purposes of § 1297(b)(2)(C), they believe that the PFIC regime does not raise the policy concerns addressed

by the cream-skimming rule in the foreign tax credit and Subpart F contexts.

- (d) Accordingly, under the proposed regulations, for purposes of the § 1297(b)(2)(C) exception, interest is properly allocable to income of the related person that is not passive income based on the relative portion of the related person's income for its taxable year that ends in or with the taxable year of the recipient that is not passive income. Prop. Treas. Reg. § 1.1297-1(c)(3)(i). Under Prop. Treas. Reg. § 1.1297-1(c)(3)(ii), dividends are treated as properly allocable to income of the related person that is not passive income based on the portion of the related payor's current-year earnings and profits for the taxable year that ends in or with the taxable year of the recipient that are attributable to non-passive income.
- (e) The proposed regulations further provide that rents and royalties are allocable to income of the related person which is not passive income to the extent the related person's deduction for the rent or royalty is allocated to non-passive income under the principles of Treas. Reg. §§ 1.861-8 through 1.861-14T. Prop. Treas. Reg. § 1.1297-1(c)(3)(iii).

E. Asset Test.

1. Methodology of Application of Asset Test.

- (a) Section 1297(a)(2) provides that a Tested Foreign Corporation is a PFIC if the average percentage of assets held by the corporation during a taxable year that produce passive income or are held for the production of passive income is at least 50%. Notice 88-22 provided that the average percentage of assets of a Tested Foreign Corporation is calculated by averaging the value of the assets of the corporation, determined as of the end of each quarterly period of the corporation's taxable year.
- (b) The proposed regulations provide that the average percentage of a Tested Foreign Corporation's assets is determined using the average of the gross values (or adjusted bases) at the end of each quarter of the foreign corporation's taxable year. Prop. Treas. Reg. § 1.1297-1(d)(1)(i) and (d)(1)(ii)(A). Alternatively, the assets of a Tested Foreign Corporation can be measured for purposes of the Asset Test more frequently than quarterly (for example, weekly or monthly). The quarter or shorter interval used by a Tested Foreign Corporation is referred to as its "measuring period."

- (c) Applying the Asset Test based on a period that recurs more frequently than a quarter provides a more precise measurement of “average,” but the more frequently recurring basis is not required because of the potential administrative burden that it could impose on a shareholder of a Tested Foreign Corporation. The same measuring period must be used for the Tested Foreign Corporation for the initial year (including a short year) that for which the shareholder elects to use the alternative measuring period and any and all subsequent years unless the election to use the more frequently recurring measuring period is revoked. Prop. Treas. Reg. § 1.1297-1(d)(1)(ii)(B).
- (d) Under Prop. Treas. Reg. § 1.1297-1(d)(1)(ii)(C), if a Tested Foreign Corporation has a short taxable year, the quarterly measuring dates for purposes of the Asset Test are the same as they would be for a full taxable year, except that the final quarterly measuring date will be the final day of the short taxable year. Thus, for instance, if a Tested Foreign Corporation for which the election for a shorter period has not been made has a short year of eight months, the corporation would have two quarters ending on the foreign corporation’s normal quarterly measuring dates and a third quarter ending on the final day of the short taxable year.
- (e) The asset amounts for those three quarterly measuring dates would be averaged to determine the average percentage of a Tested Foreign Corporation’s assets that are passive for the year. Treasury and the IRS believe that applying the Asset Test based on the taxable year quarters that ended during the short year properly accounts for the administrative difficulties of calculating quarterly measurements with respect to a short year.
- (f) Under § 1297(e), the assets of a Tested Foreign Corporation are required to be measured based on (i) value, pursuant to § 1297(e)(1), if it is a publicly traded corporation for the taxable year, or if § 1297(e)(2) does not apply to it for the taxable year; or (ii) adjusted basis, pursuant to § 1297(e)(2), if it is a CFC, or elects the application of § 1297(e)(2). The statute does not specify whether a corporation that is publicly traded during only part of the taxable year is publicly traded “for the taxable year,” and thus whether such a corporation’s assets should be measured for the taxable year based on value or on adjusted basis or whether, if the corporation is a CFC for the remainder of the year, a combination of the two should be used.
- (g) For instance, a Tested Foreign Corporation that is a CFC at the beginning of its taxable year and became publicly traded during the last month of its taxable year could be required under § 1297(e) to

have its assets measured based on either adjusted basis or value for all four quarterly measuring periods or based on adjusted basis for its first three quarterly measuring periods and value for its fourth quarterly measuring period.

- (h) The proposed regulations provide that the Asset Test should apply on the basis of value for the entire year if the corporation was publicly traded on the majority of days during the year or § 1297(e)(2) did not apply to the corporation on the majority of days of the year. Otherwise, the Asset Test should apply on the basis of adjusted basis for the entire year. Prop. Treas. Reg. § 1.1297-1(d)(1)(v). Treasury and the IRS believe that allowing a shareholder the option of choosing either method with respect to a Tested Foreign Corporation could facilitate the avoidance of the PFIC rules, and that the rule in the proposed regulation imposes the least administrative burden.
- (i) Under the proposed regulations, the rules for making or revoking an election for an alternative measuring period also apply for purposes of the election provided in § 1297(e)(2)(B) to use adjusted bases of assets for purposes of the Asset Test. Prop. Treas. Reg. § 1.1297-1(d)(1)(iii)(B) and (d)(1)(iv). Both elections may be made by a U.S. person that is eligible under Treas. Reg. § 1.1295-1(d) regarding the Tested Foreign Corporation or that would be eligible if the Tested Foreign Corporation were a PFIC. Prop. Treas. Reg. § 1.1297-1(d)(1)(iv)(A).
- (j) Thus, in the case of a Tested Foreign Corporation owned by a domestic partnership in which U.S. individuals are partners, only the domestic partnership and not its partners may make the elections, ensuring that the Tested Foreign Corporation is treated consistently for all of the partners, which would facilitate reporting by the partnership if the Tested Foreign Corporation were a PFIC.
- (k) However, Treasury and the IRS requested comments as to whether either election should be available to any U.S. person that is a shareholder (within the meaning of Treas. Reg. § 1.1291-1(b)(7) or (8)) of the Tested Foreign Corporation or that would be a shareholder of the Tested Foreign Corporation if it were a PFIC.
- (l) If the person is required to file the Form 8621 (or successor form) regarding the Tested Foreign Corporation, the elections may be made in the manner provided in the instructions to the Form 8621. Until such instructions are provided, the elections may be made by attaching a written statement to the Form 8621 providing for the election to a return for the year for which the election is made. If the person is not required to file the Form 8621 regarding the

Tested Foreign Corporation (for example, because the Tested Foreign Corporation is not a PFIC), the person may make the elections by attaching a written statement providing for the election to a return for the year for which the election is made.

- (m) The elections are revoked in a similar manner. Prop. Treas. Reg. § 1.1297-1(d)(1)(iv)(B). A new election for an alternative measuring period or under § 1297(e)(2)(B) may not be made until the sixth taxable year following the year for which the previous such election was revoked, and such subsequent election may not be revoked until the sixth taxable year following the year for which the subsequent election was made.

2. Characterization of Dual-Character Assets.

- (a) Pursuant to § 1297(a), an asset is considered passive for purposes of the Asset Test if it produces passive income or is held for the production of passive income. Notice 88-22 stated that an asset that produces both passive income and non-passive income during a Tested Foreign Corporation's taxable year is treated partly as a passive asset and partly as a non-passive asset in proportion to the relative amounts of income generated by the asset during the year. Prop. Treas. Reg. § 1.1297-1(d)(2) generally adopts the rule set forth in Notice 88-22, and provides that an asset that produces both passive income and non-passive income during a taxable year is treated as two assets, one of which is passive and one of which is non-passive.
- (b) Consistent with the rule in Notice 88-22, for purposes of applying the Asset Test, the value (or adjusted basis) of the asset is allocated between the passive assets and non-passive assets based on the ratio of passive income produced by the asset during the taxable year to non-passive income.
- (c) Prop. Treas. Reg. § 1.1297-1(d)(2)(iii) provides a specific rule for stock of a related person with respect to which no dividends are received or accrued, as applicable based on the recipient's method of accounting, during a taxable year but that previously generated dividends that were characterized as non-passive income, in whole or in part, under § 1297(b)(2)(C). The stock is characterized based on the dividends received or accrued, as applicable based on the recipient's method of accounting, with respect thereto for the prior two years.
- (d) Treasury and the IRS believe that it may also be appropriate to bifurcate an asset that in part produces income and in part does not produce income between a passive and a non-passive asset for

purposes of the Asset Test in order to provide a more accurate measure of the Tested Foreign Corporation's passive assets. For example, if a Tested Foreign Corporation uses a portion of a building, which is depreciable real property, in its trade or business that generates non-passive income, while renting a portion of the building in exchange for rents that are treated as passive, it would be appropriate for the portions of the building to be considered separately as non-passive and passive assets, respectively.

- (e) Accordingly, the proposed regulations provide that for purposes of applying the Asset Test, if an asset in part produces income and in part does not produce any income, the asset must be bifurcated pursuant to the method that most reasonably reflects the uses of the property. Prop. Treas. Reg. § 1.1297-1(d)(2)(ii). A similar approach applies to characterize gain for Subpart F purposes. Treas. Reg. § 1.954-2(e)(1)(iv).

3. Characterization of Partnership Interests.

- (a) The proposed regulations provide guidance on the characterization of a partnership interest for purposes of the Asset Test. Treasury and the IRS believe that it is appropriate to treat a partnership in a manner similar to a corporate subsidiary for purposes of determining whether a Tested Foreign Corporation is a PFIC. Accordingly, Prop. Treas. Reg. § 1.1297-1(d)(3)(i) provides that for purposes of the Asset Test, a Tested Foreign Corporation that directly or indirectly owns an interest in a partnership is treated as if it held its proportionate share of the assets of a partnership, provided the Tested Foreign Corporation owns, directly or indirectly, at least 25%, by value, of the interests in the partnership.
- (b) A corporation's proportionate share of a partnership asset is treated as producing passive income, or being held to produce passive income, to the extent the asset produced, or was held to produce, passive income in the partnership's hands, taking into account only the partnership's activities, taking into account activities performed by certain subsidiaries of the Tested Foreign Corporation. If a Tested Foreign corporation owns less than 25% of the value of the partnership, its interest in the partnership is treated as a passive asset. Prop. Treas. Reg. § 1.1297-1(d)(3)(ii).

4. Characterization of Dealer Property.

- (a) For purposes of the Asset Test, an asset is considered passive if it produces passive income or is held for the production of passive income. Under the dealer exception in § 954(c)(2)(C), gain from

the disposition of certain dealer property is treated as non-passive income for purposes of the Income Test. However, certain other income derived with respect to the dealer property (such as dividends and interest) is treated as passive income.

- (b) Treasury and the IRS believe that the exception from passive income for dealer property in § 954(c)(2)(C) is predicated on the fact that a dealer holds the property as part of its trade or business and not for the production of passive income. Accordingly, they have determined that, given that the PFIC regime is concerned with whether the asset is part of an active business, it is appropriate to characterize dealer property for purposes of the Asset Test based solely on the character of the gain derived from the disposition of the property. Accordingly, the proposed regulations provide that property that is subject to the dealer exception is characterized as a non-passive asset for purposes of the Asset Test, notwithstanding the dual-character asset rules. Prop. Treas. Reg. § 1.1297-1(d)(4).

F. Treatment of Stapled Entities.

1. Treasury and the IRS are concerned that, in certain situations, equity interests in two or more foreign entities must be sold together as stapled interests within the meaning of § 269B(c)(3). Stapled entities (as defined in § 269B(c)(2)) may be structured in such a way that income and the assets generating the income are in one entity, while the activities generating the income are engaged in by the other entity. For example, two stapled entities might jointly carry on a real estate business, with one stapled entity owning real property that is leased to third parties to generate rental income, while the other stapled entity provides management services with respect to the real property that, if engaged in by the first stapled entity, would allow the rental income received by it to be characterized as non-passive income pursuant to § 954(c)(2)(A) and these proposed regulations.
2. If the PFIC status of the stapled entity receiving the rental income were determined on a stand-alone basis, the income might be treated as passive income. Given that stapled interests represent a single economic interest to their shareholders, Treasury and the IRS believe that it is appropriate, for purposes of determining whether a stapled entity is a PFIC, to treat them as such. This is consistent with the treatment of stapled entities in § 269B(a)(3) for purposes of determining whether a stapled entity is a regulated investment company (“RIC”) or a real estate investment trust (“REIT”). Accordingly, the proposed regulations provide that for purposes of determining whether any stapled entity is a PFIC, all entities that are stapled entities with respect to each other are treated as one entity. Prop. Treas. Reg. § 1.1297-1(e).

G. Look-Through Rule for 25-Percent-Owned Subsidiaries. In determining PFIC status, § 1297(c) applies when a Tested Foreign Corporation owns, directly or indirectly, at least 25% of the value of the stock of another corporation, a “Look-Through Subsidiary.” In such instance, the Tested Foreign Corporation is treated as if it directly held its proportionate share of the assets and directly received its proportionate share of the income of the Look-Through Subsidiary. The preamble states, § 1297(c) was enacted to prevent “foreign corporations owning the stock of subsidiaries engaged in active businesses [from being] classified as PFICs.”

1. Determining a Tested Foreign Corporation’s Ownership of a Look-Through Subsidiary and Proportionate Share of a Look-Through Subsidiary’s Assets and Income.

- (a) Neither the statute nor the regulations provide guidance on how to calculate a Tested Foreign Corporation’s indirect ownership in another corporation for purposes of determining whether the corporation is a Look-Through Subsidiary under § 1297(c). In addition, the statute and regulations do not provide a methodology for determining a Tested Foreign Corporation’s proportionate share of a Look-Through Subsidiary’s income and assets for purposes of § 1297(c).
- (b) Under § 1297(c), the determination of whether a Tested Foreign Corporation owns, directly or indirectly, at least 25% of the stock of another corporation is based on value. The proposed regulations provide that indirect stock ownership for purposes of § 1297(c) is determined under the principles of § 958(a) applicable for determining ownership by value. Prop. Treas. Reg. § 1.1297-2(b)(1). These principles apply without regard to whether entities are domestic or foreign, and thus indirect ownership includes corporate ownership through intermediate corporations, partnerships, trusts, and estates, regardless of whether such intermediate entities are foreign or domestic. In addition, stock considered owned by reason of applying the § 958(a) indirect ownership rules is generally considered actually owned for purposes of reapplying the indirect ownership rules. Treas. Reg. § 1.958-2(f)(1).
- (c) Section 1297(c) provides that a Tested Foreign Corporation is treated as holding its proportionate share of the assets of the Look-Through Subsidiary, and receiving its proportionate share of the income of the Look-Through Subsidiary. The proposed regulations provide guidance on the meaning of “proportionate share” for purposes of § 1297(c). Specifically, Prop. Treas. Reg. § 1.1297-2(b)(2) provides that a Tested Foreign Corporation is treated as owning a share of each asset, and receiving a proportionate share of each item of income, of a Look-Through

Subsidiary proportionate to the Tested Foreign Corporation's percentage ownership (by value) of the Look-Through Subsidiary.

- (d) Changes in stock ownership may cause fluctuations in a Tested Foreign Corporation's ownership in a Look-Through Subsidiary during a taxable year. For purposes of the Asset Test, ownership of a Look-Through Subsidiary is determined on each measuring date. Prop. Treas. Reg. § 1.1297-2(b)(2)(i). If the requisite 25-percent ownership is not met with respect to a corporation on the last day of a measuring period, the stock of the corporation would be a passive asset for purposes of that measuring period, absent the application of a special rule, such as the new rule for dealer property in Prop. Treas. Reg. § 1.1297-1(d)(4).
- (e) For purposes of the Income Test, a subsidiary is considered a Look-Through Subsidiary if the Tested Foreign Corporation owns an average of 25% of the value of the subsidiary for the year, taking into account its ownership on the last day of each measuring period of the Tested Foreign Corporation's taxable year. Prop. Treas. Reg. § 1.1297-2(b)(2)(ii)(A). If the Tested Foreign Corporation does not maintain, on average, at least 25-percent ownership of the subsidiary for the taxable year, the Tested Foreign Corporation is not, under the general rule in the proposed regulations, treated as receiving its proportionate share of the income of the subsidiary for that year under § 1297(c).
- (f) However, the Tested Foreign Corporation may be treated as receiving directly its proportionate share of the income of the subsidiary for each measuring period in a taxable year for which the 25-percent ownership requirement is met on the relevant measuring date, provided the taxpayer can establish gross income for each of those measuring periods. Prop. Treas. Reg. § 1.1297-2(b)(2)(ii)(B).

2. Overlap Between § 1297(c) and § 1298(b)(7).

- (a) Section 1298(b)(7) provides a special characterization rule that applies when a Tested Foreign Corporation owns at least 25% of the value of the stock of a domestic corporation and is subject to the accumulated earnings tax under § 531 (or waives any benefit under a treaty that would otherwise prevent imposition of such tax). In this instance, § 1298(b)(7) treats the qualified stock held by the domestic corporation as a non-passive asset, and the related income as non-passive income.
- (b) By its terms, the § 1297(c) look-through rule also could apply to the qualified stock, which is stock in a domestic C corporation that

is not a RIC or REIT, and look through to the assets of the corporation that issued the qualified stock for purposes of the Income Test and Asset Test. For example, assume a Tested Foreign Corporation owns 50% of the value of the stock in a domestic corporation, US1, which, in turn, owns 50% of the stock of a lower tier domestic corporation, US2 (which is not a RIC or a REIT). US2 wholly owns the stock of a foreign corporation, FC.

- (c) The § 1297(c) look-through rule applies to treat the Tested Foreign Corporation as if it held its proportionate share of the assets, and received a proportionate share of the income, of US1. Both the § 1297(c) look-through rule and the § 1298(b)(7) characterization rule, by their terms, would apply to the stock of US2. The § 1297(c) rule would look through to the assets of US2 and FC. The § 1298(b)(7) characterization rule would treat the stock of US2 as a non-passive asset, and the income derived from the stock as income as non-passive income.
- (d) Treasury and the IRS believe that the special characterization rule of § 1298(b)(7) should generally take precedence over the § 1297(c) look-through rule when both rules would apply simultaneously because the characterization rule of § 1298(b)(7) is the more specific rule where the Tested Foreign Corporation owns a domestic corporation. Thus, the proposed regulations provide that the look-through rule of § 1297(c) does not apply to a domestic corporation, and any subsidiaries of the domestic corporation, if the stock of the domestic corporation is characterized, under § 1298(b)(7), as a non-passive asset producing non-passive income. Prop. Treas. Reg. § 1.1297-2(b)(2)(iii). However, these proposed regulations provide certain limitations on the application of § 1298(b)(7), including a new anti-abuse rule, in which case § 1297(c) would apply.

3. Elimination of Certain Assets and Income for Purposes of Applying § 1297(a).

- (a) Section 1297(c) aggregates the income and assets of a Tested Foreign Corporation and a Look-Through Subsidiary for purposes of testing the PFIC status of the Tested Foreign Corporation. However, there are no statutory or regulatory rules that prevent the double counting of income and assets arising from contracts and other transactions among a Tested Foreign Corporation and one or more Look-Through Subsidiaries.
- (b) Intercompany items that are not eliminated for purposes of determining a Tested Foreign Corporation's PFIC status may result in a duplication of passive income or passive assets attributed to

the Tested Foreign Corporation. For instance, if a wholly-owned Look-Through Subsidiary earned \$100x of passive income during a taxable year, and distributed the \$100x as a dividend to a Tested Foreign Corporation, the Tested Foreign Corporation would have a total of \$200x of passive income (\$100x of passive income under § 1297(c) and a \$100x dividend) for purposes of the Income Test, even though only \$100 of passive income was earned economically. Any double-counting of intercompany income and assets distorts the effect of § 1297(c) on the Income Test and Asset Test.

- (c) The legislative history of the PFIC rules provides an approach that would eliminate certain assets and income in order to prevent double-counting. Treasury and the IRS believe that it is appropriate to follow that approach. Thus, the proposed regulations provide that intercompany payments of dividends and interest between a Look-Through Subsidiary and the Tested Foreign Corporation and stock and debt receivables are eliminated in applying the Income Test and the Asset Test. Prop. Treas. Reg. § 1.1297-2(c)(1) and (2).
- (d) In the case of dividends, in order to qualify for elimination, the payment must be attributable to income of a Look-Through Subsidiary that was included in gross income by the Tested Foreign Corporation for purposes of determining its PFIC status. Prop. Treas. Reg. § 1.1297-2(c)(2). Thus, dividends attributable to income of the Look-Through Subsidiary earned in a year before the Tested Foreign Corporation owned, on average, at least 25% by value of the Look-Through Subsidiary would generally not qualify for elimination.
- (e) As a result of the elimination rule, for example, interest and dividends received by a Tested Foreign Corporation from a wholly owned Look-Through Subsidiary are eliminated from the Tested Foreign Corporation's gross income for purposes of applying § 1297(a)(1), except to the extent that dividend amounts are attributable to income that has not been treated as received directly by the Tested Foreign Corporation under the § 1297(c) look-through rule.
- (f) Additionally, the proposed regulations extend this treatment to intercompany payments between two Look-Through Subsidiaries of a Tested Foreign Corporation and the associated stock and debt receivables. Similarly, stock and debt investments in a lower-tier Look-Through Subsidiary are eliminated for purposes of applying the Income Test and Asset Test to the Tested Foreign Corporation.

- (g) In the case of a Tested Foreign Corporation that owns less than 100% of a Look-Through Subsidiary, the proposed regulations provide that while stock and dividends are eliminated in their entirety, eliminations of debt receivables and interest are made in proportion to the shareholder's direct and indirect ownership (by value) in the Look-Through Subsidiary. The proposed regulations also provide for eliminations under these principles for ownership interests in a Look-Through Partnership, as well as intercompany debt receivables and interest paid or accrued thereon between a Tested Foreign Corporation and a Look-Through Partnership. Prop. Treas. Reg. § 1.1297-2(c)(3).

4. Section 1297(b)(2)(C) Related Person Determination Regarding Interest, Dividends, Rents, and Royalties Received by Look-Through Subsidiaries and Certain Partnerships.

- (a) Section 1297(c) provides that a Tested Foreign Corporation is treated as receiving directly its proportionate share of the income of a Look-Through Subsidiary for purposes of applying the Income Test to the Tested Foreign Corporation. Section 1297(b)(2)(C) provides that, for purposes of the Income Test, passive income does not include interest, dividends, rents or royalties received or accrued from a related person (within the meaning of § 954(d)(3)) to the extent such amount is properly allocable to income of the related person that is not passive income.
- (b) The statute and current regulations do not address the level at which the "related person" determination is made if a Look-Through Subsidiary receives or accrues an item of income that is treated as directly received by a Tested Foreign Corporation pursuant to § 1297(c). Thus, the interaction and application of the two rules is unclear in cases in which the payor of an item of income is a "related person" with respect to either the Look-Through Subsidiary or the Tested Foreign Corporation, but not with respect to both.
- (c) Treasury and the IRS believe that, because § 1297(c) generally applies by classifying an item at the level of Look-Through Subsidiary and then carrying that classification up to the Tested Foreign Corporation, it is appropriate to determine whether the § 1297(b)(2)(C) exception applies (and, thus, determine the passive or non-passive character of an item of income) at the Look-Through Subsidiary level, and then flow up the passive or non-passive character of the item to the Tested Foreign Corporation for purposes of applying the Income Test.

- (d) Accordingly, Prop. Treas. Reg. § 1.1297-2(d)(1) provides that, in applying § 1297(b)(2)(C), “related person” status is tested with respect to the payor of the item of income and the Look-Through Subsidiary. The same rule applies for items of income received by a partnership and treated as received directly by a Tested Foreign Corporation pursuant to Prop. Treas. Reg. § 1.1297-1(c)(2).

5. Attribution of Activities of a Look-Through Subsidiary and Certain Partnerships.

- (a) The interaction of § 1297(c) and certain exceptions from passive income also raises issues that require a threshold determination of whether an exception should apply at a Look-Through Subsidiary level or a Tested Foreign Corporation level. For instance, under Prop. Treas. Reg. § 1.1296-4 (April 28, 1995), the banking exception in § 1297(b)(2)(A) applies only if a number of requirements are satisfied, including a deposit taking requirement, a lending requirement, and a license requirement.
- (b) In a bank holding company structure, in which a Tested Foreign Corporation wholly owns a Look-Through Subsidiary that separately satisfies the § 1297(b)(2)(A) requirements, the banking exception would apply to the income derived by the Look-Through Subsidiary in its banking business if an approach that applied the exception at the Look-Through Subsidiary level were adopted, but would not apply if an approach that applied the exception at the Tested Foreign Corporation level were adopted because the Tested Foreign Corporation would not literally meet all of the banking exception requirements.
- (c) Similarly, the character of assets held by a Look-Through Subsidiary that is a dealer in property in the ordinary course of its trade or business as a dealer would depend on whether an approach that applied the exception in § 954(c)(2)(C) at the Look-Through Subsidiary level were adopted, or whether an approach were applied that determined the character at the level of a Tested Foreign Corporation that was not itself a dealer.
- (d) A corollary issue arises regarding the application of other exceptions to passive income under § 954(c). For instance, under Treas. Reg. § 1.954-2(c)(1)(ii), the active rental income exception in § 954(c)(2)(A) applies if certain activities are performed with respect to real property by the lessor’s own employees. In a structure in which a Tested Foreign Corporation holds real estate assets directly and employees of its Look-Through Subsidiary conduct the activities related to the Tested Foreign Corporation’s real estate business necessary to satisfy the exception, the

exception would apply if the character of the income were determined at the level of the Tested Foreign Corporation and the activities of the managers and employees of the Look-Through Subsidiary were attributed to the Tested Foreign Corporation.

- (e) However, the exception would not apply if the activities were not attributed to the Tested Foreign Corporation, because in such case the relevant activities are not performed by employees of the Tested Foreign Corporation, as literally required in the regulation. Additional complexities arise when the Tested Foreign Corporation owns less than 100% of the Look-Through Subsidiary.
- (f) Under current law, the character of income or assets is determined at the level of the entity that directly earns the income or holds the assets based on the activities of that entity. However, Treasury and the IRS believe that active businesses in foreign jurisdictions generating rent and royalty income are often organized with assets and income, on the one hand, and activities, on the other hand, contained in separate entities for various business reasons.
- (g) They believe that if assets are held and activities undertaken in separate entities within a group of wholly-owned Look-Through Subsidiaries headed by a Tested Foreign Corporation, the activities of the Look-Through Subsidiaries should be taken into account for purposes of determining whether an item of rent or royalty income of the Tested Foreign Corporation is passive income, as they would if the Look-Through Subsidiaries were disregarded as separate from the Tested Foreign Corporation for U.S. Federal income tax purposes.
- (h) Accordingly, the proposed regulations provide that an item of rent or royalty income received or accrued by a Tested Foreign Corporation (or treated as received or accrued by the Tested Foreign Corporation pursuant to § 1297(c)) that would otherwise be passive income under the general rule is not passive income for purposes of § 1297 if the item would be excluded from passive income, determined by taking into account the activities performed by the officers and employees of the Tested Foreign Corporation as well as activities performed by the officers and employees of certain Look-Through Subsidiaries and certain partnerships in which the Tested Foreign Corporation or one of the Look-Through Subsidiaries is a partner. Prop. Treas. Reg. § 1.1297-2(e)(1).
- (i) In some cases, a Look-Through Subsidiary or Look-Through Partnership may have more than one unrelated owner owning at least 25% of the entity's value. Activities, unlike income or expense, are qualitative in nature and cannot be easily allocated

between owners based on their percentage ownership. If activities are attributed to any owner of 25% or more of the Look-Through Subsidiary or partnership, then up to four owners could potentially be able to take into account the same activities.

- (j) Because it may be difficult to allocate activities among multiple entities but inappropriate to allow double-counting of the activities by attributing the activities of a Look-Through Subsidiary or a partnership to multiple unrelated entities, the proposed regulations provide that a Tested Foreign Corporation may take into account the activities performed only by those Look-Through Subsidiaries or partnerships with respect to which the Tested Foreign Corporation owns (directly or indirectly) more than 50% of the value, because at this level of ownership the activities of the Look-Through Subsidiary or Look-Through Partnership could be attributed to only another foreign corporation within the same chain of ownership as the Tested Foreign Corporation and not an unrelated entity.

6. Gain on the Disposition of Stock of a Look-Through Subsidiary.

- (a) Section 1297(c) does not address the treatment of a Tested Foreign Corporation's gain from the disposition of stock of a Look-Through Subsidiary for purposes of the Income Test. Questions have been raised as to whether such a disposition should be treated as a disposition of stock or a deemed disposition of the assets of the Look-Through Subsidiary, and how gain on the disposition should be characterized for purposes of the Income Test.
- (b) The proposed regulations provide that, for purposes of the Income Test, the disposition of a Look-Through Subsidiary is treated as the disposition of stock, and gain is computed accordingly. However, they limit the amount of the gain taken into account for purposes of the Income Test in order to avoid double-counting any income that the Tested Foreign Corporation takes into account under § 1297(c) in determining the PFIC status of the Tested Foreign Corporation during the year of the disposition or took into account for such purpose in a prior year that has not been distributed as a dividend to the Tested Foreign Corporation.
- (c) Thus, the amount of gain taken into account for purposes of the Income Test ("Residual Gain") requiring first calculating the total gain recognized by the Tested Foreign Corporation on the disposition. This amount is reduced (but not below zero) by the amount (if any) a calculated amount. This amount is the aggregate income (if any) of the Look-Through Subsidiary (and any other Look-Through Subsidiary, to the extent stock in such other Look-

Through Subsidiary is owned indirectly through the Look-Through Subsidiary) taken into account by the Tested Foreign Corporation under § 1297(c)(2) regarding the disposed Look-Through Subsidiary stock minus the aggregate dividends (if any) received by the Tested Foreign Corporation from the Look-Through Subsidiary with respect to the disposed stock (including dividends attributable to stock of any other Look-Through Subsidiary owned indirectly through the Look-Through Subsidiary).

- (d) Under Prop. Treas. Reg. § 1.1297-2(f)(1), the Residual Gain is computed on a share-by-share basis regarding income of a Look-Through Subsidiary that was taken into account by the Tested Foreign Corporation and dividends received from a Look-Through Subsidiary.
- (e) Gain from the disposition of stock generally is treated as FPHCI under § 954(c)(1)(B)(i). However, § 954(c) does not contain a look-through rule comparable to § 1297(c). In order to comport with the policy underlying § 1297(c), Treasury and the IRS believe that the character of the gain from the disposition of a Look-Through Subsidiary should correspond to the character of the underlying assets of the Look-Through Subsidiary.
- (f) Accordingly, Prop. Treas. Reg. § 1.1297-2(f)(2) provides that the Residual Gain taken into account by the Tested Foreign Corporation will be characterized as passive income or non-passive income in proportion to the passive assets and non-passive assets of the disposed-of Look-Through Subsidiary (and any other Look-Through Subsidiary, to the extent owned indirectly through the Look-Through Subsidiary) treated as held by the Tested Foreign Corporation pursuant to § 1297(c) on the date of the disposition, measured using the method (value or adjusted bases) that is used to measure the assets of the Tested Foreign Corporation for purposes of the Asset Test.
- (g) Pursuant to Prop. Treas. Reg. § 1.1297-1(c)(1)(i)(C), § 954(c)(4) applies regarding the disposition of interests in a Look-Through Partnership.

H. Change-of-Business Exception (Including Dispositions of Stock of a Look-Through Subsidiary).

- 1. Section 1298(b)(3) provides an exception from PFIC status (the “Change-of-Business Exception”) for a Tested Foreign Corporation that is “in transition from one active business to another active business.” Under § 1298(b)(3), the Change-of-Business Exception applies for a taxable year of the Tested Foreign Corporation if (i) neither the Tested Foreign

Corporation nor a predecessor of the Tested Foreign Corporation was a PFIC in a prior taxable year; (ii) it is established to the satisfaction of the IRS that (A) substantially all of the passive income of the Tested Foreign Corporation for the taxable year is attributable to proceeds from the disposition of one or more active trades or businesses, and (B) the Tested Foreign Corporation will not be a PFIC for either of the two taxable years following such taxable year; and (iii) the Tested Foreign Corporation is not, in fact, a PFIC for either of such two taxable years.

2. Thus, notwithstanding the legislative history and the title of § 1298(b)(3), a Tested Foreign Corporation may qualify for the Change-of-Business Exception even if it does not engage in an active business after a disposition.
3. The proposed regulations provide general guidance with respect to the Change-of-Business Exception. First, they provide that for purposes of § 1298(b)(3)(B), the existence of an active trade or business and the determination of whether assets are used in an active trade or business is determined by reference to Treas. Reg. § 1.367(a)-2(d)(2), (3), and (5), except that officers and employees do not include the officers and employees of related entities as provided in Treas. Reg. § 1.367(a)-2(d)(3). Prop. Treas. Reg. § 1.1298-2(c)(3).
4. If, however, the activity attribution rules would apply to cause the activities of another entity to be taken into account, they are taken into account for purposes of determining the applicability of the Change-of-Business Exception. In addition, the proposed regulations provide that income attributable to proceeds from the disposition of an active trade or business means income earned on investment of such proceeds but does not include the proceeds themselves. Prop. Treas. Reg. § 1.1298-2(c)(1). The regulations also provide that § 1298(b)(3) may apply to either a taxable year of the disposition of the active trade or business or the immediately succeeding taxable year, but in any event may apply to only one year with respect to a disposition. Prop. Treas. Reg. § 1.1298-2(e).
5. Thus, a Tested Foreign Corporation that receives proceeds from a disposition in more than one taxable year may apply the Change-of-Business Exception to only one year. A Tested Foreign Corporation can choose which year it applies the Change-of-Business Exception if the exception can apply in more than one year.
6. Several comments inquired regarding the application of the Change-of-Business Exception to the sale or exchange of stock of a Look-Through Subsidiary that conducts an active trade or business. They questioned whether, by reason of § 1297(c), the Tested Foreign Corporation should be treated as disposing of an active trade or business conducted by a Look-Through Subsidiary for purposes of the Change-of-Business Exception.

7. Treasury and the IRS believe that, given that § 1297(c) applies “for purposes of determining whether [a] foreign corporation is a [PFIC],” the Change-of-Business Exception should, in appropriate circumstances, apply to a Tested Foreign Corporation’s disposition of its interest in a Look-Through Subsidiary that is engaged in an active trade or business. Thus, Prop. Treas. Reg. § 1.1298-2(d) provides that, for purposes of the Change-of-Business Exception, a disposition of stock of a Look-Through Subsidiary is treated as a disposition of a proportionate share of the assets held by the Look-Through Subsidiary on the date of the disposition.
8. Therefore, the portion of the proceeds attributable to assets used by a Look-Through Subsidiary in an active trade or business is considered for purposes of the Change-of-Business Exception to be proceeds from the disposition of an active trade or business.
9. Treasury and the IRS believe that Tested Foreign Corporations might not be able to satisfy the requirements of the Change-of-Business Exception provided in § 1298(b)(3) in certain situations in which proceeds from the disposition of an active trade or business cause the Tested Foreign Corporation to qualify as a PFIC pursuant to the Asset Test. They believe that if a Tested Foreign Corporation has historically engaged in an active trade or business and proceeds from the disposition of such business cause it to qualify as a PFIC, it may be appropriate in certain circumstances to which § 1298(b)(3) does not apply to treat the Tested Foreign Corporation as not a PFIC.
10. Accordingly, Prop. Treas. Reg. § 1.1298-2(b)(2)(ii) expands the Change-of-Business Exception in § 1298(b)(3) to apply if, on the measuring dates that occur during the taxable year to which the Change-of-Business Exception is proposed to apply and after the disposition, on average, substantially all of the passive assets of a corporation are attributable to proceeds from the disposition of one or more active trades or businesses.
11. Treasury and the IRS also believe that in certain circumstances, the Change-of-Business Exception could apply to the liquidation of a Tested Foreign Corporation if it were not for the fact that foreign law restrictions make it difficult to complete the liquidation within the year for which the exception applies. They believe that it is appropriate to allow the Change-of-Business Exception to be relied upon when such a liquidation is completed within a reasonable period of time after the disposition.
12. Accordingly, in the case of a corporation, substantially all of the passive assets of which are attributable to proceeds from the disposition of one or more active trades or businesses, Prop. Treas. Reg. § 1.1298-2(c)(4) provides that a Tested Foreign Corporation will be deemed to satisfy the requirement that the Tested Foreign Corporation not be a PFIC for the two years following the year for which it relies on the Change-of-Business

Exception if it completely liquidates by the end of the year following the year for which it relies on the Change-of-Business Exception. U.S. Federal income tax principles apply to determine whether a Tested Foreign Corporation has completely liquidated.

I. Domestic Subsidiary Stock Rule.

1. Section 1298(b)(7) provides a special characterization rule that applies if a Tested Foreign Corporation owns at least 25% of the value of the stock of a domestic corporation and is subject to the accumulated earnings tax under § 531 (or waives any benefit under a treaty that would otherwise prevent imposition of such tax). The proposed regulations clarify that stock of the 25-percent-owned domestic corporation and the qualified stock generally must be owned by the Tested Foreign Corporation and the 25-percent-owned domestic corporation, respectively, either directly or indirectly through one or more partnerships. Prop. Treas. Reg. § 1.1298-4(b)(1) and (c).
2. Treasury and the IRS believe that the accumulated earnings tax need not actually be imposed on a foreign corporation in a taxable year in order for it to qualify for § 1298(b)(7). Furthermore, a Tested Foreign Corporation's ability to rely on § 1298(b)(7) in a given year should not depend on whether it has U.S. source income in that year, as it would if § 1.532-1(c) applied to determine whether the Tested Foreign Corporation was subject to tax under § 531.
3. Accordingly, Prop. Treas. Reg. § 1.1298-4(d)(1) provides that a Tested Foreign Corporation is considered subject to the tax imposed by § 531 for purposes of § 1298(b)(7) regardless of whether the tax actually is imposed on the corporation and regardless of whether the requirements of § 1.532-1(c) are met.
4. Comments raised questions concerning the waiver of treaty benefits that would prevent imposition of the accumulated earnings tax. The proposed regulations provide that a Tested Foreign Corporation must waive any benefit under a treaty by attaching to its U.S. Federal income tax return for the taxable year for which it applies § 1298(b)(7) a statement that it irrevocably waives treaty protection against the imposition of the accumulated earnings tax, effective for all prior, current, and future taxable years. Prop. Treas. Reg. § 1.1298-4(d)(2)(i).
5. If a Tested Foreign Corporation is not otherwise required to file a U.S. Federal income tax return, the waiver can be made in a resolution (or other governance document) to be kept in the entity's records or, in the case of a publicly traded corporation, in a statement in the corporation's public filings. Prop. Treas. Reg. § 1.1298-4(d)(2)(ii).

6. Treasury and the IRS believe that foreign corporations may be relying on § 1298(b)(7) to avoid being treated as PFICs notwithstanding their direct and indirect ownership of predominantly passive assets by ensuring that a sufficient amount of such assets are held indirectly through two tiers of domestic subsidiaries. For example, a Tested Foreign Corporation might hold stock of another foreign corporation that is PFIC, but rely on a two-tiered domestic chain holding passive assets to avoid being treated as a PFIC; as a result, a U.S. person holding stock of the Tested Foreign Corporation would generally not be treated as a shareholder of the PFIC stock owned by the Tested Foreign Corporation.
7. Accordingly, the proposed regulations provide that, notwithstanding the general coordination rule between § 1297(c) and § 1298(b)(7) in Prop. Treas. Reg. § 1.1297-2(b)(2)(iii), § 1298(b)(7) does not apply for purposes of determining if a foreign corporation is a PFIC for purposes of the ownership attribution rules in § 1298(a)(2) and Treas. Reg. § 1.1291-1(b)(8)(ii). Prop. Treas. Reg. § 1.1298-4(e).
8. Thus, if a Tested Foreign Corporation would qualify as a PFIC if § 1298(b)(7) did not apply, either because § 1297(c) applied to treat the Tested Foreign Corporation as owning directly the assets of a domestic corporation in which it indirectly held qualified stock, or because the qualified stock was treated as a passive asset, then persons that held stock of a PFIC through the Tested Foreign Corporation would be considered under § 1298(a)(2)(B) and Treas. Reg. § 1.1291-1(b)(8)(ii)(B) to own a proportionate amount (by value) of the stock of the PFIC regardless of the level of their ownership interest in the Tested Foreign Corporation.
9. To address the possibility of passive assets – particularly non-stock assets that could not themselves be eligible for the special treatment of § 1298(b)(7) – being held through a two-tiered chain of domestic subsidiaries in order to avoid the PFIC rules, the proposed regulations further provide anti-abuse rules under the authority of § 1298(g), one of which provides that § 1298(b)(7) will not apply if the Tested Foreign Corporation would be a PFIC if the qualified stock or any income received or accrued with respect thereto were disregarded. Prop. Treas. Reg. § 1.1298-4(f)(1).
10. Furthermore, under a second anti-abuse rule, § 1298(b)(7) will not apply if a principal purpose for the Tested Foreign Corporation's formation or acquisition of the 25-percent-owned domestic corporation is to avoid classification of the Tested Foreign Corporation as a PFIC. A principal purpose will be deemed to exist if the 25-percent-owned domestic corporation is not engaged in an active trade or business in the U.S. Prop. Treas. Reg. § 1.1298-4(f)(2).

- J. PFIC Insurance Exception Rules. The proposed regulations provide guidance regarding whether the income of a foreign corporation is excluded from passive income pursuant to § 1297(b)(2)(B) because the income is derived in the active conduct of an insurance business by a QIC.
- K. QIC Status Requirement. Generally, § 1297(f) provides that a QIC is a foreign corporation that (1) would be subject to tax under subchapter L if it were a domestic corporation and (2) has applicable insurance liabilities that constitute more than 25% of its total assets. Prop. Treas. Reg. § 1.1297-4 provides guidance regarding the requirements under § 1297(f)(1) that a foreign corporation must satisfy to qualify as a QIC.
1. Insurance Company Requirement. Prop. Treas. Reg. § 1.1297-4(b)(1) provides guidance regarding when a foreign corporation would be the type of corporation that would be taxable under subchapter L (that is, an insurance company) if the corporation were a domestic corporation. *See* § 1297(f)(1)(A). It provides that a foreign corporation would be subject to tax under subchapter L if it were a domestic corporation if it is an insurance company as defined in § 816(a) (generally requiring more than half of the corporation’s business during the taxable year to be the issuing of insurance or annuity contracts, or the reinsuring of risks underwritten by insurance companies).
 2. 25% Test. In addition to the insurance company requirement, generally a foreign corporation’s “applicable insurance liabilities” (defined in § 1297(f)(3)(A) and proposed § 1.1297-4(f)(2)) must exceed 25% of its “total assets” (defined in Prop. Treas. Reg. § 1.1297-4(f)(7) to be a QIC. Section 1297(f)(1)(B); Prop. Treas. Reg. § 1.1297-4(c). This determination is made on the basis of the foreign corporation’s liabilities and assets as reported on the corporation’s applicable financial statement for the last year ending with or within the taxable year. This test hereinafter is referred to as the “25% test.” Prop. Treas. Reg. § 1.1297-4(c) provides guidance regarding the application of the 25% test.
 3. Alternative Facts and Circumstance Test. If a foreign corporation fails the 25% test, § 1297(f)(2) permits a U.S. person to elect to treat stock in the corporation as stock of a QIC under certain circumstances. Specifically, to make the election, the foreign corporation must be predominantly engaged in an insurance business, and its applicable insurance liabilities must constitute 10% or more of its total assets, hereinafter the “10% test.” A U.S. person may only make this election if the foreign corporation fails the 25% test solely due to runoff-related or rating-related circumstances involving its insurance business.

4. Predominantly Engaged in an Insurance Business.

- (a) Prop. Treas. Reg. § 1.1297-4(d)(2) provides guidance regarding the circumstances under which a foreign corporation is predominantly engaged in an insurance business. In the case of a foreign corporation that fails the 25-percent test, Congress included the predominantly engaged requirement as part of the alternative facts and circumstances test to ascertain whether a foreign corporation is truly engaged in an insurance business despite the low ratio of applicable insurance liabilities to assets.
- (b) The proposed regulations clarify that each relevant factor is intended to be tested based on whether the particular facts and circumstances of the foreign corporation are comparable to commercial insurance arrangements providing similar lines of coverage to unrelated parties in arm's length transactions.
- (c) To qualify as an insurance company, more than one half of a corporation's business must be the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. See §§ 816(a) and 831(c). Although such a corporation might otherwise be considered to be "predominantly engaged" in an insurance business (where predominantly means "for the most part"), the predominantly engaged requirement of the alternative facts and circumstances test in § 1297(f) is separate from, and in addition to, the requirement that a corporation would be subject to tax under subchapter L if the foreign corporation were a domestic corporation.
- (d) Therefore, in order to give effect to this predominantly engaged requirement, Prop. Treas. Reg. § 1.1297-4(d)(2) incorporates the specific factors enumerated in the legislative history as a part of a foreign corporation's analysis of whether it is predominantly engaged in an insurance business under the alternative facts and circumstances test, while retaining the requirement that "more than half" of the business be of a certain type, because the foreign corporation must separately satisfy that threshold with respect to the character of its insurance business under § 1297(f)(1)(A).

5. Runoff-Related or Rating-Related Circumstances.

- (a) To qualify for the alternative facts and circumstances test, Prop. Treas. Reg. § 1.1297-4(d)(3) and (4) clarify the circumstances under which a foreign corporation fails to satisfy the 25% test solely due to runoff-related or rating-related circumstances involving its insurance business.

- (b) Prop. Treas. Reg. § 1.1297-4(d)(3) provides that runoff-related circumstances occur when a corporation has adopted a plan of liquidation or termination of operations under the supervision of its applicable insurance regulatory body. Additionally, the corporation may not issue or enter into any new insurance, annuity, or reinsurance contracts during the taxable year (other than contractually obligated renewals of existing insurance contracts or reinsurance contracts pursuant to and consistent with the corporation's plan of liquidation or termination of operations) and must make payments during the annual reporting period covered by the applicable financial statement to satisfy the claims under insurance, annuity, or reinsurance contracts issued or entered into before the corporation ceased entering into new business.
- (c) Prop. Treas. Reg. § 1.1297-4(d)(4) provides that rating-related circumstances occur when a generally recognized credit rating agency requires a foreign corporation to maintain a surplus of capital to receive or maintain a minimum credit rating for the foreign corporation to be classified as secure to write new insurance business for the current year. Treasury and the IRS believe that it is possible that the minimum credit rating required to be classified as secure to write new insurance business may be higher for some lines of insurance business than for other lines of insurance business. For this purpose, the proposed rule is intended to apply to the highest minimum credit rating required to be classified as secure to write new insurance business for any line of insurance business.
- (d) Treasury and the IRS also believe that there may be certain lines of insurance business, such as financial guaranty insurance, where market realities require a credit rating in excess of the minimum credit rating for a foreign corporation to be classified as secure to write new insurance business in the relevant business line for the current year.

6. Election to Apply the Alternative Facts and Circumstances Test.

- (a) Prop. Treas. Reg. § 1.1297-4(d)(5)(i) generally requires that the foreign corporation with respect to which the election is made directly provide the U.S. person a statement or make a publicly available statement (such as in a public filing, disclosure statement, or other notice provided to U.S. persons that are shareholders of the foreign corporation) that it satisfied the requirements of § 1297(f)(2) and § 1.1297-4(d)(1) during the foreign corporation's taxable year and certain information relevant to that statement. A U.S. person, however, may not rely upon any statement by the foreign corporation to make the election under § 1297(f)(2) if the

shareholder knows or has reason to know that the statement made by the foreign corporation was incorrect.

- (b) Because the foreign corporation possesses the information necessary to make an election under the alternative facts and circumstances test, Treasury and the IRS believe that it is appropriate to require a U.S. person to obtain that information from the foreign corporation in order to make the election.
- (c) Prop. Treas. Reg. § 1.1297-4(d)(5)(iii) describes the time and manner for making the election. To make the election before final regulations are published, a U.S. person that owns stock of a foreign corporation electing to treat that stock as stock of a QIC under the alternative facts and circumstances test must file a limited-information Form 8621 (or successor form). For this purpose, a U.S. person must file a Form 8621 with the box checked regarding the QIC election and must provide the identifying information of the shareholder and the foreign corporation. The U.S. person is not required to complete any other part of Form 8621 if that person is only filing the Form 8621 to make the QIC election under the alternative facts and circumstances test.

7. Limitations on the Amount of Applicable Insurance Liabilities.

- (a) When applying the 25% test to a foreign corporation, § 1297(f)(3)(B) provides that the amount of the foreign corporation's applicable insurance liabilities cannot exceed the lesser of (i) the amount that the foreign corporation reported to its "applicable insurance regulatory body" (defined in § 1297(f)(4)(B) and Prop. Treas. Reg. § 1.1297-4(f)(3)), (ii) the amount required by applicable law or regulation, or (iii) the amount determined under regulations prescribed by Treasury and the IRS.
- (b) Prop. Treas. Reg. § 1.1297-4(e) provides additional guidance regarding the limitation on the amount of applicable insurance liabilities for purposes of the 25% test and the 10% test. Specifically, the proposed regulations provide that the amount of applicable insurance liabilities may not exceed the lesser of (1) the amount shown on the most recent applicable financial statement; (2) the minimum amount required by applicable law or regulation of the jurisdiction of the applicable insurance regulatory body; and (3) the amount shown on the most recent financial statement made on the basis of U.S. generally accepted accounting principles ("US GAAP") or international financial reporting standards ("IFRS") if such financial statement was not prepared for financial reporting purposes.

- (c) Treasury and the IRS believe that the additional limitations are necessary to clarify which financial statements are used to apply the 25% test and the 10% test, and that it is appropriate to limit the amount of applicable insurance liabilities to the minimum amount of liabilities required to be reported by an insurance regulator, even if the foreign corporation's regulator would accept a higher liability amount for regulatory purposes. In addition, under § 1297(f)(4), an applicable financial statement only includes financial statements made on the basis of US GAAP or IFRS if such a statement has been prepared for financial reporting purposes.
- (d) If a foreign corporation prepares a financial statement on the basis of US GAAP or IFRS for a purpose other than financial reporting, Treasury and the IRS believe that the amount of applicable insurance liabilities under this financial statement, if lower than the amount on the applicable financial statement, is an appropriate limit on the amount of applicable insurance liabilities. They stated that this limitation is appropriate because Congress has expressed a preference for widely used standards of financial accounting through its references to such standards in § 1297(f)(4)(A).
- (e) Under the proposed regulations, a special rule applies with respect to applicable financial statements that are neither prepared under US GAAP nor IFRS. To the extent that such an applicable financial statement does not discount losses on an economically reasonable basis, the foreign corporation must reduce its applicable insurance liabilities to reflect discounting that would apply under either US GAAP or IFRS. Treasury and the IRS believe that a method of determining insurance liabilities that fails to provide for a reasonable discounting rate does not take into account a factor that is necessary to appropriately and accurately report the amount of applicable insurance liabilities. For this purpose, the question of whether losses are discounted on an economically reasonable basis is determined under the relevant facts and circumstances. However, in order for losses to be discounted on an economically reasonable basis, discounting must be based on loss and claim payment patterns for either the foreign corporation or insurance companies in similar lines of insurance business.
- (f) In addition, a discount rate based on these loss and claim payment patterns of at least the risk free rate in U.S. dollars or in a foreign currency in which the foreign corporation conducts some or all of its insurance business must be used. A loss discounting methodology consistent with that used for US GAAP or IFRS purposes is considered reasonable for this purpose.

- (g) Finally, a special rule applies for certain foreign corporations that change their method of preparing their applicable financial statement by ceasing to prepare this statement under either US GAAP or IFRS and have no non-Federal tax business purpose for preparing a statement that is not consistent with US GAAP or IFRS. Under the proposed regulations, absent a non-Federal Tax business purpose, a foreign corporation must continue to prepare its applicable financial statement under either US GAAP or IFRS.
- (h) If the foreign corporation fails to do so, the foreign corporation will be treated as having no applicable insurance liabilities for purposes of the QIC test. Absent this proposed rule, Treasury and the IRS expressed a concern that a foreign corporation might change its method for preparing its financial statement to benefit from certain elements of a local regulatory accounting regime, such as a more expansive definition of insurance liability or a method of calculating a larger amount of insurance liabilities, solely for purposes of qualifying as a QIC.

- 8. Insurance Business. For purposes of the PFIC insurance exception, Prop. Treas. Reg. § 1.1297-5(c)(2) defines an insurance business as the business of issuing insurance and annuity contracts or reinsuring risks underwritten by other insurance companies (or both). Under the proposed regulations, an insurance business also includes the investment activities and administrative services required to support (or that are substantially related to) those insurance, annuity, or reinsurance contracts issued or entered into by the QIC. Prop. Treas. Reg. § 1.1297-5(h)(2) provides that investment activities are any activities that generate income from assets that a QIC holds to meet its obligations under insurance and annuity contracts issued or reinsured by the QIC.

L. Active Conduct.

- 1. To give effect to the active conduct requirement, the 2015 proposed regulations differentiated between activities performed by a corporation through its officers and employees and activities performed by other persons (for example, employees of other entities or independent contractors) for the corporation. The 2015 proposed regulations accomplished this separation by defining the term “active conduct” in § 1297(b)(2)(B) to have the same meaning as in § 1.367(a)-2T(b)(3) (now § 1.367(a)-2(d)(3)), except that officers and employees would not have included the officers and employees of related entities.
- 2. Hence, under the 2015 proposed regulations, only insurance investment business activities performed by a corporation’s officers and employees would be included in the corporation’s active conduct of its insurance business. Accordingly, under the 2015 proposed regulations, investment

income would have qualified for the PFIC insurance exception only if the corporation's own officers and employees performed the insurance business activities that produce the income.

3. Prop. Treas. Reg. § 1.1297-5(c)(3)(i) provides that the term active conduct is based on all of the facts and circumstances and that, in general, a QIC actively conducts an insurance business only if the officers and employees of the QIC carry out substantial managerial and operational activities. For this purpose, active conduct is intended to be interpreted consistently with the active conduct standard in § 1.367(a)-2(d)(5). The proposed regulation further provides that a QIC's officers and employees are considered to include the officers and employees of another corporation if the QIC satisfies the control test set forth in Prop. Treas. Reg. § 1.1297-5(c)(3)(ii).
4. Generally, to satisfy the control test, (i) the QIC must either own, directly or indirectly more than 50% of the vote and value (for a corporation) or capital and profits interest (for a partnership) of the entity whose officers or employees are performing services for the QIC or (ii) a common parent must own, directly or indirectly, more than 80% of the vote and value or capital and profits interest of both the QIC and the entity performing services for the QIC. In addition, the QIC must exercise regular oversight and supervision over the services performed by the other entity's officers and employees for the QIC.
5. The QIC must also either (i) pay directly all the compensation of the other entity's officers and employees attributable to services performed for the QIC for the production or acquisition of premiums and investment income on assets held to meet obligations under insurance, annuity, or reinsurance contracts issued or entered into by the QIC; (ii) reimburse the other entity for the portion of its expenses, including compensation and related expenses (determined in accordance with § 482, taking into account all expenses that would be included in the total services costs under § 1.482-9(j) and § 1.482-9(k)(2)) and add a profit markup, as appropriate, for these services performed for the QIC by the other entity's officers and employees; or (iii) otherwise pay arm's length compensation in accordance with § 482 on a fee-related basis to the other entity for the services provided to the QIC.
6. For example, it is common to charge for investment advisory or management services via a fee calculated as a percentage of the underlying assets under management (AUM), and a fee calculated on this basis may be arm's length under § 482 principles.
7. Under Prop. Treas. Reg. § 1.1297-5(c)(4), a QIC determines the annual amount of its income that is derived in the active conduct of an insurance business (the active conduct test) and excluded from passive income under

§ 1297(b)(2)(B) for purposes of § 1297(a). To make this determination, the QIC must determine its active conduct percentage.

8. If the QIC's active conduct percentage is greater than or equal to 50%, then all of the QIC's passive income (as defined in § 1.1297-1, taking into account the exceptions in § 1297(b)(2) other than § 1297(b)(2)(B) and § 1.1297-5) is excluded from passive income pursuant to the exception in § 1297(b)(2)(B) for the active conduct of an insurance business. If the QIC's active conduct percentage is less than 50%, then none of its income is excluded from passive income pursuant to the exception in § 1297(b)(2)(B) for the active conduct of an insurance business. In response to comments made to the 2015 proposed regulations, the active conduct percentage is based on the QIC's expenses to provide a bright-line test for measuring the QIC's active conduct. Treasury and the IRS determined that the amount of expenses for insurance activities performed by the QIC (or by a related party) as compared to the total expenses of the QIC indicates the extent to which the QIC conducts the business itself and therefore, actively engages in an insurance business.

M. Treatment of Income and Assets of Certain Look-Through Subsidiaries and Look-Through Partnerships Held by a QIC.

1. Prop. Treas. Reg. § 1.1297-5(f) provides that certain items of income and assets that are passive in the hands of a look-through subsidiary or look-through partnership may be treated as active by a QIC. Under this provision, a Tested Foreign Corporation is treated as if it directly holds its proportionate share of the assets and as if it directly receives its proportionate share of the income of the Look-Through Subsidiary or Look-Through Partnership.
2. Generally, if the income or assets are passive in the hands of the Look-Through Subsidiary or Look-Through Partnership, the income or assets are treated as passive income and passive assets of the Tested Foreign Corporation. However, if the Tested Foreign Corporation is a QIC, the income and assets are tested under § 1.1297-5(c) and (e) to determine if they qualify for the § 1297(b)(2)(B) insurance exception to passive income.
3. For this rule to apply, the Look-Through Subsidiary or Look-Through Partnership, as the case may be, must have its assets and liabilities included in the applicable financial statement of the foreign corporation for purposes of the 25% test and the 10% test. This rule does not change the character of the items of income or assets as passive income or passive assets to the Look-Through Subsidiary or Look-Through Partnership.

N. Qualifying Domestic Insurance Corporations. Prop. Treas. Reg. § 1.1297-5(d) provides that income of a qualifying domestic insurance corporation is not treated

as passive income. Similarly, Prop. Treas. Reg. § 1.1297-5(e)(2) provides that assets of a qualifying domestic insurance corporation are not treated as passive assets. A qualifying domestic insurance corporation is a domestic corporation that is subject to tax as an insurance company under subchapter L and is subject to Federal income tax on its net income. This rule is intended to address situations where a Tested Foreign Corporation owns a domestic insurance corporation through a structure to which § 1298(b)(7) does not apply.

O. No Double Counting Rule. Prop. Treas. Reg. § 1.1297-5(g) provides that nothing in Prop. Treas. Reg. § 1.1297-4 or § 1.1297-5 permits any item to be counted more than once (for example, for determining a reserve or an applicable insurance liability for purposes of the 25% test and the 10% test). Including this general principle is consistent with subchapter L provisions that do not allow double counting. For example, § 811(c)(2) provides that the same item may not be counted more than once for reserve purposes, § 811(c)(3) provides that no item may be deducted (either directly or as an increase in reserves) more than once, and § 832(d) prohibits the same item from being deducted more than once.

P. Applicability Dates.

1. These regulations are proposed to apply to taxable years of U.S. persons that are shareholders in certain foreign corporations beginning on or after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register. However, until these regulations are finalized, taxpayers may choose to apply these proposed regulations (other than the proposed regulations under Treas. Reg. §§ 1.1297-4 and 1.1297-5) in their entirety to all open tax years as if they were final regulations provided that taxpayers consistently apply the rules of these proposed regulations.
2. Until finalization, U.S. persons that are shareholders in certain foreign corporations may apply the rules of Treas. Reg. §§ 1.1297-4 and 1.1297-5 for taxable years beginning after December 31, 2017, provided those U.S. persons consistently apply the rules of Treas. Reg. §§ 1.1297-4 and 1.1297-5 as if they were final regulations. In addition, taxpayers may continue to rely on Notice 88-22 until these regulations are finalized.

XVII. NON-TCJA DEVELOPMENTS.

A. § 987 Anti-Abuse Regulations Finalized.

1. Treasury and the IRS issued final § 987 regulations relating to combinations and separations of qualified business units (“QBUs”) subject to § 987. The regulations also finalize rules regarding the recognition and deferral of § 987 foreign currency gain or loss in connection with certain QBU terminations and transactions involving partnerships. Both are primarily anti-abuse regulations. Finally, Treasury and the IRS withdrew

temporary regulations regarding the allocation of assets and liabilities of certain partnerships for purposes of § 987.

2. General.¹⁴

- (a) On December 8, 2016, Treasury and the IRS issued Treasury Decision 9794 (the “2016 final regulations”). These regulations contain rules relating to the determination of the taxable income or loss of a taxpayer regarding a § 987 QBU, as well as to the timing, amount, character, and source of any § 987 gain or loss and other provisions. Treasury and the IRS also published Treasury Decision 9795 (the “temporary § 987 regulations”) on that date as well as a notice of proposed rulemaking by cross-reference to those temporary regulations. These regulations are extremely complicated.
- (b) The new 2019 § 987 regulations finalized Temp. Treas. Reg. §§ 1.987-2T and 1.987-4T, relating to combinations and separations of QBUs, and Temp. Treas. Reg. § 1.987-12T, which requires deferral of foreign currency gain or loss under § 987 in certain transactions defined as deferral events or outbound loss events--transactions that generally include QBU terminations and certain partnerships transactions. Treasury and the IRS also withdrew Temp. Treas. Reg. § 1.987-7T, which provides a liquidation value percentage methodology for allocating assets and liabilities of certain partnerships (§ 987 aggregate partnerships, as defined in Treas. Reg. § 1.987-1(b)(5) of the 2016 final regulations).
- (c) The temporary § 987 regulations also include the following rules that were not addressed in the new 2019 regulation: an annual deemed termination election for a § 987 QBU; an elective method, available to taxpayers that make the annual deemed termination election, for translating all items of income or loss regarding a § 987 QBU at the yearly average exchange rate; rules regarding the treatment of § 988 transactions of a § 987 QBU; rules regarding QBUs with the U.S. dollar as their functional currency; rules regarding the translation of income used to pay creditable foreign income taxes; and rules under § 988 regarding the deferral of

¹⁴ The § 987 regulations’ history actually starts with the 1986 Tax Act and a 1991 set of proposed regulations that Treasury and the IRS decided later that they didn’t like. Then came 2006 proposed regulations. They, too, largely ended up on the scrap pile, although some significant portions of those regulations seem to have survived the 2016 purge and have some continuing vitality. It’s been a tumultuous 33-year history so far and we soon (2020) will have § 987 regulations that nobody seems to like. Treasury even put them on the Executive Order 13789 President’s list of “bad boy” regulations (undue financial burden/undue complexity) but so far without any announced improvements. We only have seven months to go which probably means more temporary regulations.

certain § 988 loss that arises with respect to related-party loans. These regulations remain in their temporary and proposed form.

3. Notices and Effective Dates.

- (a) On January 17, 2017, Treasury and the IRS published Notice 2017-07, 2017-3 I.R.B. 423, announcing that certain rules under Temp. Treas. Reg. § 1.987-12T would be modified to prevent potential abuse by taxpayers making retroactive check-the-box elections. Temp. Treas. Reg. § 1.987-12T(j)(1) states that Temp. Treas. Reg. § 1.987-12T generally applies to any deferral event or outbound loss event that occurs on or after January 6, 2017 (that is, thirty days after the date that Temp. Treas. Reg. § 1.987-12T was filed with the Federal Register).
- (b) Under Temp. Treas. Reg. § 1.987-12T(j)(2), Temp. Treas. Reg. § 1.987-12T also applies to any deferral event or outbound loss event that occurs on or after December 7, 2016, if the deferral event or outbound loss event is undertaken with a principal purpose of recognizing § 987 loss. Notice 2017-07 indicated that Temp. Treas. Reg. § 1.987-12T(j)(2) would be modified so that Temp. Treas. Reg. § 1.987-12T also will apply to any deferral event or outbound loss event that is undertaken with a principal purpose of recognizing § 987 loss¹⁵ and that occurs as a result of an entity classification election made under Treas. Reg. § 301.7701-3 that is filed on or after December 22, 2016, and that is effective before December 7, 2016.
- (c) Additionally, Notice 2017-07 provided that Temp. Treas. Reg. § 1.987-12T(j)(1) would be modified so that Temp. Treas. Reg. § 1.987-12T also will apply to any deferral event or outbound loss event that occurs as a result of an entity classification election made under Treas. Reg. § 301.7701-3 that is filed on or after January 6, 2017, and that is effective before January 6, 2017.
- (d) On October 16, 2017, Treasury and the IRS issued Notice 2017-57, 2017-42 I.R.B. 325, announcing that future guidance would defer the applicability dates of Temp. Treas. Reg. §§ 1.987-2T, 1.987-4T, and 1.987-7T and certain other provisions of the 2016 final regulations and temporary § 987 regulations by one year (generally to 2019 for calendar year taxpayers). The temporary § 987 regulations provide that these sections apply to taxable years beginning on or after the day that is one year after the first day of

¹⁵ Notice 2017-07 inadvertently referred to a principal purpose of recognizing § 987 gain or loss. The new 2019 final regulations, by contrast, finalize the rule in the temporary regulations by applying Treas. Reg. § 1.987-12(j)(2) solely to deferral events and outbound loss events undertaken with a principal purpose of recognizing § 987 loss.

the first taxable year following December 7, 2016. *See* Temp. Treas. Reg. §§ 1.987-2T(e), 1.987-4T(h), 1.987-7T(d).

- (e) On June 25, 2018, Treasury and the IRS published Notice 2018-57, 2018-26 IRB 774, announcing that future guidance would defer the applicability dates of Temp. Treas. Reg. §§ 1.987-2T, 1.987-4T, and 1.987-7T and certain other provisions of the 2016 final regulations and temporary § 987 regulations by one additional year (generally to 2020 for calendar year taxpayers).

4. Executive Order 13789.

- (a) Executive Order 13789, issued on April 21, 2017, instructs Treasury to review all significant tax regulations issued on or after January 1, 2016, and to take concrete action to alleviate the burdens of regulations that (i) impose an undue financial burden on U.S. taxpayers; (ii) add undue complexity to the Federal tax laws; or (iii) exceed the statutory authority of the IRS. E.O. 13789 further instructed Treasury to submit to the President within 60 days an interim report that identified regulations that meet these criteria. Notice 2017-38, 2017- 30 I.R.B. 147, which was published on July 24, 2017, included the 2016 final regulations in a list of eight regulations identified by Treasury in the interim report as meeting at least one of the first two criteria specified in E.O. 13789.
- (b) E.O. 13789 further instructed Treasury to submit to the President by September 18, 2017, a final report that recommended specific actions to mitigate the burden imposed by regulations identified in the interim report. On October 16, 2017, Treasury published in the Federal Register the final report, which indicated, among other things, that Treasury and the IRS intended to propose certain modifications to the 2016 final regulations to reduce burden and compliance challenges associated with those regulations and were actively considering other rules in connection with that proposal.

5. Discussion. Deferral of § 987 Gain or Loss on Certain Terminations; Partnerships.

- (a) Under the 2016 final regulations, the owner of a § 987 QBU that terminates includes in income all of the net unrecognized § 987 gain or loss regarding § 987 QBU in the year it terminates. Under these rules, a termination can result, for example, solely from a transfer of a § 987 QBU from a taxpayer to a related party, notwithstanding that the QBU's assets continue to be used in the same trade or business by the related party.

- (b) Because a termination can result in the deemed remittance of all the assets of a § 987 QBU in circumstances in which the assets continue to be used by a related person in the conduct of the same trade or business that formerly was conducted by the § 987 QBU, terminations can facilitate the selective recognition of § 987 losses.
- (c) In issuing the temporary § 987 regulations, Treasury and the IRS determined that terminations of § 987 QBUs generally should not be permitted to facilitate the selective recognition of losses when the assets and liabilities of the § 987 QBU are transferred to a related person and remain subject to § 987 in the hands of the transferee.
- (d) Similar policy considerations arise when the transfer of a partnership interest to a related person results in deemed transfers that cause the recognition of § 987 loss regarding a § 987 QBU owned through the partnership, notwithstanding that the trade or business of the § 987 QBU continues without interruption and remains subject to § 987, and in the context of certain outbound transfers even when the assets do not remain subject to § 987 in the hands of the transferee (because, for example, the transferee has the same functional currency as the QBU).
- (e) In order to address these policy concerns, the temporary § 987 regulations deferred § 987 losses resulting from certain termination events, partnership transactions, and certain other transactions involving outbound transfers. *See* Temp. Treas. Reg. § 1.987-12T which was discussed at length in our January 9, 2017 column on pp. 222-225.
- (f) In addition, the temporary § 987 regulations generally applied to defer the recognition of § 987 gains as well as losses when the transferee was subject to § 987 regarding the assets of the § 987 QBU. The temporary § 987 regulations did not, however, defer gain to the extent the assets of a § 987 QBU were transferred by a U.S. person to a related foreign person, consistent with the policies underlying § 367.

6. Combinations and Separations of QBUs.

- (a) The temporary § 987 regulations also included rules to prevent similarly inappropriate results when certain § 987 QBUs are combined or separated. Absent a special rule, the combination of multiple § 987 QBUs that have the same owner, or the separation of a § 987 QBU into two or more § 987 QBUs that have the same owner, would give rise to a transfer between an owner and one or more § 987 QBUs under the 2016 final regulations.

- (b) Consistent with the policy of deferring § 987 gain or loss under Temp. Treas. Reg. § 1.987-12T when assets of a § 987 QBU are reflected on the books and records of another § 987 QBU in the same controlled group as a result of certain transactions that result in deemed transfers, the temporary § 987 regulations provided that § 987 gain or loss generally is not recognized when two or more § 987 QBUs (combining QBUs) with the same owner combine into a single § 987 QBU (combined QBU) or when a § 987 QBU (separating QBU) separates into multiple § 987 QBUs (each, a separated QBU).
- (c) The temporary § 987 regulations also included certain mechanical rules applicable in this context, including (i) rules related to determining the net unrecognized § 987 gain or loss of combined QBUs and separated QBUs, and (ii) provisions regarding combining § 987 QBUs that have different functional currencies than their respective combined QBUs.

7. A Partner's Share of Assets and Liabilities of a § 987 Aggregate Partnership.

- (a) The 2016 final regulations set forth rules applicable to § 987 aggregate partnerships, which are defined as partnerships regarding which all of the capital and profits interests are owned, directly or indirectly, by persons that are related within the meaning of § 267(b) or § 707(b). Under the aggregate approach set forth in the 2016 final regulations, assets and liabilities reflected on the books and records of an eligible QBU of a § 987 aggregate partnership are allocated to each partner, which is considered an indirect owner of the eligible QBU. If the eligible QBU has a functional currency different from its indirect owner, then the assets and liabilities of the eligible QBU that are allocated to the partner are treated as a § 987 QBU of the indirect owner.
- (b) The temporary § 987 regulations provided specific rules for determining a partner's share of the assets and liabilities reflected on the books and records of an eligible QBU owned indirectly through a § 987 aggregate partnership. Specifically, Temp. Treas. Reg. § 1.987-7T(b) provided that, in any taxable year, a partner's share of each asset and liability of a § 987 aggregate partnership is proportional to the partner's liquidation value percentage regarding the aggregate partnership. Temp. Treas. Reg. § 1.987-7T was discussed in our January 9, 2017 column at p. 228.
- (c) A partner's liquidation value percentage was defined as the ratio of the liquidation value of the partner's interest in the partnership to the aggregate liquidation value of all the partners' interests in the

partnership. The liquidation value of the partner's interest in the partnership was the amount of cash the partner would receive regarding its interest if, immediately following the applicable determination date, the partnership sold all of its assets for cash equal to the fair market value of the assets (taking into account § 7701(g)), satisfied all of its liabilities (other than those described in Treas. Reg. § 1.752-7), paid an unrelated third party to assume all of its Treas. Reg. § 1.752-7 liabilities in a fully taxable transaction, and then liquidated.

8. Taxpayer Comments: Temp. Treas. Reg. §§ 1.987-2, 4 and 12.

- (a) A number of commentators recommended that all of the temporary regulations, including Temp. Treas. Reg. §§ 1.987-2T, 1.987-4T, and 1.987-12T, be withdrawn. Commentators generally indicated that the 2016 final regulations and the temporary regulations are unduly complex and present significant financial and compliance burdens for taxpayers subject to the 2016 final regulations.
- (b) In its final report to the President in response to E.O. 13789, Treasury indicated that the 2016 final regulations have proved difficult for many taxpayers to apply. The final report indicated that Treasury and the IRS intended to propose modifications to the 2016 final regulations that will reduce the compliance burdens associated with the regulations.
- (c) While Treasury and the IRS intend to reduce those burdens, they continue to consider it inappropriate to permit the selective recognition of § 987 losses and the deferral of § 987 gains. This is particularly true when such selective loss recognition may be accomplished through related-party transactions that do not significantly impact the conduct of the trade or business of a § 987 QBU or its owner but nonetheless generate significant tax benefits, as is true of deferral events and outbound loss events.
- (d) Treasury and the IRS believe that finalizing Temp. Treas. Reg. §§ 1.987-2T, 1.987-4T, and 1.987-12T, while simultaneously deferring the applicability date of the 2016 final regulations and developing guidance to mitigate the complexity and administrative challenges associated with, the 2016 final regulations,¹⁶ will appropriately balance taxpayers' burdens with the need to prevent abuse under the 2016 final regulations or under another method of

¹⁶ “Complexity” and “administrative challenges” are overly kind descriptions. Those regulations are better described as “compliance proof” (taxpayers likely will find most of the rules close to impossible with which to comply) and “audit proof” (how will IRS examiners ever possibly audit taxpayers’ efforts at compliance with them?). How could anyone – in the government or not – conceivably want rules such as these?

complying with § 987 utilized by a taxpayer during a period for which the 2016 final regulations are not applicable.

9. Effective Dates.

- (a) Some commentators recommended that the applicability date for the 2016 final regulations and the temporary regulations, including Temp. Treas. Reg. §§ 1.987-2T, 1.987-4T, and 1.987-12T, be delayed for a specified period, such as one or two years. Similarly, comments recommended that the final and temporary regulations, including Temp. Treas. Reg. §§ 1.987-2T, 1.987-4T, and 1.987-12T, be withdrawn in their entirety and repropose (in one case, with an effective date at least two years after those regulations are finalized) to allow taxpayers time to effectively plan to implement the final and temporary regulations.
- (b) Generally, the commentators indicated that taxpayers required additional time to update and implement existing systems to comply with the 2016 final regulations and the temporary regulations.
- (c) One commentator specifically recommended that the applicability date for Temp. Treas. Reg. § 1.987-12T be delayed until the applicability date of the 2016 final regulations. The commentator indicated that, in certain instances, the applicability date of Temp. Treas. Reg. § 1.987-12T prevented the recognition of losses in connection with certain transactions that were in the planning and implementation stages when the temporary regulations were issued. No comments identified specific compliance challenges associated with Temp. Treas. Reg. § 1.987-12T (of course not since the regulations would ban those transactions).
- (d) Treasury and the IRS declined to delay the applicability date of Temp. Treas. Reg. § 1.987-12T. Temp. Treas. Reg. § 1.987-12T prevents taxpayers from selectively recognizing § 987 losses through certain technical terminations of a § 987 QBU and similar transactions that would be relatively easy to effect through related-party transactions without meaningfully impacting a taxpayer's business operations.
- (e) If the applicability date were delayed, taxpayers would be incentivized to engage in the selective recognition of § 987 losses, which would be contrary to the purposes of § 987 and Temp. Treas. Reg. § 1.987-12T.
- (f) Delaying the application of related provisions under Temp. Treas. Reg. §§ 1.987-2T and 1.987-4T concerning combinations and

separations of a § 987 QBU could similarly incentivize transactions designed to accelerate § 987 losses for taxpayers that have elected to apply the 2016 final regulations early.

- (g) Treasury and the IRS stated that the transactions to which Temp. Treas. Reg. §§ 1.987-2T, 1.987-4T, and 1.987-12T are applicable occur exclusively among related persons, such that taxpayers may avoid the application of those sections by avoiding undertaking those transactions.
- (h) Accordingly, the final regulations retain the applicability dates of the temporary regulations, as modified by Notice 2017-07, Notice 2017-57, and Notice 2018-57. Specifically, the final regulations provide that Treas. Reg. §§ 1.987-2(c)(9), 1.987-4(c)(2), and 1.987-4(f) apply to taxable years beginning on or after the day that is three years after the first day of the first taxable year following December 7, 2016. If, however, a taxpayer makes an election under Treas. Reg. § 1.987-11(b), then Treas. Reg. §§ 1.987-2(c)(9), 1.987-4(c)(2), and 1.987-4(f) apply to taxable years to which Treas. Reg. §§ 1.987-1 through 1.987-10 apply as a result of the election.
- (i) Similarly, Treas. Reg. § 1.987-12 incorporates the applicability date provisions of Temp. Treas. Reg. § 1.987-12T, as modified by Notice 2017-07. Thus, the final regulations under Treas. Reg. § 1.987-12 generally apply to any deferral event or outbound loss event that occurs on or after January 6, 2017. Treas. Reg. § 1.987-12 also applies to any deferral event or outbound loss event that occurs as a result of an entity classification election made under § 301.7701-3 that is filed on or after January 6, 2017, and that is effective before January 6, 2017.
- (j) It also applies to any deferral event or outbound loss event occurring on or after December 7, 2016 if the deferral event or outbound loss event was undertaken with a principal purpose of recognizing § 987 loss. Finally, Treas. Reg. § 1.987-12 applies to any deferral event or outbound loss event that occurs as a result of an entity classification election made under Treas. Reg. § 301.7701-3 that was filed on or after December 22, 2016, that was effective before December 7, 2016, and that was undertaken with a principal purpose of recognizing § 987 loss.

10. Withdrawal: Temp. Treas. Reg. § 1.987-7T.

- (a) Commentators recommended alternative approaches for determining a partner's share of the assets and liabilities of a § 987 aggregate partnership. They recommended that Treas. Reg.

§ 1.987-7 be withdrawn and replaced with the approach of the 2006 proposed regulations under § 987, which provided that a partner's share of assets and liabilities reflected on the books and records of an eligible QBU held indirectly through the partnership must be determined in a manner consistent with how the partners have agreed to share the economic benefits and burdens corresponding to those partnership assets and liabilities, taking into account the rules and principles of subchapter K.

- (b) These commentators indicated that the liquidation value percentage approach was inconsistent with certain principles of subchapter K, resulting in distortions in the calculation of § 987 gain or loss in certain cases.
- (c) Treasury and the IRS believe that, in the absence of a more comprehensive set of rules for determining a partner's share of assets and liabilities reflected on the books and records of an eligible QBU held indirectly through the partnership that also articulates the interaction of those rules with applicable rules in subchapter K, a more flexible approach is warranted.
- (d) Moreover, they also believe that, in certain instances, the liquidation value percentage methodology set forth in Temp. Treas. Reg. § 1.987-7T may be interpreted as applying in a way that inappropriately distorts the computation of § 987 gain or loss. Specifically, under such an interpretation, certain changes in a partner's liquidation value percentage may introduce distortions in the calculation of net unrecognized § 987 gain or loss under Treas. Reg. § 1.987-4, giving rise to net unrecognized § 987 gain or loss that is not attributable to fluctuations in exchange rates.
- (e) For example, an appreciation or depreciation in property value can result in a change in liquidation value percentage that causes a change in owner functional currency net value for purposes of Step 1 of the Treas. Reg. § 1.987-4(d) calculation of unrecognized § 987 gain or loss for a taxable year without an offsetting adjustment under Step 6 or otherwise that would prevent the change in liquidation value percentage from distorting the calculation of unrecognized § 987 gain or loss.
- (f) As a result, the unrecognized appreciation or depreciation generally can result in unrecognized § 987 gain or loss for a taxable year being allocated to each partner that indirectly owns a § 987 QBU even when there is no change in exchange rates.
- (g) Accordingly, Treasury and the IRS withdrew Temp. Treas. Reg. § 1.987-7T (and made a conforming change to an example in

Treas. Reg. § 1.987-12). Until new regulations are proposed and finalized, taxpayers may use any reasonable method for determining a partner's share of assets and liabilities reflected on the books and records of an eligible QBU held indirectly through the partnership.

- (h) For this purpose, taxpayers may rely on subchapter K principles (consistent with the 2006 proposed regulations under § 987) or an approach similar to the liquidation value percentage method set forth in Temp. Treas. Reg. § 1.987-7T.
- (i) However, Treasury and the IRS do not believe that it would be reasonable to apply the liquidation value percentage method without corresponding adjustments to the determination of net unrecognized § 987 gain or loss. Thus, for example, a taxpayer using the liquidation value percentage method may be required to adjust its determination of net unrecognized § 987 gain or loss of a § 987 QBU that is owned indirectly through a partnership to prevent the determination of unrecognized § 987 gain or loss that is not attributable to fluctuations in exchange rates.
- (j) These adjustments may include, for example, treating any change in a partner's owner functional currency net value that is attributable to a change in the partner's liquidation value percentage as resulting in a transfer to or from an indirectly owned § 987 QBU.

B. Treaties.

1. The Senate voted to approve tax protocols with Spain, Switzerland, Japan and Luxembourg. Only two Senators, Rand Paul (R-Ky.) and Mike Lee (R-Utah), voted against all of the protocols. Senator Richard Durbin (D-IL) joined Paul and Lee in opposing the Luxembourg protocol.
2. Treaties and protocols have been on hold since Paul objected to approving treaties based on privacy concerns with the information-sharing provisions. Three treaties (Hungary, Chile, and Poland) and four protocols (Spain, Switzerland, Luxembourg, and Japan) have been on hold. *See* our column in Tax Notes Int'l, July 1, 2019. After years of delay and lobbying pressure, the Senate finally approved the protocols over Paul's objections. As a result of these objections a more lengthy approval process was required. The protocols had to clear the Senate Foreign Relations Committee and then be the subject of a Senate floor.
3. Senate Finance Committee Chairman Ron Wyden stated in a July 17 press release that "Senate approval of tax treaties with Spain, Switzerland, Japan and Luxembourg is welcome and long overdue." He also stated that it is

“unfortunate that the Senate did not also move on three additional treaties with Chile, Hungary and Poland. It had an opening to get all seven treaties approved, but the administration made the process unnecessarily difficult by pushing last-minute changes.”

4. The protocol with Spain was accompanied by a memorandum of understanding (“MOU”). The protocol makes a number of important changes to the 1990 treaty to make it closer to the U.S. model treaty. The new protocol was originally signed in 2013 and was sent to the Senate for approval in 2014.
5. The Spain protocol provides for exclusive residence-country taxation of interest, royalties, certain direct dividends and capital gains. Certain parent-subsidiary dividends are exempt from source country withholding tax if the parent company owns at least 80% of the stock of the subsidiary and meets certain other conditions including a 12-month holding period. Dividends paid to a company that directly owns at least 10% of the voting stock are subject to a 5% withholding tax. All other dividends continue to be subject to a 15% withholding tax.
6. The Spain protocol eliminates withholding tax on most interest payments. The current treaty imposes a 10% withholding tax on interest.
7. All royalties are exempt from source country withholding tax under the Spanish protocol. The protocol updates the provisions under which permanent establishment business income is not taxed unless the earnings are substantial enough to constitute a permanent establishment. It also permits source country taxation of capital gains on the sale of real property (“FIRPTA”).
8. The protocol adopts the anti-treaty shopping provisions of the U.S. model treaty convention. It also contains a comprehensive limitation on benefits (“LOB”) provision, mutual agreement procedures and an exchange of information provision.
9. The protocol with Switzerland was signed in 2009 and corrected with an exchange of notes in 2010. It prohibits bank secrecy laws from denying a request to disclose taxpayer information that may be relevant to tax evasion and adopts a mandatory binding arbitration provision.
10. The MOU contains a provision addressing fiscal transparency. It also states that under the LBO provision a person is deemed related if the person participates directly or indirectly in the management, control or capital of another entity.
11. The protocol with Japan and related exchange of notes was signed in 2013. Like the Spain protocol, it makes a number of important tax changes to bring it closer to the U.S. model. The protocol denies treaty

benefits to companies that claim dual residency in Japan and the U.S. It eliminates withholding tax on most interest payments; expands the category of dividends eligible for zero rate of withholding tax when the beneficial owner of the dividends has owned at least 50 percent (instead of “more than 50 percent” under the existing treaty) of the voting power for a period of six months (instead of “twelve months” under the existing treaty). Accordingly, a company that owns 50 percent of the voting stock in a 50/50 joint venture company could qualify for the zero rate for dividends.

12. The Japan Protocol also amends the capital gains provisions in a manner that permits the U.S. to fully apply FIRPTA and establishes mandatory arbitration procedures and exchange of information provisions.
13. The protocol with Luxembourg was originally signed in 2009 and amends the treaty concluded in 1996. The Luxembourg protocol only updates the exchange of information provision and the technical explanation. It does not amend any tax specific provisions.

C. Cloud Computing.

1. Long-awaited cloud computing regulations were proposed on August 9, 2019. They provide new guidance regarding cloud transactions (Prop. Treas. Reg. § 1.861-19) and updated guidance on the classification of transactions involving digital content (Prop. Treas. Reg. § 1.861-18). Prop. Treas. Reg. § 1.861-19 provides rules for classifying a cloud transaction as either a provision of service or a lease of property although most cloud transactions are characterized under these proposed new rules as a service.
2. The character and source of income classification of a transaction impacts the tax treatment. U.S. sourcing rules, generally contained in Code §§ 861 to 865, determine domestic or foreign source income. U.S. taxpayers, especially those with significant foreign tax credits (“FTCs”), typically prefer foreign source income in order to maximize the use of FTCs and minimize U.S. taxes. The source of income is also important to determine whether certain income may be subject to U.S. withholding taxes.
3. Source of income depends on character of that income (for example, interest, dividend, compensation for services, royalties paid under a license, gains recorded in a sale). For software transactions, digital content and cloud transactions, the types of income most relevant are sales, licenses, and services. Treas. Reg. § 1.861-18 addressed software transactions some years back.
4. The character of income also affects income earned through controlled foreign corporations (“CFCs”) because the character of income impacts

the Subpart F analysis and whether the income is effectively connected with a U.S. trade or business.

5. The character of income could also impact § 59A (the base erosion and anti-abuse tax BEAT) and § 250 (foreign derived intangible income (“FDII”) and global intangible low-taxed income (“GILTI”). For example, under BEAT, the characterization of a cloud transaction as a service, as opposed to a lease, may implicate the services cost method exception. The characterization may also impact the documentation requirements or eligibility for treatment as FDII.
6. Traditionally, the distinction between services income and income from the use of intangible property has hinged on whether the owner and the user of the intangible property are the same person. If assets are produced from the rendering of the services, the service provider typically will not own the newly created assets.
7. Prop. Treas. Reg. § 1.861-19.
 - (a) In general, a cloud transaction involves access to property or use of property, instead of the sale, exchange, or license of property, and therefore typically would be classified as either a lease of property or a provision of services. Section 7701(e) and case law provide factors that are relevant for classifying a transaction as either a lease of property or a provision of services.
 - (b) Prop. Treas. Reg. § 1.861-19 provides rules for classifying a cloud transaction as either a lease of property (*i.e.*, computer hardware, digital content, or other similar resources) or a provision of services. These rules contain a non-exhaustive list of factors which include statutory factors described in § 7701(e)(1) and factors applied by courts.
 - (c) As the examples illustrate, however, most cloud transactions will be classified as the provision of services under these proposed new rules.
8. Definition of “Cloud Transaction.”
 - (a) Prop. Treas. Reg. § 1.861-19(b) defines a cloud transaction as a transaction through which a person obtains non-de minimis on-demand network access to computer hardware, digital content (as defined in Prop. Treas. Reg. § 1.861-18(a)(3)), or other similar resources. This definition is not limited to computer hardware and software, or to the Infrastructure as a Service (“IaaS”), Platform as a Service (“PaaS”); and Software as a Service (“SaaS”) models, because it is intended also to apply to other transactions that share characteristics of on-demand network access to technological

resources, including access to streaming digital content and access to information in certain databases.

- (b) Although this definition is broad, it does not encompass every transaction executed or completed through the Internet. For example, Prop. Treas. Reg. § 1.861-19 clarifies that the mere download or other electronic transfer of digital content for storage and use on a person's computer hardware or other electronic device does not constitute on-demand network access to the digital content and so would not be considered a cloud transaction.

9. Classification of Cloud Transactions.

- (a) Prop. Treas. Reg. § 1.861-19(c) provides that a cloud transaction is classified solely as either a lease of property or the provision of services. Certain cloud transactions may have characteristics of both, but generally are not bifurcated. For example, § 7701(e)(1) classifies a purported service contract as either a lease or a service contract and does not contemplate mixed classifications of a single, integrated transaction.
- (b) In some cases, the facts and circumstances may support the conclusion that an arrangement involves multiple cloud transactions. In these cases, Prop. Treas. Reg. § 1.861-19 requires a separate classification of each cloud transaction except any transaction that is de minimis.

10. Determination Based on All Relevant Factors.

- (a) Prop. Treas. Reg. § 1.861-19(c)(1) provides that all relevant factors must be taken into account in determining whether a cloud transaction is classified as a lease of property (specifically, computer hardware, digital content (as defined in Prop. Treas. Reg. § 1.861-18(a)(3)), or other similar resources) or the provision of services. The relevance of any factor varies depending on the factual situation, and any particular factor may not be relevant in a given instance.
- (b) Prop. Treas. Reg. § 1.861-19(c)(2) contains a non-exhaustive list of factors for determining whether a cloud transaction is classified as the provision of services or a lease of property. In addition to the statutory factors described in § 7701(e)(1), the proposed regulations set forth several factors applied by courts that Treasury and the IRS have determined are relevant in demonstrating that a cloud transaction is classified as the provision of services: whether the provider has the right to determine the specific property used in the cloud transaction and replace such property with comparable

property; whether the property is a component of an integrated operation in which the provider has other responsibilities, including ensuring the property is maintained and updated; and whether the provider's fee is primarily based on a measure of work performed or the level of the customer's use rather than the mere passage of time. In general, the Proposed Regulations apply the relevant factors to treat the cloud transactions addressed in the Examples as the provision of services rather than a lease of property.

- (c) Certain factors that are relevant under Prop. Treas. Reg. § 1.861-19(c) may be the same as or similar to those used to determine whether transactions other than cloud transactions are classified as leases or services under other authorities. However, cloud transactions, which involve on-demand network access to property such as computer hardware and digital content, may have significant differences from other lease and service transactions that involve direct physical access to property. Accordingly, the preamble states that the interpretation of factors and their application to cloud transactions require an analysis that is sensitive to the inherent differences between transactions involving physical access to property and transactions involving on-demand network access.

11. Classification of Cloud Transactions Related to Other Transactions.

Certain arrangements may involve multiple transactions and Prop. Treas. Reg. § 1.861-19(c)(3) provides that, in such cases, the classification rules apply only to classify the cloud transaction, and any non-cloud transaction will be classified separately under such other section of the Code or regulations, or under general tax law principles. However, no transaction will be classified separately if it is de minimis.

12. Examples

Example 1: Computing Capacity. Corp A operates data centers on its premises in various locations. Corp A provides Corp B computing capacity on Corp A's servers in exchange for a monthly fee based on the amount of computing power made available. Corp B provides its own software to run on Corp A's servers. Depending on utilization levels, the servers accessed by Corp B may also be used simultaneously by other customers. The computing capacity provided to Corp B can be sourced from a variety of servers in one or more of Corp A's data centers, and Corp A determines how its computing resources are allocated among customers. Corp A agrees to keep the servers operational, including by performing physical maintenance and repair, and may replace any server with another server of comparable functionality. Corp A agrees to provide

Corp B with a payment credit for server downtime. Corp B has no ability to physically alter any server.

The computing capacity transaction between Corp A and Corp B is a cloud transaction because Corp B obtains a non-de minimis right to on-demand network access to computer hardware of Corp A.

Corp B has neither physical possession of nor control of the servers, beyond Corp B's right to access and use the servers. Corp A may replace any server with a functionally comparable server. The servers are a component of an integrated operation in which Corp A has other responsibilities, including maintaining the servers. The transaction does not provide Corp B with a significant economic or possessory interest in the servers. The agreement provides that Corp A will provide Corp B with a payment credit for server downtime, such that Corp A bears risk of substantially diminished receipts in the event of contract nonperformance. The servers may, depending on utilization levels, be used by Corp A to provide significant computing capacity to entities unrelated to Corp B. Corp A is compensated according to the level of Corp B's use (that is, the amount of computing power made available) and not solely based on the passage of time. Taking into account all of the relevant factors, the transaction between Corp A and Corp B is classified as the provision of services.

Example 2: Computing Capacity on Dedicated Servers. The facts are the same as in Example 1, except that, in order to offer more security to Corp B, Corp A provides Corp B computing capacity exclusively through designated servers, which are owned by Corp A and located at Corp A's facilities. Corp A agrees not to use a designated server for any other customer for the duration of its arrangement with Corp B. Corp A's compensation reflects a substantial return for maintaining the servers in addition to the rental value of the servers.

The fact that Corp A provides computing capacity to Corp B through designated servers indicates that such servers are not used concurrently by other Corp A customers. However, Corp A retains physical possession of the servers. In addition, Corp A's sole responsibility for maintaining the servers, and its sole right to replace or physically alter the servers, indicate that Corp A controls the servers. Although Corp B obtains the exclusive right to use certain servers, Corp B does not have a significant economic or possessory interest in the servers because, among other things, Corp A retains the right to replace the servers, Corp A bears the risk of damage to the servers, and Corp B does not share in cost savings associated with the servers because the fee paid by Corp B to Corp A does not vary based on Corp A's costs. The compensation to Corp A substantially exceeds the rental value of the servers. Taking into account all of these factors, the

transaction between Corp A and Corp B is classified as a provision of services.

Example 3: Access to Software Development Platform and Website Hosting. Corp A provides Corp B a software platform that Corp B uses to develop and deploy websites with a range of features, including blogs, message boards, and other collaborative knowledge bases. The software development platform consists of an operating system, web server software, scripting languages, libraries, tools, and back-end relational database software and allows Corp B to use in its websites certain visual elements subject to copyrights held by Corp A. The software development platform is hosted on servers owned by Corp A and located at Corp A's facilities. Corp B's finished websites are also hosted on Corp A's servers. The software development platform and servers are also used concurrently to provide similar functionality to Corp A customers unrelated to Corp B. Corp B accesses the software development platform via a standard web browser. Corp B has no ability to alter the software code. A small amount of scripting code is downloaded onto Corp B's computers to facilitate secure logins and access to the software development platform. All other functions of the software development platform execute on Corp A's servers, and no portion of the core software code is ever downloaded by Corp B or Corp B's customers. Corp A is solely responsible for maintaining the servers and software development platform, including ensuring continued functionality and compatibility with Corp B's browser, providing updates and fixes to the software for the duration of the contract with Corp B, and replacing or upgrading the servers or software at any time with a functionally similar version. Corp B pays Corp A a monthly fee for the platform and website hosting that takes into account the storage requirements of Corp B's websites and the amount of website traffic supported, but there is no stand-alone fee for use of the software development platform. Corp B agrees to pay for Corp A's website hosting services for a minimum period, after which Corp B may continue to pay for Corp A's website hosting services or transfer its developed websites to a different hosting provider. Corp A agrees to provide Corp B with a payment credit for server downtime.

Corp A's provision to Corp B of access to the software platform is a cloud transaction. Corp A's hosting of Corp B's finished websites is part of the provision of access to the software platform and hardware.

Corp B does not have physical possession of the software platform or servers. Although Corp B uses Corp A's platform to develop and deploy websites, Corp B does not maintain the software platform or the servers on which it is hosted, and Corp B cannot alter the software platform. Accordingly, Corp B does not control the software platform or the servers. Corp A maintains the right to replace or upgrade the software platform and servers with functionally similar versions. The servers and

software platform are components of an integrated operation in which Corp A has various responsibilities, including maintaining the servers and updating the software. Corp B does not have a significant economic or possessory interest in Corp A's software platform or servers. Corp B may lose revenue with respect to the websites that it deploys on Corp A's servers when the servers are down; nonetheless, Corp A bears the risk of substantially diminished receipts in the event of contract nonperformance because Corp A will provide Corp B with a payment credit for server downtime. Corp A provides access to the servers and platform to Corp B and other customers concurrently. Corp A is compensated based on Corp B's level of use (that is, the amount of computing resources provided) and not solely by the passage of time. Taking into account all of the factors, the transaction between Corp A and Corp B is classified as a provision of services.

Although the download of a small amount of scripting code to facilitate logins and access to the software platform would otherwise constitute a transfer of a computer program, instead of a cloud transaction, the download is de minimis in the context of the overall arrangement, and therefore, there is no separate classification of the download. Similarly, the fact that Corp B receives rights to publicly display certain copyrighted visual elements resulting from Corp A's software development platform on Corp B's own websites, which would otherwise constitute a transfer of copyright rights under Treas. Reg. § 1.861-18, instead of a cloud transaction, does not require separate classification because the right to use such elements is also de minimis. Thus, the entire arrangement is classified as a service.

Example 4: Access to Software. The facts are the same as in Example 3, except that, instead of providing website development software, Corp A provides Corp B access to customer relationship management software under several options such as "entry-level," "mid-level," and "advanced-level," via a standard web browser, which Corp A hosts on its servers for a monthly subscription fee. Corp B has no ability to alter the software code, and Corp A agrees to make available new versions of the software as they are developed for the duration of Corp B's contract, and to ensure servers' uptime in accordance with the service level agreement. The transaction is a cloud transaction.

The relevant factors are analyzed in the same manner as in Example 3, except that compensation due to Corp A is determined based on the option chosen and the passage of time rather than a measure of computing resources utilized. Although as a general matter compensation based on the passage of time is more indicative of a lease than a service transaction, that factor is outweighed by the other factors, which support classification as a service transaction. Taking into account all of the

factors, the transaction between Corp A and Corp B is classified as a provision of services.

Example 5: Downloaded Software Subject to Treas. Reg. § 1.861-18. Corp A provides software for download to Corp B that enables Corp B to create a scalable, shared pool of computing resources over Corp B's own network for use by Corp B's employees. Corp B downloads the software, which runs solely on Corp B's servers. Corp A provides Corp B with free updates for download as they become available. Corp B pays Corp A an annual fee, and, upon termination of the arrangement, an electronic lock is activated that prevents Corp B from further using the software.

The download of software for use with Corp B's computer hardware does not constitute on-demand network access by Corp B to Corp A's software. Accordingly, the transaction between Corp A and Corp B is not a cloud transaction. Because the transaction involves the transfer of digital content as defined in Treas. Reg. § 1.861-18(a)(3), it is classified under Treas. Reg. § 1.861-18.

Example 6: Access to Online Software Via an Application. Corp A provides Corp B word processing, spreadsheet, and presentation software and allows employees of Corp B to access the software over the Internet through a web browser or an application ("app"). In order to access the software from a mobile device, Corp B's employees usually download Corp A's app onto their devices. To access the full functionality of the app, the device must be connected to the Internet. Only a limited number of features on the app are available without an Internet connection. Corp B has no ability to alter the software code. The software is hosted on servers owned by Corp A and located at Corp A's facilities and is used concurrently by other Corp A customers. Corp A is solely responsible for maintaining and repairing the servers and software, and ensuring continued functionality and compatibility with Corp B's employees' devices and providing updates and fixes to the software (including the app) for the duration of the contract with Corp B. Corp B pays a monthly fee based on the number of employees with access to the software. Upon termination of the arrangement, Corp A activates an electronic lock preventing Corp B's employees from further utilizing the app, and Corp B's employees are no longer able to access the software via a web browser.

Corp A's provision to Corp B of a non-de minimis right to on-demand network access to Corp A's computer hardware and software resources for the purpose of fully utilizing Corp A's software is a cloud transaction.

Corp B has neither physical possession of nor control over Corp A's word processing, spreadsheet, and presentation software or computer

hardware. Additionally, the servers and software are part of an integrated operation in which Corp A maintains the servers and updates the software. Corp A makes available its word processing, spreadsheet, and presentation software and servers to Corp B and other customers concurrently. Corp A's compensation, though based in part on the passage of time, is also determined by reference to Corp B's level of use (that is, the number of Corp B employees with access to the software). Taking into account all of the factors, the transaction between Corp A and Corp B is classified as the provision of services.

The provision of the app to Corp B's employees by download onto their devices would be a transfer of a computer program rather than a cloud transaction. However, it is necessary to consider whether that transfer is de minimis in the context of the overall arrangement and in light of the surrounding facts and circumstances. Here, the significance of the download of the app by Corp B's employees is limited by the fact that the device running the app must be connected to Corp A's servers via the Internet to enable most of the app's core functions. The software that enables such functionality remains on Corp A's servers and is accessed through an on-demand network by Corp B's employees. Therefore, the download of the app is de minimis, the entire arrangement is classified as a service.

Example 7: Access to Offline Software with Limited Online Functions. Corp A provides Corp B word processing, spreadsheet, and presentation software that is functionally similar to the software in Example 6. The software is made available for access over the Internet but only to download the software onto a computer or onto a mobile device in the form of an app. The downloaded software contains all the core functions of the software. Employees of Corp B can use the software on their computers or mobile devices regardless of whether their computer or mobile device is online. When online, the software provides a few ancillary functions that are not available offline, such as access to document templates and data collection for diagnosing problems with the software. Whether working online or offline, Corp B employees can store their files only on their own computer or mobile device, and not on Corp A's data storage servers. Because the software provides near full functionality without access to Corp A's servers, it requires more computing resources on employees' computers and devices than the app in Example 6. Corp B's employees can also download updates to the software as part of the monthly fee arrangement. Upon termination of the arrangement, an electronic lock is activated so that the software can no longer be accessed.

The provision of the software constitutes a lease of a copyrighted article under Treas. Reg. § 1.861-18. *See* Treas. Reg. § 1.861-18(h)(4). The access to the online ancillary functions otherwise would constitute a

cloud transaction, but the access to these functions is de minimis in the context of the overall arrangement, considering that the core functions are available offline through the downloaded software. There is no cloud transaction.

Example 8: Data Storage, Separate from Access to Offline Software. The facts are the same as in Example 7, except that Corp A also provides data storage to Corp B on Corp A's server systems in exchange for a monthly fee based on the amount of data storage used by Corp B. Under the data storage terms, Corp B employees may store files created by Corp B employees using Corp A's software or other software. Although Corp A's word processing software is compatible with Corp A's data storage systems, the core functionality of Corp A's software is not dependent on Corp B's purchase of the storage plan. Depending on utilization levels, the server systems providing data storage to Corp B may also be used simultaneously for other customers. The data storage provided to Corp B can be sourced from a variety of server systems in one or more of Corp A's data centers, and Corp A determines how its computing resources are allocated among customers. Corp A agrees to keep the server systems operational, including by performing physical maintenance and repair, and may replace any server system with another one of comparable functionality. Corp A agrees to provide Corp B with a payment credit for server downtime. Corp B has no ability to physically alter the server systems.

Corp A's provision of software and data storage capacity constitute separate transactions, and neither is de minimis. Therefore, the transactions are classified separately. Corp B's download of fully functional software, along with on-demand network access to certain limited online features, does not constitute a cloud transaction, but rather constitutes a lease of a copyrighted article. Corp A's provision of data storage constitutes a cloud transaction because Corp B obtains a non-de minimis right to on-demand network access to computer hardware of Corp A.

Corp B has neither physical possession of nor control of the server systems, beyond Corp B's right to access and use the servers. Corp A may replace any server with a functionally comparable server. The server systems are a component of an integrated operation in which Corp A has other responsibilities, including maintaining the server systems. The transaction does not provide Corp B with a significant economic or possessory interest in the servers. The servers may, depending on utilization levels, be used by Corp A to provide significant services to entities unrelated to Corp B. Corp A is compensated according to the level of Corp B's use (that is, the amount of data storage used by Corp B) and not solely based on the passage of time. Because Corp A will provide Corp B with a payment credit for server downtime, Corp A bears risk of

substantially diminished receipts in the event of contract nonperformance. Taking into account all of these factors, the transaction for data storage is classified as a provision of services.

Example 9: Streaming Digital Content Using Third-Party Servers.

Corp A streams digital content in the form of videos and music to end-users from servers located in data centers owned and operated by Data Center Operator. Data Center Operator's content delivery network facility services multiple customers. Each end-user uses a computer or other electronic device to access unlimited streaming video and music in exchange for payment of a flat monthly fee to Corp A. The end-user may select from among the available content the particular video or song to be streamed. Corp A continually updates its content catalog, replacing content with higher quality versions and adding new content at no additional charge to the end-user. Content that is streamed to the end-user is not stored locally on the end-user's computer or other electronic device and therefore can be played only while the end-user's computer or other electronic device is connected to the Internet. Corp A pays Data Center Operator a fee based on the amount of data storage used and computing power made available in connection with Corp A's content streaming. The storage and computing power provided to Corp A can be sourced from a variety of servers in one or more of Data Center Operator's facilities, and Data Center Operator determines how computing resources are allocated among its customers. Data Center Operator covenants to keep the servers operational, including performing physical maintenance and repair. Corp A has no right or ability to physically alter the servers.

The relevant factors for classifying the transaction between Corp A and Data Center Operator are analyzed in the same manner as the computing capacity and data storage transactions in Example 1 and Example 8, respectively, such that the transaction between Corp A and Data Center Operator is classified as a provision of services. A transaction between Corp A and an end-user is a cloud transaction because the end-user obtains a non-de minimis right to on-demand network access to digital content of Corp A.

An end-user has neither physical possession of nor control of the digital content. Additionally, Corp A has the right to determine the digital content used in the cloud transaction and retains the right to modify its selection of digital content. Digital content accessed by end-users is a component of an integrated operation in which Corp A's other responsibilities include maintaining and updating its content catalog. Corp A's end-users do not obtain a significant economic or possessory interest in any of the digital content in Corp A's catalog. The digital content provided by Corp A may be accessed concurrently by multiple unrelated end-users. Although, as a general matter, compensation based on the passage of time is more indicative of a lease than a service

transaction, that factor is outweighed by the other factors, which support a services classification. Taking into account all of the factors, a transaction between an end-user and Corp A is classified as a provision of services.

Example 10: Downloaded Digital Content Subject to Treas. Reg. § 1.861-18. Corp A offers digital content in the form of videos and music solely for download onto end-users' computers or other electronic devices for a fee. Once downloaded, the end-user accesses the videos and songs from the end-user's computer or other electronic device, which does not need to be connected to the Internet in order to play the content. The end-user owes no additional payment to Corp A for the ability to play the content in the future.

The download of digital content onto an end-user's computer for storage and use on that computer does not constitute on-demand network access by the end-user to the digital content of Corp A. Accordingly, the transaction between the end-user and Corp A is not a cloud transaction. Because the transaction involves the transfer of digital content as defined in Treas. Reg. § 1.861-18(a)(3), it will be classified under Treas. Reg. § 1.861-18. *See* Treas. Reg. § 1.861-18(h)(21).

Example 11: Access to Online Database. Corp A offers an online database of industry-specific materials. End-users access the materials through Corp A's website, which aggregates and organizes information topically and hosts a proprietary search engine. Corp A hosts the website and database on its own servers and provides multiple end-users access to the website and database concurrently. Corp A is solely responsible for maintaining and replacing the servers, website, and database (including adding or updating materials in the database). End-users have no ability to alter the servers, website, or database. Most materials in Corp A's database are publicly available by other means, but Corp A's website offers an efficient way to locate and obtain the information on demand. Certain materials in Corp A's database constitute digital content within the meaning of Treas. Reg. § 1.861-18(a)(3), and Corp A pays the copyright owners a license fee for using them. Each end-user may download any of the materials to its own computer and keep such materials without further payment. The end-user pays Corp A a fee based on the number of searches or the amount of time spent on the website, and such fee is not dependent on the amount of materials the end-user downloads. The fee that the end-user pays is substantially higher than the stand-alone charge for accessing the same digital content outside of Corp A's system.

Corp A's provision to an end-user of access to Corp A's website and online database is a cloud transaction. An end-user's downloading of the digital content would be classified as a sale of copyrighted articles under Treas. Reg. § 1.861-18. Nonetheless, taking into account the entire arrangement, including that the primary benefit to the end-user is access to

Corp A's database and its proprietary search engine, and that the stand-alone charge for accessing the digital content would be substantially less than the fee Corp A charges, the downloads are de minimis. Accordingly, there is no separate classification of the downloads.

The end-user has neither physical possession of nor control of the database, software, or the servers that host the database or software. Corp A retains the right to replace its servers and update its software and database. The database, software, and servers are part of an integrated operation in which Corp A is responsible for curating the database, updating the software, and maintaining the servers. Corp A provides each end-user on-demand network access to its software and online database concurrently with other end-users. Certain end-users pay Corp A a fee based on time spent on Corp A's website, which could be construed as compensation based on the passage of time and thus be more indicative of a lease than a service transaction. However, the fee that the end-user pays is substantially higher than the stand-alone charge for accessing the same digital content outside of Corp A's system. Accordingly, on balance, the fee arrangement supports the classification of the transaction as a service transaction. Taking into account all of these factors, the arrangement between end-users and Corp A is treated as the provision of services.

13. Modifications of Treas. Reg. § 1.861-18.

- (a) Existing Treas. Reg. § 1.861-18 provides rules for classifying transfers of computer programs as, for example, a license of a computer program, a lease of a computer program, or a sale of a computer program. Prop. Treas. Reg. § 1.861-18 broadens the scope of existing Treas. Reg. § 1.861-18 to apply to all transfers of digital content.
- (b) Treas. Reg. § 1.861-18 generally does not provide a comprehensive basis for categorizing many common transactions involving "cloud computing," which the Preamble states is typically characterized by on-demand network access to computing resources, such as networks, servers, storage, and software.
- (c) Cloud computing transactions typically are described for non-tax purposes as following one or more of the following three models: SaaS allows customers to access applications on a provider's cloud infrastructure through an interface such as a web browser. PaaS allows customers to deploy applications created by the customer onto a provider's cloud infrastructure using programming languages, libraries, services, and tools supported by the provider. IaaS allows customers to access processing, storage, networks, and other infrastructure resources on a provider's cloud infrastructure.

- (d) The preamble states that a cloud computing transaction typically do not involve any transfer of a computer program classified as a transfer of a copyright right or copyrighted article or any provision of development services or know-how relating to computer programs or programming. Although certain cloud computing transactions may provide similar functionality with respect to computer programs as transactions subject to Treas. Reg. § 1.861-18 (for example, the transfer of a computer program via download may provide similar functionality as the same program accessed via a web browser), Treas. Reg. § 1.861-18 does not address the provision of online access to use the computer program. Accordingly, Treas. Reg. § 1.861-18 would not apply to classify such a transaction.
- (e) The Preamble states that other transactions exist that are not solely related to computing but still involve on-demand network access to technological resources (“cloud transactions”). Examples include streaming music and video, transactions involving mobile device applications (“apps”), and access to data through remotely hosted software.
- (f) Prop. Treas. Reg. § 1.861-18 provides clarity around the title passage rule of Treas. Reg. § 1.861-7(c) by providing that when copyrighted articles are sold, the sale is deemed to occur at the location of the download or installation onto the end-user’s device, or in the absence of that information then at the location of the customer.
- (g) Treasury and the IRS determined that the rules and principles underlying existing Treas. Reg. § 1.861-18 have provided useful guidance and should apply to certain other digital content. Accordingly, Prop. Treas. Reg. § 1.861-18 broadens the scope of existing Treas. Reg. § 1.861-18 to apply to all transfers of “digital content,” defined in Prop. Treas. Reg. § 1.861-18(a)(3) as any content in digital format and that is either protected by copyright law or is no longer protected by copyright law solely due to the passage of time, whether or not the content is transferred in a physical medium. Digital content includes, for example, books, movies, and music in digital format in addition to computer programs.
- (h) Certain terms have been changed in Prop. Treas. Res. § 1.861-18, including references to computer programs being replaced with references to digital content. The application of Prop. Treas. Res. § 1.861-18 to digital content other than computer programs is illustrated by Prop. Treas. Res. § 1.861-18(h)(19) through (21) (Examples 19 through 21).

Example 19. Corp A operates a website that offers electronic books for download that are protected by copyright law. Under the agreements, Corp A receives from the content owners a digital master copy of each book, which Corp A downloads onto its server, in addition to the non-exclusive right to distribute unlimited copies in return for paying a specified amount for each copy sold. Corp A may not transfer any of the distribution rights it receives from the content owners. The term of each agreement Corp A has with a content owner is shorter than the remaining life of the copyright. Corp A charges each end-user a fixed fee for each book purchased. When purchasing a book on Corp A's website, the end-user must acknowledge the terms of a license agreement with the content owner that states that the end-user may view the electronic book but may not reproduce or distribute copies of it. In addition, the agreement provides that the end-user may download the book onto a limited number of its devices. Once the end-user downloads the book from Corp A's server onto a device, the end-user may access and view the book from that device, which does not need to be connected to the Internet in order for the end-user to view the book. The end-user owes no additional payment to Corp A for the ability to view the book in the future.

Notwithstanding the license agreement between each end-user and content owner granting the end-user rights to use the book, the relevant transactions are the transfer of a master copy of the book and rights to sell copies from the content owner to Corp A, and the transfers of copies of books by Corp A to end-users. Each end-user obtains those rights directly from Corp A. Because the end-user receives only a copy of each book and does not receive any of the copyright rights, the transaction between Corp A and the end-user is classified as the transfer of a copyrighted article. The transaction is classified as a sale and not a lease, because the end-user receives the right to view the book in perpetuity on its device.

The transaction between each content owner and Corp A is a transfer of copyright rights. In obtaining a master copy of the book along with the right to sell an unlimited number of copies to customers, Corp A receives a copyright right. The digital master copy is de minimis. There has not been a transfer of all substantial rights in the copyright rights to the content because each content owner retains the right to further license or sell the copyrights, subject to Corp A's interest; Corp A has acquired no right itself to transfer the copyright rights to any of the content; and the grant of distribution rights is for less than the remaining life of the copyright to each book. Therefore, the transaction between each

content owner and Corp A is classified as a license, and not a sale, of copyright rights.

Example 20. Corp A offers end-users memberships that provide them with unlimited access to Corp A's catalog of copyrighted music in exchange for a monthly fee. In order to access the music, an end-user must download each song. The end-user may download songs onto a limited number of its devices. Under the membership agreement terms, an end-user may listen to the songs but may not reproduce or distribute copies of them. Once the end-user stops paying Corp A the monthly membership fee, an electronic lock is activated so that the end-user can no longer access the music.

The end-users do not receive copyright rights and instead receive only copies of the digital content. Therefore, each download is classified as the transfer of a copyrighted article. Although an end-user will retain a copy of the content at the end of the payment term, the end-user cannot access the content after the electronic lock is activated. The activation of the electronic lock is the equivalent of having to return the copy. Therefore, each transaction is classified as a lease of a copyrighted article because the right to access the music is limited.

Example 21. Corp A offers a catalog of movies and TV shows, all of which are subject to copyright protection. Corp A gives end-users several options for viewing the content, each of which has a separate price. A "streaming" option allows an end-user to view the video, which is hosted on Corp A's servers, while connected to the Internet for as many times as the end-user wants during a limited period. A "rent" option allows an end-user to download the video to its computer or other electronic device (which does not need to be connected to the Internet for viewing) and watch the video as many times as the end-user wants for a limited period, after which an electronic lock is activated and the end-user may no longer view the content. A "purchase" option allows an end-user to download the video and view it as many times as the end-user chooses with no end date. Under all three options, the end-user may view the video but may not reproduce or distribute copies of it. Under the "rent" and "purchase" options, the end-user may download the video onto a limited number of its devices.

For the "rent" and "purchase" options, the end-user receives no copyright rights but, rather, receives only copies of the digital content. Therefore, transactions under those two options are transfers of copyrighted articles. Transactions for which the end-

user chooses the “purchase” option are classified as sales of copyrighted articles because the end-user receives the right to view the videos in perpetuity. Transactions under the “rent” option are classified as leases of copyrighted articles because the end-user’s right to view the videos is for a limited period.

For transactions under the “streaming” option, there is no transfer of any copyright rights. There is also no transfer of a copyrighted article, because the content is not downloaded by an end-user, but rather is accessed through an on-demand network. The transaction also does not constitute the provision of services for the development of digital content or the provision of know-how. The transaction is a cloud transaction that is classified under Treas. Reg. § 1.861-19. *See* Treas. Reg. § 1.861-19(d)(9).

14. Rights to Advertise Copyrighted Articles. Treasury and the IRS determined that the transfer of the right to publicly perform or display digital content for the purpose of advertising the sale of the digital content should not constitute the transfer of a copyright right for purposes of those portions of the Code enumerated in Treas. Reg. § 1.861-18(a)(1). For example, rights provided to a video game retailer allowing the retailer to display screenshots of a video game on television commercials promoting sales of the game generally would not, on their own, constitute a transfer of copyright rights that is significant in context. Accordingly, Prop. Treas. Reg. § 1.861-18 modifies existing Treas. Reg. § 1.861-18(c)(2)(iii) and (iv) to provide that a transfer of the mere right to public performance or display of digital content for purposes of advertising the digital content does not by itself constitute a transfer of a copyright right.
15. Source of Income for Sales of Copyrighted Articles in Electronic Medium.
 - (a) Treasury and the IRS noted the uncertainty associated with determining the source of sales of copyrighted articles by application of Treas. Reg. § 1.861-7(c), in particular in the context of electronically downloaded software. In many sales of copyrighted articles, the location where rights, title, and interest are transferred is not specified. In some cases, due to intellectual property law concerns, there may be no passage of legal title when the copyrighted article is sold. Moreover, the contractual specification of a location transfer could be easily manipulated and would bear little connection to economic reality.
 - (b) In light of these considerations, Prop. Treas. Reg. § 1.861-18(f)(2)(ii) provides that when copyrighted articles are sold and transferred through an electronic medium, the sale is deemed to occur at the location of download or installation onto the end-user’s device used to access the digital content for purposes of

Treas. Reg. § 1.861-7(c). It is expected that vendors generally will be able to identify the location of such download or installation. Comments are requested as to the availability, reliability and cost of information about the location of such download or installation. In the absence of information about the location of download or installation onto the end-user's device used to access the digital content, the sale is deemed to have occurred at the location of the customer based on the taxpayer's recorded sales data for business or financial reporting purposes.

- (c) Consistent with existing Treas. Reg. § 1.861-18, Prop. Treas. Reg. § 1.861-18(f)(2)(ii) provides that income from sales or exchanges of copyrighted articles is sourced under §§ 861(a)(6), 862(a)(6), 863, or 865(a), (b), (c), or (e), as appropriate. Treasury and the IRS do not expect Prop. Treas. Reg. § 1.861-18(f)(2)(ii) to impact the application of income tax treaties to which the U.S. is a party given that the taxation of gains under those treaties is generally determined by reference to the residence country of the seller and not the source of income from the sale. Income from leases of copyrighted articles is sourced under § 861(a)(4) or 862(a)(4), as appropriate.
- (d) In order to make other sections consistent with Prop. Treas. Reg. § 1.861-18(f)(2)(ii), a cross-reference has been added in the rules for sales of inventory property in Treas. Reg. § 1.861-7(c), and Example 4 in Treas. Reg. § 1.937-3(e) has been removed from the rules for determining whether income is derived from sources within a U.S. possession or territory.

- 16. Change in Method of Accounting. The application of these new rules for purposes of the affected Code sections may require certain taxpayers to change their methods of accounting under § 446(e) for affected transactions. The Preamble states that any change in method of accounting made to comply with the regulations would be a change initiated by the taxpayer.
- 17. Request for Comments. Treasury and the IRS have requested comments on these rules, including answers to some specific questions which we will not address here. One of the questions asks about administering them under §§ 861 through 865.

XVIII. NEW OECD PROPOSAL.

- A. The OECD released a unified approach outlining the Pillar One proposal to deal with the digital economy. Pillar One focuses on new profit allocation and nexus rules. The united approach draws on the three alternatives under Pillar One and is a significant change to the long standing international tax structure. The unified

approach concept is very similar to some of the OECD special measures. The approach covers digital business models but is much broader and focuses on all consumer-facing businesses.

- B. For businesses within its scope, the unified approach creates a new nexus, not dependent on physical presence but largely based on sales. The new nexus could have thresholds including country specific sales thresholds to ensure that jurisdictions with smaller economies can also benefit. The unified approach would be designed as a new self-standing treaty provision.
- C. The unified approach creates a new profit allocation rule irrespective of marketing or distribution presence. The report states that the approach largely retains the current transfer pricing rules based on the arm's length principle but complements them with formula based solutions in areas where tensions in the current system are the highest. This statement that the current arm's length principle would remain is not accurate. The unified method is not compatible with the arm's length method. Any approach that prices transactions based on allocation factors rather than what is done at arm's length, does not retain the current transfer pricing rules based on the arm's length principle.
- D. The report states that the unified approach increases tax certainty for taxpayers and tax administrations. While it would be nice if that were true, in reality the approach creates a lot of uncertainty. The unified method consists of a three tier profit allocation mechanism, as follows:
 - Amount A – a share of deemed residual profit allocated to market jurisdictions using a formulaic approach (the new taxing right);
 - Amount B – a fixed remuneration for baseline marketing and distribution functions that take place in the market jurisdiction (an arm's length analysis); and
 - Amount C – binding and effective dispute prevention and resolution mechanisms.
- E. Amount A is the big change that would reallocate a portion of the deemed residual profit of a multinational business (on a group or business line basis) to market jurisdictions irrespective of the location and/or residence of that business, consistent with the creation of a new nexus unconstrained by physical presence requirements. The deemed residual profit would represent the profit that remains after designating a deemed routine profit on the activities of the group or business line. The report states that this reallocation would specifically address the concerns raised by the remote and non-physical participation of some businesses in the economy of a market jurisdiction, and the question of how taxing rights on income generated from cross-border activities in the digital age are allocated.
- F. In broad terms, this approach would replicate features of both the residual profit split ("RPS") method (by introducing a threshold based on profitability to exclude

the remuneration of routine activities) and the fractional apportionment method (by relying on formula-based calculations). Thus, the unified approach Amount A is really formulaic apportionment.

- G. The starting point for the determination of Amount A would be the identification of the group's profits. The second step in calculating Amount A is to approximate the remuneration of the routine activities based on an agreed level of profitability. In broad terms, these are profits which, by analogy to the residual profit split method, would be regarded as rewarding routine functions. The report states that the level of profitability deemed to represent routine profits could be determined using a variety of approaches, but a simplified approach would be to agree a fixed percentage(s), possibly with variances by industry. This is the key point that creates uncertainty. How the fixed percentages are determined is important.
- H. It is then necessary to determine the split of those deemed non-routine profits between the market jurisdiction and other factors such as trade intangibles, capital and risk, etc. The report states that this is important as non-routine profit is attributable to many activities including those not targeted by the new taxing right. For example, a social media business may generate non-routine profit from its customers' data and valuable brand, but also from its innovative algorithms and software.
- I. The report recommends an internationally-agreed fixed percentage, though it is possible that different percentages might be applied to different industries or business lines. This is the key point in the unified approach that creates uncertainty. Determining the percentages is critical. It is unclear how the percentages will be determined and agreed to by all relevant countries. It will be difficult to get countries to agree, every country will want to tax as much of the profits as possible.
- J. The report states that there are increasing doubts that the arm's length principle can be relied on to give an appropriate result in all cases. However, there are also serious doubts that this new approach will give appropriate results in all cases. Who determines what are appropriate results? Concepts of fairness and justice are hard to quantify. If countries do not agree, then businesses will face taxation in multiple countries on the same income. This type of taxation discourages international trade.
- K. The report adds that there seems to be agreement that the arm's length principle is becoming an increasing source of complexity and that simplification would be desirable to contain the increasing administration and compliance costs of trying to apply it. Thus, the report concludes that an "administrable" solution is essential to lower the risks of disputes. However, this statement is short sighted and unrealistic. The new approach adds a whole new level of complexity and makes the system extremely uncertain. In an ideal world all countries would agree which countries have a right to tax which income, but in practice countries

do not agree and the arm's length system, while complex, allocates profits based on what uncontrolled parties do at arm's length.

- L. The report states that the proposed unified approach would retain the current rules based on the arm's length principle in cases where they are widely regarded as working as intended, but would introduce formula-based solutions in situations where tensions have increased – notably because of the digitalisation of the economy. This could leave us with no international tax system if every country determines for itself what profits it should be entitled to based on no objective criteria.
- M. The report states that once it is determined that a country has a right to tax profits of a non-resident enterprise, the next question is how much profit the rules allocate to that jurisdiction. This even further opens the doors for uncertainty and subjectivity.
- N. The new profit allocation rules would go beyond the arm's length principle and beyond the limitations on taxing rights determined by reference to a physical presence, two principles generally accepted as cornerstones of the current rules.
- O. The report states that the new rules, taken together with existing transfer pricing rules, will need to deliver the agreed quantum of profit to market jurisdictions and do so in a way that is simple, avoids double taxation, and significantly improves tax certainty. That is easy to say, but that is not practically feasible under this new unified approach.
- P. The report notes implementation issues such as the fact that enforcement and collection could be complex when an entity is not a resident. The report suggests a withholding tax mechanism for the collection of the designated Amount A.
- Q. The OECD Report Provides an Illustration
 - 1. Group X provides streaming services, has no other business lines and is highly profitable. The parent company (P Co resident in Country 1), owns all the intangible assets and is entitled to all the non-routine profit.
 - 2. Q Co (resident in Country 2), is responsible for marketing and distributing. Q Co sells streaming services directly to customers in Country 2 and has recently started selling remotely to customers in Country 3.
 - 3. Under the new taxing right (Amount A), it will be necessary to determine whether Group X has a new non-physical nexus in Country 2. The example assumes that Q Co makes sufficient sales in Country 2 to meet the revenue threshold. This would give Country 2 the right to tax a portion of the deemed non-routine profits of Group X (Amount A). Country 2 may tax that income directly from the entity that is treated as owning the deemed non-routine profit (in this example, P Co), with the

possibility of Q Co held jointly liable for the tax due to facilitate administration. Relief from double taxation would be provided once P Co claims a foreign tax credit or an exemption in Country 1. This is a big assumption in the example. Will the U.S. be willing to give a FTC for this new taxing right? Giving a FTC for the new taxing right will significantly decrease the U.S. fisc. If a FTC is not given, that would result in a double taxation.

4. The example then states that transfer pricing adjustments would be made to transactions between P Co and Q Co to eliminate double taxation. The report does not explain how transfer pricing principles could apply when there is first a tax on a non-arm's length amount.
5. Finally, the report states if Country 2 considers that Q Co should have additional profits taxed under the arm's length principle because its activities go beyond the baseline activity assumed in the fixed return arrangement for marketing and distribution activities (Amount C), Country 2 would be subject to robust measures to resolve disputes and prevent double taxation.
6. The example then explains the Country 3 results. In Country 3, Group X does not have a taxable presence, however, Q Co is making remote sales in the country. Under the new taxing right (Amount A), it will be necessary to determine whether Group X has a non-physical nexus in that jurisdiction. The example assumes that Group X makes sufficient sales in Country 3 to meet the revenue threshold. Country 3 would then also have the right to tax a portion of the deemed non-routine profits of Group X (Amount A). Country 3 may tax that income directly from the entity that is treated as owning the non-routine profit (*i.e.* P Co), with P Co being held to have a taxable presence in Country 3 under the new nexus rules.
7. In an effort to create a united approach that every country will support, the OECD has created a very complex and subjective system. The report basically states that formulary apportionment taxation will be allowed as a new taxing right (Amount A) and that arm's length adjustments (Amount B) can still be made, if appropriate. It then states any disputes will be resolved under Amount C mechanisms. In theory, the approach seems like a compromise, however these concepts don't fit together in practice. The practical result of these rules is chaos. We are left with a system of every country can do what they want, if they determine arm's length pricing is not "fair" or is not working and then it is up to the taxpayer to seek dispute resolution to resolve every pricing allocation.