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Global Tax Alert

US Treasury and the IRS propose complex, taxpayer-favorable regulations to reduce possibility of double taxation caused by anti-abuse rules on GILTI gap period

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Executive summary

On 21 August 2020, the United States (US) Treasury Department (Treasury) and the Internal Revenue Service (IRS) released taxpayer-favorable proposed regulations under Internal Revenue Code[1] Sections 245A and 951A (REG-124737-19) to coordinate two independent sets of anti-abuse rules that apply to extraordinary dispositions and disqualified transfers (together, EDs). Both rules apply to certain transactions of a controlled foreign corporation (CFC) occurring during the so-called global intangible low-taxed income (GILTI) gap period. Absent the proposed regulations, gain recognized in an ED effectively could be taxed twice:

- Once, in the form of a taxable dividend distributed by a CFC (because the dividend is deemed to be attributable to the ED)
- Twice, either as increased subpart F income or GILTI inclusions from a CFC (because deductions attributable to basis acquired in the ED may not reduce subpart F income or tested income) or as increased gain from transactions in CFC stock (because those deductions generally still reduce earnings and profits)

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The proposed regulations, which would not be elective, would coordinate the two sets of anti-abuse rules so that one set generally would not apply to the extent that the other set resulted in taxable income. Taxpayers may apply the proposed regulations before they are finalized, including retroactively to past tax years of foreign corporations.

This Alert summarizes the proposed regulations, which contain numerous and complex rules, conditions, and exceptions. EY Global Tax Alert, *US Treasury and IRS finalize DRD anti-abuse regulations with few changes*, dated 1 September 2020 discusses final regulations under Section 245A that Treasury and the IRS released simultaneously with the proposed regulations (TD 9909).

Detailed discussion

Background

The proposed regulations would coordinate two sets of anti-abuse rules, each of which apply to an ED. In general, an ED is a disposition of certain property (specified property) by a CFC to a related party outside of the ordinary course of the CFC's activities. The disposition must have occurred during the CFC's so-called GILTI gap period in 2018 (under the proposed regulations, the disqualified period).

First set of anti-abuse rules: Taxable dividends

The first set of anti-abuse rules relates to Sections 245A and 954(c)(6). In general, the rules cause a dividend to give rise to marginal taxable income when the dividend otherwise would not. In this Alert, we refer to these rules as the ED rules.

Under certain conditions, a corporate US shareholder (a Section 245A shareholder) of a foreign corporation (a specified 10%-owned foreign corporation, or SFC) that receives a dividend from the foreign corporation may claim a 100% dividends-received deduction under Section 245A (a Section 245A dividends received deduction (DRD)).

The regulations containing the ED rules effectively reduce the Section 245A DRD to 50% for the portion of an otherwise qualifying dividend that is attributable to an ED. The portion of the dividend attributable to an ED is generally referred to as the dividend's ED *amount*; a dividend's ED amount arises to the extent a dividend is treated as paid out of the positive balance in an ED *account*. Parallel ED rules apply to dividends received by a CFC, but instead turn off the Section 954(c)(6) look-through exception to foreign personal holding company income. The portion of the dividend to which the parallel rules render Section 954(c)(6) inapplicable generally is known as the dividend's *tiered* ED amount.

Second set of anti-abuse rules: Denial of CFC deductions, etc.

The second set of anti-abuse rules concerns certain basis resulting from an ED (disqualified basis). The disqualified basis anti-abuse rules (DQB rules) can increase amounts that a CFC's US shareholder must include in gross income under Sections 951 and 951A.

Section 951 requires a US shareholder of a CFC to include in gross income for a tax year the US shareholder's pro rata share of the CFC's subpart F income for the CFC's corresponding tax year. Similarly, Section 951A requires a US shareholder of a CFC to include in gross income for a tax year the US shareholder's GILTI for the CFC's corresponding tax year—a function (in part) of the US shareholder's pro rata share of the tested income (or tested loss) of the CFC.

The DQB rules require a CFC to allocate and apportion deductions attributable to disqualified basis to its residual gross income (RGI), which is its gross income *other than* gross tested income, gross income taken into account in determining subpart F income, or gross income that is effectively connected, or treated as effectively connected, with the conduct of a trade or business in the US (ECI). Consequently, Section 951 or 951A inclusions or ECI can be expected to be greater.

Despite the DQB rules, the applicable deductions generally reduce the CFC's earnings and profits (E&P). Even without a Section 951 or 951A inclusion or ECI, the E&P reduction also can result in double taxation. With less E&P, it is more likely, for example, that a taxable disposition of the CFC stock will result in gain not being characterized as a dividend under Section 1248.

Detailed explanation of the proposed regulations

As the proposed regulations would coordinate the ED rules and the DQB rules, the regulations are relevant only to the extent that a Section 245A shareholder both (i) has a positive balance in an ED account with respect to an SFC (which might be the original transferor CFC in the relevant ED, or a successor) and (ii) owns, directly or indirectly, stock of a CFC that owns an item of specified property with disqualified basis (which CFC, similarly, might be the original related-party transferee in the relevant ED, or a successor).

Moreover, the proposed regulations would mandate that the item of specified property and the ED account correspond to one another, which means that gain recognized on the disposition of the item in an ED was taken into account in determining the initial balance of the ED account.

Proposed coordination rules: In general

The proposed regulations would coordinate the ED rules and the DQB rule by introducing two new operative rules: the DQB reduction rule and the ED account (EDA) reduction rule.

The DQB reduction rule generally would reduce the disqualified basis of an item of specified property when a Section 245A shareholder's corresponding ED account gives rise to an ED (or tiered ED) amount in any tax year of the Section 245A shareholder (applicable shareholder year) in which the shareholder or a related party (including a CFC) owns the item of specified property for at least one day. The rule would reduce the disqualified basis of the item (though not below zero) by (i) the sum of all ED (and tiered ED) amounts during the applicable shareholder year *multiplied by* (ii) a fraction (a) whose numerator is the item's disqualified basis, and (b) whose denominator is the sum of the disqualified basis of each item of specified property corresponding to the ED account. The reduction would occur at the beginning of the owner's tax year that includes the date on which the applicable shareholder year ends (the amounts of disqualified basis in the prior fraction are also measured at the beginning of this owner tax year).

Conversely, the EDA reduction rule generally would reduce the balance of a Section 245A shareholder's ED account to the extent the DQB rule had effectively increased the shareholder's proportionate share of gross subpart F income, tested income, or ECI (and certain other conditions applied). More specifically, a Section 245A shareholder's ED account generally would be reduced by the lesser of:

- The amount by which the DQB rules caused those deductions and losses to be allocated and apportioned to RGI and reduced the Section 245A shareholder's (or a related domestic corporation's) proportionate share of gross tested income, gross income taken into account in determining subpart F income, or gross ECI
- The amount by which the CFC's deductions and losses reduced the Section 245A shareholder's (or a related domestic corporation's) proportionate share of the CFC's untaxed E&P

The two amounts would be measured at the end of each tax year of the CFC (adjusted to reflect the EDA reduction rule's application to prior CFC tax years). The EDA reduction rule would reduce the balance of the Section 245A shareholder's corresponding ED account (though not below zero) at the end of each tax year of the shareholder—but only after (i) determining any ED (or tiered ED) amounts with respect to the ED account, (ii) adjusting the ED account for prior ED amounts, and (iii) applying the DQB reduction rule (each, for the applicable shareholder year). An important condition: The amounts as to a CFC tax year would be taken into account only if the Section 245A shareholder or a related domestic corporation were a US shareholder of the CFC on the last day of the CFC tax year.

Simple and complex cases

Different provisions apply under the proposed regulations in a "simple case" (on the one hand) and a "complex case" (on the other). Both are intended to achieve the same result. A Section 245A shareholder may choose to apply the "simple" provisions if certain conditions (described later) are met in an applicable shareholder year and *were met* in all *prior* applicable shareholder years. If the conditions were *not* met in an applicable shareholder year, the Section 245A shareholder would be required to apply the "complex" provisions in that tax year and all succeeding tax years. In this way, the conditions generally must be met continuously, beginning in the first applicable shareholder year, if the simple provisions are to be available in a later applicable shareholder year. Many taxpayers will find that they have failed to satisfy one of the conditions already.

Some of the conditions would pertain to the transferor CFC in an ED (which must remain a CFC, not merely an SFC), and others to each corresponding item of specified property, and each transferee thereof, in that ED. As to the transferor CFC:

- The Section 245A shareholder must have owned, directly or indirectly, all of the CFC's stock on both (i) 1 January 2018, and (ii) each day of the applicable shareholder year
- The CFC must not have participated in certain corporate restructuring transactions during the applicable shareholder year

As to each corresponding item of specified property, the conditions to be met include the following:

- The original acquiror of each item of specified property in each relevant ED must have been a CFC (not, e.g., a domestic related party) at the time of the ED, and the CFC must *directly* own the item on each day of each CFC tax year beginning or ending with or within the applicable shareholder year (a beginning or ending CFC tax year, respectively).
- The Section 245A shareholder and related domestic corporations must have owned, directly or indirectly, all of the stock of each of the original transferee CFCs both (i) at the time of the relevant ED and (ii) on each day of each beginning and ending CFC tax year.
- In each ending CFC tax year of each original transferee CFC, the CFC must not have its own ED account, and the sum of the balances in the hybrid deduction accounts (under regulations issued under Section 245A(e)) must be zero.

Each previous reference to a Section 245A shareholder or CFC would *exclude* a successor thereto, so a corporate reorganization of, for example, an original transferee CFC into a successor CFC could prevent the conditions from being met.

Applicability dates

The proposed regulations would apply to tax years of foreign corporations beginning on or after the proposed regulations' finalization, and to tax years of a US person in which or with which those tax years end. For tax years beginning before the proposed regulations are finalized, however, taxpayers may apply the proposed regulations, provided they and all related parties apply the proposed regulations consistently to all such tax years.

Implications

Taxpayers that engaged in an ED should consider immediately how the proposed regulations apply to their circumstances. The regulations (which, as proposed, would not be elective) are complex and will entail significant compliance costs. In particular, a taxpayer in either of the following circumstances might benefit from taking action sooner than later:

- The ED rules have already applied to a dividend, such that the taxpayer has included marginal amounts in taxable income. The taxpayer might obtain a refund or credit upon amending past tax returns to apply the proposed regulations.
- The taxpayer intends, in the near future, to cause an SFC to distribute a dividend to which the ED rules would apply. The taxpayer might accelerate that dividend so the DQB reduction rule can increase CFC deductions in an earlier tax year, and those deductions are not otherwise lost forever.

Taxpayers should consider not merely the extent to which application of the proposed regulations would reduce, based on past tax years, their ED account balances and disqualified basis. They should also evaluate whether the proposed regulations create opportunities to manage those EDA account balances and disqualified basis efficiently in future tax years. In so doing, taxpayers should take into account foreign tax credits and other attributes, projections for future income and taxes, repatriation strategies, mergers and acquisitions, and numerous other unique considerations.

Endnote

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

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