9 September 2020
Global Tax Alert

US: Notice 2020-69 provides rules on entity treatment election for certain S corporations for purposes of GILTI in AAA inclusions

EY Tax News Update: Global Edition

EY's Tax News Update: Global Edition is a free, personalized email subscription service that allows you to receive EY Global Tax Alerts, newsletters, events, and thought leadership published across all areas of tax. Access more information about the tool and registration here.

Also available is our EY Global Tax Alert Library on ey.com.

Executive summary

In Notice 2020-69 (the Notice), the United States (US) Treasury announced its intent to issue regulations addressing the application of subpart F and the global intangible low-tax income (GILTI) regime to certain S corporations with accumulated earnings and profits (AE&P) as of 1 September 2020. The Notice permits electing S corporations to apply its provisions to tax years of S corporations ending on or after 21 June 2019.

Under the Notice, an S corporation with "transition AE&P" as of 1 September 2020, may irrevocably elect entity treatment for purposes of subpart F income and GILTI. Electing S corporations must determine a GILTI inclusion at the corporate-level and each shareholder must then include a distributive share of the S corporation's GILTI in taxable income. Once an electing S corporation ceases to have transition AE&P, the S corporation must apply the aggregate rule of Treas. Reg. Section 1.951A-1(e).

This Alert provides an overview of the Notice and related guidance issued to date. For more detailed information on the final GILTI regulations, see EY Global Tax Alerts, *US Final and proposed GILTI and subpart F regulations include favorable and unfavorable provisions for taxpayers*, dated 21 June 2019 and *US Final, temporary and proposed regulations on GILTI and ownership attribution affect domestic pass-through owners and individuals*, dated 28 June 2019. For more

Building a better working world

detailed information regarding Notice 2019-46, discussed later, see EY Global Tax Alert, *US IRS announcement allowing domestic partnerships and S corporations to file under proposed GILTI regulations has implications for tax year 2018 filings for private equity funds, alternative asset management funds and other private companies*, dated 3 September 2019.

Detailed discussion

Background

Internal Revenue Code[1] Section 951A, enacted under the *Tax Cuts and Jobs Act* (TCJA), introduced the GILTI regime (see Section 14201(a) of Pub. L. 115-97 (131 Stat. 2054. 2208). According to Section 951A(a), a US shareholder that owns stock in any controlled foreign corporation (CFC) (as defined in Section 957) for the tax year includes its GILTI amount for that year in gross income. Section 951(b) defines a US shareholder of a foreign corporation as a US person who owns, within the meaning of Section 958(a), or is considered as owning by applying the ownership rules of Section 958(b), at least 10% of the total combined voting power or value of the stock of the foreign corporation. Finally, Section 1373(a) treats an S corporation as a partnership for purposes of subparts A and F of Part III (Sections 901 through 909 and 951 through 965, respectively) and Part V (Section 999) of subchapter N of the Code.

Historically, S corporations were treated as a US shareholder within the meaning of Section 951(b) and thus as entities for purposes of subpart F income inclusions. Under this regime, an S corporation determined its subpart F income at the entity level and each S corporation shareholder included in taxable income the shareholder's pro-rata share of the S corporation's subpart F income, regardless of whether the shareholder was a US shareholder with respect to the S corporation's CFCs under Section 951(b). Under Section 958(a)(2), a partner in a foreign partnership is treated as owning the stock of any CFCs held by the foreign partnership on a proportionate basis. Thus, a foreign partnership does not have any items of taxable income arising from subpart F income of CFCs owned by the foreign partnership. Rather, the stock of the CFC is attributed proportionately to the foreign partnership's US shareholder-partners who determine their pro-rata shares of each CFC's subpart F income directly.

i. GILTI regulations

In October 2018, the IRS published proposed regulations under Section 951A (REG-104390-18, 83 FR 51072) (the Proposed GILTI Regulations), which provided a hybrid approach to the treatment of a domestic pass-through entity that is a US shareholder of a CFC. Under the approach in the Proposed GILTI Regulations, a US shareholder S corporation would determine its GILTI inclusion amount, and, as a result, all S corporation shareholders would include in taxable income their distributive share of the S corporation's GILTI inclusion amount. This meant that S corporation shareholders indirectly owning less than 10%, by vote or value, of CFCs owned by the S corporation would have a GILTI inclusion from those CFCs. S corporation shareholders that were themselves US shareholders of a CFC held by the S corporation would not consider their distributive share of the S corporation's GILTI inclusion amount, but, instead, would be treated as proportionately owning the stock of the S corporation's CFCs within the meaning of Section 958(a), as if the S corporation were a foreign partnership.

Final regulations under Section 951A (T.D. 9866, 84 FR 29288) (the Final GILTI Regulations), published in June 2019, did not adopt the hybrid approach contained in the Proposed GILTI Regulations. Under Treas. Reg. Sections 1.951A-1(l)(1) and 1.951A-5 of the Final GILTI Regulations, an S corporation does not have a GILTI inclusion amount. As such, no S corporation shareholder would have a distributive share of the S corporation's GILTI inclusion amount. Instead, for purposes of determining the GILTI inclusion of any shareholder of a US shareholder S corporation, each S corporation shareholder is treated as proportionately owning the stock of a CFC owned by the S corporation within the meaning of Section 958(a) in the same manner as if the S corporation were a foreign partnership. As a result, only an S corporation shareholder that is a Section 951(b) US shareholder with respect to the S corporation's CFCs may have a GILTI inclusion with respect to such CFCs. To facilitate the calculation of a US shareholder S corporation shareholder's GILTI inclusion amount, the S corporation merely reports each S corporation shareholder's pro rata share of the tested income, tested loss, qualified business asset investment (QBAI), and tested income taxes on the shareholder's Schedule K-1 for the tax year of the S corporation.

Issued contemporaneously with the Final GILTI Regulations, proposed Treas. Reg. Section 1.958-1(d) (REG-101828-19, 84 FR 29114) would extend this aggregate treatment to Subpart F income inclusions under Section 951 and any other provision that applies by reference to Sections 951 or 951A.

In August 2019, Treasury and the IRS issued Notice 2019-46 (2019-37 I.R.B. 965), which allowed certain electing S corporations to apply the hybrid approach contained in the Proposed GILTI Regulations for tax years ended before 22 June 2019. Notice 2019-46 waived penalties for S corporations that applied the Proposed GILTI Regulations to their tax year 2018 returns, provided the S corporation followed the prescribed notice and reporting procedures.

ii. Accumulated adjustments account

Section 1368 provides rules for a shareholder's treatment of distributions received from an S corporation.

When an S corporation does not have AE&P, a distribution by the S corporation is not included in a shareholder's gross income to the extent that the amount of the distribution does not exceed the adjusted basis of the S corporation's stock. If the distributed amount exceeds shareholder stock basis, the excess is treated as gain from the sale or exchange of the stock.

If an S corporation does have AE&P (e.g., earnings and profits carried over from a prior C corporation period or from a merger of a historic C corporation into the S corporation), the S corporation must maintain an accumulated adjustments account (AAA) in the manner provided by Section 1368(e)(1). An S corporation's distributions from an AAA are prioritized ahead of either AE&P or shareholder stock basis. As a result, a distribution received by a shareholder from an AAA is excluded from the shareholder's gross income. A distribution in excess of AAA is a taxable dividend from the S corporation's AE&P. Once AE&P is exhausted, further distributions are subject to the same treatment as distributions from S corporations without AE&P (i.e., a distribution is not taxable to the extent it does not exceed a shareholder's stock basis and is recognized as gain from the sale of stock to the extent of any excess).

AAA is designed to facilitate tax-free distributions of S corporation amounts that have already been subject to tax at the shareholder level. To achieve this goal, AAA is adjusted each year in the same manner as the basis adjustments under Section 1367. AAA increases for the S corporation's income that is taxed to its shareholders. As a result, an AAA is the primary mechanism by which shareholders of an S corporation with AE&P prevent double taxation of S corporation earnings.

The aggregate treatment provided by the Final GILTI Regulations does not result in a positive adjustment to an S corporation's AAA because an S corporation is not considered to be a shareholder of its CFCs for this purpose. Therefore, an S corporation does not have items of income related to CFC earnings under Section 951A; only an S corporation's US shareholders are considered to own the stock of the S corporation's CFCs within the meaning of Section 958(a). As a result, an S corporation that has AE&P and must make annual tax distributions to its shareholders risks such distributions being sourced to its AE&P and constituting a taxable dividend to its shareholders if the S corporation does not have additional sources of income sufficient to increase AAA by an amount at least equal to the tax due for the GILTI inclusions of its shareholders.

Notice 2020-69 permits S corporations with "transition AE&P" to irrevocably elect entity treatment

i. Effect of irrevocable election

The Notice announces that Treasury and the IRS intend to issue regulations under Section 958 to provide relief to S corporations with AE&P when transitioning from the historic entity treatment of subpart F income and the hybrid regime under the Proposed GILTI Regulations to the aggregate treatment required under the Final GILTI Regulations. The Notice and forthcoming regulations allow an S corporation with AE&P as of 1 September 2020, to elect to be treated as an entity for purposes of Subpart F income and GILTI. Such treatment allows for an increase in AAA for electing S corporations and facilitates tax-free distributions to S corporation shareholders.

An S corporation may only elect to apply the Notice if it has a balance of "transition AE&P." Transition AE&P is the balance of the S corporation's AE&P calculated as of 1 September 2020 and reduced for distributions made after this date. Transition AE&P cannot be acquired or increased as a result of transactions occurring after 1 September 2020, including by means of entity classification elections that are filed thereafter. Further, transition AE&P is nontransferable to any other person.

S corporations that do not elect to apply the Notice must apply aggregate treatment as provided in the Final GILTI Regulations, except as provided in Notice 2019-46. When an S corporation has made an election under the Notice, aggregate treatment will apply prospectively, beginning with the first tax year of the S corporation for which the S corporation has no transition AE&P on the first day of such year.

ii. Electing entity treatment under Notice 2020-69

To avail itself of the entity treatment provided by the Notice, the S corporation must:

1. Elect entity treatment with the S corporation's timely filed US tax return
2. Have elected S corporation status before 22 June 2019
3. Be treated as owning stock of a CFC on 22 June 2019, within the meaning of Section 958(a), if entity treatment applied
4. Have transition AE&P on 1 September 2020, or on the first day of any subsequent tax year
5. Maintain records supporting the S corporation's determination of transition AE&P

If an S corporation elects entity treatment, it will be required to calculate an annual GILTI inclusion amount at the S corporation level, a distributive share of which must be included in each shareholder's gross income for the S corporation year. The election is irrevocable.

An S corporation may elect to apply the Notice for the first tax year ending on or after 1 September 2020, by filing a statement with its timely filed (including extensions) original Form 1120S, *U.S. Income Tax Return for an S corporation*. For tax years of the S corporation ending before 1 September 2020 and after 21 June 2019, the S corporation and all of its shareholders may irrevocably elect entity treatment provided in the Notice by including a statement with timely filed (including extensions) original returns or on amended returns filed by 15 March 2021. The election statement must identify the election being made, include the amount of transition AE&P, and be signed by a person authorized to sign the return required to be filed under Section 6037. Forms 1120-S, Schedules K-1 (Form 1120-S), and Form 8992, *U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI)*, must be prepared by the S corporation consistent with the election.

Key takeaways

- Notice 2020-69 provides an irrevocable election for an S corporation with "transition AE&P" as of 1 September 2020, to be treated as an entity for purposes of calculating an annual GILTI inclusion with respect to CFCs for which the S corporation is a US shareholder within the meaning of Section 951(b).
- As a result of this election, an S corporation will recognize the tested items of the CFCs with respect to which the S corporation is a US shareholder, calculate a GILTI inclusion and allocate to each shareholder a distributive share of this amount to include in taxable income. S corporation shareholders who are not US shareholders with respect to the corporation's CFCs must include their distributive share of GILTI calculated and allocated by the corporation.
- An electing S corporation's GILTI inclusion will result in a positive adjustment to the corporation's AAA.
- For tax years ending on or after 1 September 2020, the election is made by filing a statement with the corporation's timely filed original Form 1120S (including extensions). For tax years ending before 1 September 2020 and after 21 June 2019, the corporation and all of its shareholders must include a statement with a timely filed original return (including extensions) or on amended returns filed by 15 March 2021.

Endnote

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

For additional information with respect to this Alert, please contact the following:

Ernst & Young LLP (United States), National Tax – International Tax and Transaction Services – Private Company

- Mitchell Kops, *New York* mitchell.kops@ey.com
- RJ Acosta, *Chicago* rj.acosta@ey.com

Ernst & Young LLP (United States), National Tax – Private Client Services

- David H. Kirk, *Washington, DC* david.kirk@ey.com
- Laura MacDonough, *Washington, DC* laura.macdonough@ey.com

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

EYG no. 006236-20Gbl

1508-1600216 NY
ED None

ey.com