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Global Tax Alert

US Treasury and IRS finalize DRD anti-abuse regulations with few changes

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Executive summary

On 21 August 2020, the United States (US) Treasury Department (Treasury) and the Internal Revenue Service (IRS) released final regulations under Internal Revenue Code[1] Section 245A (TD 9909) providing anti-abuse rules for "extraordinary dispositions" and "extraordinary reductions." These regulations finalize proposed regulations and replace temporary regulations that were issued in June 2019. (For discussion of the proposed and temporary regulations, see EY Global Tax Alert, *US temporary and proposed DRD regulations reflect GILTI-centric view of international tax rules enacted under TCJA*, dated 21 June 2019).

The final regulations are substantially similar to the proposed and temporary regulations, with a limited number of generally taxpayer-favorable changes at the margin. While the substantive rules did not change much, taxpayers should pay close attention to new examples illustrating anti-abuse rules. Several new examples illustrate the anti-abuse rules, and one of them would extend the application of the extraordinary-disposition rules beyond "dispositions."

At the same time, Treasury and the IRS released new proposed regulations that would coordinate the final regulations with certain rules under Section 951A that effectively deny deductions arising from "disqualified basis" that is generated during the global intangible low-taxed income (GILTI) gap period, as defined later. Discussion of the proposed regulations can be found in EY Global Tax Alert, *Treasury and the IRS propose complex, taxpayer-favorable regulations to reduce possibility of double taxation caused by anti-abuse rules on GILTI gap period*, dated 1 September 2020.

Detailed discussion

Extraordinary dispositions

The final regulations continue to deny the Section 245A dividends received deduction (DRD) for 50% of the dividends paid by specified 10%-owned foreign corporation (SFCs) to the extent attributable to earnings and profits (E&P) from extraordinary dispositions. An extraordinary disposition occurs when an SFC disposes of property to a related party outside of its ordinary course of business and the disposition:

- Occurs after 31 December 2017, but before the close of a tax year to which the GILTI rules under Section 951A do not apply (the GILTI gap period)
- Would have resulted in tested income (or reduced tested income) if gain (or loss) were recognized outside of the GILTI gap period

Whether a disposition of tangible property is outside of the SFC's ordinary course of business is a facts-and-circumstance determination. In contrast, dispositions of intangible property and dispositions undertaken with a principal purpose of generating E&P during the GILTI gap period are *per se* outside of the ordinary course of the SFC's business. The final regulations provide a new, limited exception to the per se rule for related-party, intangible-property transfers if the related acquirer is reasonably expected to resell the intangible property to an unrelated customer within one year.

Taxpayers must maintain extraordinary disposition accounts. A Section 245A shareholder's extraordinary disposition account for an SFC at any time equals the following:

> [Shareholder's percentage, by value, of the SFC stock x the amount of the E&P resulting from extraordinary dispositions] – extraordinary disposition amounts (i.e., portion of dividends paid out of the extraordinary disposition account) already taken into account by the shareholder

In a correction to an apparent oversight in the temporary regulations, the final regulations reduce a Section 245A shareholder's extraordinary disposition account for income inclusions under Section 956.

The final regulations retain the favorable ordering rule from the temporary regulations, in which a dividend is first considered paid out of non-extraordinary disposition E&P and is then considered paid out of the Section 245A shareholder's extraordinary disposition account. When determining non-extraordinary disposition E&P, the final regulations measure the Section 245A shareholder's share of the SFC's Section 959(c)(3) E&P based on the percentage of stock owned immediately *before* the distribution. As a result, when the Section 245A shareholder disposes of all its SFC stock (e.g., when a gain from the sale is recharacterized as a dividend under Section 1248), a portion of the dividend related to the sale may now be treated as distributed from non-extraordinary disposition E&P.

The final regulations include successor rules that are broader in some circumstances than the rules in the temporary regulations, but narrower in others. In particular, the final regulations generally eliminate a Section 245A shareholder's extraordinary disposition account if: (i) the shareholder transfers all its directly or indirectly owned stock in an SFC to persons that are not Section 245A shareholders; and (ii) no related person is a Section 245A shareholder of the SFC after the transfer. In addition, the final regulations expand the successor rules for nonrecognition transactions, including certain Section 355 distributions, triangular asset reorganizations and restructuring transactions described in Treas. Reg. Section 1248-8(a)(1). To address perceived abuses around issuances of SFC stock, the final regulations treat related domestic corporations (within the meaning of Sections 267(b) or 707(b)) as a single domestic corporation for purposes of determining the extent to which a dividend is an extraordinary disposition amount or a tiered extraordinary disposition amount.

Extraordinary reductions

The final regulations continue to deny 100% of the Section 245A DRD for certain dividends paid in a tax year in which an extraordinary reduction occurs. An extraordinary reduction is a transaction in which either: (i) a "controlling Section 245A shareholder" transfers more than 10% (by value) of its controlled foreign corporation (CFC) stock (at least 5% of total CFC stock); or (ii) the controlling Section 245A shareholder's overall ownership of the CFC changes more than 10% (by value) and at least five percentage points. A controlling Section 245A shareholder is a CFC shareholder that owns more than 50% of the CFC's stock, including through attribution.

The Section 245A DRD is denied to the extent that: (i) the shareholder would have included subpart F income or tested income had the transfer or other reduction in ownership not occurred (the US shareholder's pre-reduction pro-rata share); and (ii) a different US person who is a US shareholder after the transfer does not take the amounts into account (the Extraordinary Reduction Amount).

Election to close the CFC's tax year

The final regulations continue to provide an election for extraordinary reductions under which: (i) the relevant CFC's tax year closes as of the extraordinary reduction's end date; and (ii) the Extraordinary Reduction Amount equals zero. Generally, this permits taxpayers to convert dividend income that is fully taxable by reason of the extraordinary-reduction rule into GILTI or subpart F income, thereby allowing foreign tax credits and the Section 250 deduction.

The Section 245A shareholder must make the election with its tax return for the applicable tax year. The final regulations confirm that the election is bilateral; it must be made by both seller and buyer Section 245A shareholders. Before making the election, the Section 245A shareholder must enter into a written, binding agreement providing that the election will be made and applying to each US tax resident that is a US shareholder of the CFC at the end of the day of the extraordinary reduction.

Denial of exclusion for related CFCs

The final regulations continue to deny the Section 954(c)(6) exception, in whole or in part, if a lower-tier CFC distributes a dividend to an upper-tier CFC and that distribution is attributable to a "tiered" extraordinary disposition amount or a "tiered" extraordinary reduction with respect to the lower-tier CFC.

Anti-abuse rule

The final regulations retain the general anti-abuse rule but modify it to be self-executing (as opposed to applicable under the discretion of the Commissioner). As before, the anti-abuse rule provides for appropriate adjustments, including adjustments that would disregard a transaction or arrangement, if the taxpayer engages in the transaction or arrangement with a principal purpose of avoiding the purposes of the final regulations.

The final regulations include several new examples illustrating the application of the anti-abuse rule. In one of these examples, a CFC prepaid a royalty obligation to another related CFC during the GILTI gap period. Because a principal purpose of prepaying the royalty was to generate E&P during the GILTI gap period, the example concludes that the E&P is treated as extraordinary disposition E&P.

This example expands the scope of the extraordinary-disposition rules to transactions that do not involve "dispositions" of property. In this regard, the example is similar to Prop. Reg. Section 1.951A-2(c)(6), which would expand the disqualified-basis rule in the GILTI regulations to include "disqualified payments."

Applicability dates

The final regulations apply to tax periods ending on or after 14 June 2019, while Temp. Treas. Reg. Section 1.245A-5T continues to apply to distributions made after 31 December 2017, to which the final regulations do not apply. Taxpayers may apply the final regulations retroactively, provided that they and all related parties apply them consistently.

Endnote

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.

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