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Global Tax Alert

US: Final and proposed regulations limit impact of repeal of Section 958(b)(4)

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Executive summary

On 21 September 2020, the United States (US) Treasury Department (Treasury) and the Internal Revenue Service (IRS) released final regulations (TD 9908) and proposed regulations (REG-110059-20) on the repeal of Internal Revenue Code[1] Section 958(b)(4) by the *Tax Cuts and Jobs Act* (TCJA). The regulations do not undo the repeal of Section 958(b)(4). Instead, the regulations modify certain provisions so they apply in a manner consistent with their application before the repeal of Section 958(b)(4).

The final regulations generally adopt, with some changes, the proposed regulations that were issued on 2 October 2019 (2019 proposed regulations). The new proposed regulations would modify the application of Section 954(c)(6) and certain rules under Section 367(a) to take into account the repeal of Section 958(b)(4). For Section 954(c)(6), the proposed regulations would deny look-through treatment for payments made by a controlled foreign corporation (CFC) that is only a CFC as a result of the repeal of Section 958(b)(4).

This Tax Alert discusses the final and proposed regulations in light of the repeal of Section 958(b)(4).

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Detailed discussion

Background on the repeal of Section 958(b)(4)

If one or more "United States shareholders" (each a US shareholder) owns directly or indirectly under Section 958(a), or constructively under Section 958(b), more than 50% of the stock (by vote or value) of a foreign corporation, that foreign corporation is a CFC. A US shareholder with respect to a foreign corporation is a US person that owns, under Section 958(a) and Section 958(b), 10% or more of the shares (by vote or value) of the foreign corporation. A US shareholder of a CFC is subject to a Subpart F or global intangible low-taxed income (GILTI) inclusion with respect to CFC shares that it owns directly or indirectly under Section 958(a) (a US inclusion shareholder).

Section 958(b) applies the constructive ownership rules of Section 318(a), including the downward ownership attribution rules of Section 318(a)(3). Under the downward attribution rules of Section 318(a)(3), if a shareholder owns (directly or indirectly) 50% or more of the shares of a corporation by value, any other stock owned (directly or indirectly) by the shareholder is treated as owned by that corporation. Also, stock owned (directly or indirectly) by a partner is treated as owned by the partnership by reason of the downward attribution rules of Section 318(a)(3). Section 958(b)(4) prevented downward attribution of stock owned by a foreign person to a US person before its repeal by the TCJA.

The TCJA repealed Section 958(b)(4), effective for the last tax year of a foreign corporation beginning before 1 January 2018. The impact of Section 958(b)(4)'s repeal is wide-ranging, causing foreign corporations that previously were not CFCs to become CFCs without any change in ownership. Numerous provisions (including non-Subpart F provisions) control the treatment of an item of income or deduction, scope of an exemption, or relevant status or reporting obligation of an entity based on the CFC-status of a foreign corporation. As discussed later, the final and proposed regulations take into account the repeal of Section 958(b)(4) for these provisions to apply in a manner consistent with their application before the repeal of Section 958(b)(4).

Notable changes in the final regulations from the 2019 proposed regulations

Deduction for certain payments to foreign related persons under Section 267(a)(3)

Generally, regulations issued under Section 267(a)(3) defer the deduction of an accrual-basis taxpayer for an expense accrued to a related foreign person (within the meaning of Section 267(b)) until the amount is paid to that person. The regulations under Section 267(a)(3), however, provide exceptions to allow a deduction in the year of accrual for an amount that accrued to a related foreign person and is: (1) foreign-source income (other than interest) not effectively connected with the conduct of a US trade or business by the related foreign person; (2) income (other than interest) exempt from US tax under a US tax treaty (Section 267(a)(3) treaty exception); or (3) income effectively connected with the conduct of a US trade or business by the related foreign person.

Congress enacted Section 267(a)(3)(B) in 2004 to limit the deduction for an amount payable to a CFC (or passive foreign investment company (PFIC)) from occurring in a tax year before the year in which payment is made. The limitation in Section 267(a)(3)(B) applies unless the amount is attributable to an item includible in the gross income of a US shareholder with Section 958(a) ownership of the CFC stock. Prior to the repeal of Section 958(b)(4), many foreign corporate payees were not CFCs so Section 267(a)(3)(B) did not apply. Frequently, the payor could rely on an exception to the other limitation on deductibility in Section 267(a)(3)(A) (e.g., the Section 267(a)(3) treaty exception) and deduct an accrued amount to a related foreign corporation in a tax year before the amount was paid. With the repeal of Section 958(b)(4), many foreign corporate payees became CFCs and payors could no longer rely on **an** exception **under** Section 267(a)(3)(A) because CFC-status triggered the limitations of Section 267(a)(3)(B).

The final regulations provide welcome relief by excluding from the application of Section 267(a)(3)(B) the deduction for an accrued amount that is income of a related CFC with no US inclusion shareholder. The final regulations expand upon the relief provided by the 2019 proposed regulations, which only revised the Section 267(a)(3) treaty exception.

The final regulations allow an amount (other than interest) owed to a CFC to be deductible before the year in which the amount is paid if (1) the amount is owed to a CFC and would be exempt from US withholding tax under a US tax treaty and (2) the CFC has no US inclusion shareholder. Thus, the 2019 proposed regulations did not extend similar relief to other amounts that accrued to a foreign corporation and otherwise would be exempt from the limitations of Section 267(a)(3) (e.g., certain foreign-source income that is not effectively connected with the conduct of a US trade or business).

Application of the PFIC asset test under Section 1297(e)

A foreign corporation is a passive foreign investment company (PFIC) if (1) 75% or more of its gross income for the tax year is passive income (the PFIC income test), or (2) 50% or more of its average percentage of assets that are held during the tax year produce, or are held to produce, passive income (the PFIC asset test). A US person that is a PFIC shareholder is generally subject to a deferred tax and interest charge on an excess distribution under the PFIC regime. Similarly, deferred tax and interest charges apply to gain from the shareholder's sale of a PFIC interest that is treated as an excess distribution. Alternatively, these US persons may, in certain instances, elect to be currently taxed on the PFIC's earnings on an undistributed basis under the Qualified Electing Fund (QEF) rules or on an annual mark-to-market basis under Section 1296.

The PFIC asset test generally applies based on the fair market value of the assets of the foreign corporation under Section 1297(e). The PFIC asset test must, however, be applied based on the adjusted tax bases of the foreign corporation's assets if the foreign corporation is both a CFC and is not publicly traded.

Goodwill is an important asset of a foreign corporation that conducts active business operations and is generally considered a non-passive asset. A foreign corporation that did not qualify as a PFIC under the PFIC asset test primarily because the fair market value of its self-created goodwill accounts for a sufficiently large percentage of its overall assets for the year would be forced to use the adjusted tax bases of all its assets in applying the PFIC asset test if it became a CFC due to Section 958(b)(4)'s repeal. A foreign corporation in these circumstances would likely qualify as a PFIC under the PFIC asset test because the tax basis of any self-created goodwill would be zero.

The 2019 proposed regulations provided relief by defining a CFC for purposes of the PFIC asset as a CFC determined without regard to the repeal of Section 958(b)(4). The final regulations do not finalize this proposed rule. Rather, Treasury and the IRS in the Preamble state that the proposed rule will be finalized as part of regulations finalizing the proposed PFIC regulations issued on 11 July 2019 (REG-105474-18) (see EY Global Tax Alert, *US proposed regulations provide guidance on passive foreign investment companies, clarify longstanding PFIC issues and contain both favorable and unfavorable provisions for taxpayers*, dated 18 July 2019 for a discussion of the proposed PFIC regulations). Before the rule is finalized, however, taxpayers may still apply the proposed rule to the last tax year of a foreign corporation beginning before 1 January 2018, and each subsequent tax year of the foreign corporation.

Provisions of the 2019 proposed regulations adopted by the final regulations without any material change

Liquidation of an applicable holding company under Section 332

Section 332(d)(3) treats any liquidating distribution by an "applicable holding company" to a CFC as full payment to the CFC in exchange for the applicable holding company's stock, which causes the CFC to recognize gain (or loss) on the redeemed shares under Section 331. For this purpose, an "applicable holding company" generally means a domestic corporation that is the common parent holding company of an affiliated group of domestic subsidiaries. Any gain recognized by the CFC generally would be Subpart F income that results in a Subpart F income inclusion to a US shareholder with Section 958(a) ownership of the CFC. A foreign corporation that is a CFC because of Section 958(b)(4)'s repeal may not have any US shareholders that have Section 958(a) ownership in the CFC and are subject to a Subpart F income inclusion, and any gain recognized by the foreign corporation is generally not subject to US tax.

The final regulations define a CFC for these purposes without regard to the repeal of Section 958(b)(4). The result is to treat a distribution by an applicable holding company to a foreign corporation that is a CFC because of Section 958(b)(4) repeal the same as a distribution to a foreign corporation that is not a CFC under Section 332(d)(1). Specifically, under Section 332(d)(1), the liquidating distribution to a foreign corporation is subject to Section 301 and potentially subject to US withholding tax to the extent the distribution is a dividend.

Treatment of payments under the look-through rules of Section 904(d)(3)

Generally, dividends, interest, rents and royalties received by a taxpayer are passive-category income for purposes of applying the Section 904 foreign tax credit limitation to each separate basket of foreign-source taxable income under Section 904(d)(1) (i.e., general, passive, foreign branch, and GILTI). Section 904(d)(3), however, provides a set of look-through rules (FTC look-through rules) to treat dividends, interest, rents or royalties received or accrued by a US shareholder from a CFC as passive-category income only to the extent the amounts are allocable to the CFC's passive income. Amounts received by the US shareholder that are not allocable to the CFC's passive income are generally treated as general-basket income.[2] Similar look-through treatment applies to Subpart F income and GILTI inclusion amounts of a US shareholder with respect to a CFC, so that those amounts are treated as passive-category income only to the extent the inclusion amounts are allocable to the CFC's passive income.

The final regulations define a CFC and US shareholder for purposes of applying the FTC look-through rules without regard to the repeal of Section 958(b)(4). The final regulations also exclude foreign corporations that are CFCs because of Section 958(b)(4)'s repeal from being a member of an affiliated group with respect to another CFC for purposes of determining whether the rents, royalties or financial services income of that other CFC qualifies as general-category income under the Section 904 active-rents-and-royalties exception or financial-services-income rule.

Triggering event exception for certain dispositions or events under Treas. Reg. Section 1.367(a)-8(k)(14)

The transfer by a US person of certain stock or securities of a foreign corporation is not subject to gain recognition under Section 367(a)(1) if the US transferor enters into a gain recognition agreement (GRA) for such transfer. The US transferor must generally recognize gain if a triggering event (e.g., the disposition of the transferred stock or securities by the transferee foreign corporation) occurs before the expiration of the GRA, unless a triggering-event exception applies. The final regulations revise the "catch-all" triggering event exception under Treas. Reg. Section 1.367(a)-8(k)(14) to disregard the repeal of Section 958(b)(4) in applying Section 318's ownership rules; these rules determine whether the US transferor owns (1) at least 5% of the total shares (by vote and value) of the foreign corporation that acquired the transferred stock or securities, or (2) substantially all the assets of the transferred corporation, as applicable. Thus, whatever stock the US transferor may be considered owning in the relevant foreign corporation because of Section 958(b)(4) repeal is disregarded in determining whether the exception's 5% ownership threshold is satisfied.

CFC's ownership of a trust under Section 672

The repeal of Section 958(b)(4) creates the potential for avoidance of the "throwback tax" rules under Sections 665-668. This could occur when a foreign corporation is a CFC due to Section 958(b)(4) repeal and is treated as the grantor of a foreign trust under Section 672(f) without having any US inclusion shareholders. The foreign trust would be treated as a grantor trust and be able to accumulate foreign-source income without incurring any US tax. US beneficiaries would be able to receive distributions of the accumulated income without being subject to the tax or additional interest charge under the throwback tax rules. The final regulations prevent this scenario by providing that a CFC only includes, for purposes of applying Section 672(f), a foreign corporation that would be treated as a CFC without regard to the repeal of Section 958(b)(4).

Space and ocean income and international-communications income of a CFC under Section 863

The regulations under Section 863(d) generally treat space and ocean income derived by a CFC as US-source income. The regulations under Section 863(e) generally bifurcate international-communications income derived by a CFC as 50% US-source income and 50% foreign-source income. The final regulations determine the status of a foreign corporation as a CFC for purposes of these sourcing rules without regard to the repeal of Section 958(b)(4).

Form 1099 reporting requirements by a CFC under Section 6049

A CFC may be subject to Form 1099 reporting requirements under Section 6049 for certain payments or transactions. The final regulations modify the definition of a CFC for these reporting purposes to only include a foreign corporation that is a CFC without regard to the repeal of Section 958(b)(4). The change avoids increased Form 1099 reporting by foreign corporations that may not have US persons as direct or indirect owners.

Rules for determining the tax year of a partnership under Section 706

In determining the tax year of a partnership under the regulations of Section 706, a foreign partner's interest is generally not taken into account unless the partner is allocated a share of the partnership's income that is effectively connected with the conduct of a US trade or business. For purposes of these rules, a CFC is not treated as a foreign partner. The final regulations exclude from the definition of foreign partner only CFCs with a US shareholder that owns stock of the CFC under Section 958(a) for purposes of determining the tax year of a partnership under these rules.

New 2020 proposed regulations

Section 954(c)(6) look-through exception for foreign personal holding company income

Section 954(c)(6), most recently extended to apply to tax years of foreign corporations beginning before 1 January 2021, generally provides that dividends, interest, rents and royalties received or accrued by a CFC from a related CFC are not treated as foreign personal holding company income. Section 954(c)(6) only applies, however, to the extent the CFC's dividends, interest, rents and royalties are attributable or properly allocable to income of the related person that is neither Subpart F income nor effectively connected income (Section 954(c)(6) look-through treatment).

The Preamble to the proposed regulations notes that Section 954(c)(6) look-through treatment is intended to apply to payments between CFCs of a US-based multinational group that have active foreign earnings that are subject to the Subpart F provisions. If a foreign corporation is a CFC due to Section 958(b)(4) repeal, that foreign corporation's earnings may not be subject to US tax (under Subpart F, GILTI or otherwise). Accordingly, the Preamble asserts that allowing payments to qualify for the Section 954(c)(6) exception would be inconsistent with the purposes of the provision when the payment is from a foreign corporation that is only a CFC due to Section 958(b)(4) repeal. Citing policy and consistency with certain anti-abuse rules originally provided in Notice 2007-9, the proposed regulations would deny Section 954(c)(6) look-through treatment for dividends, interest, rents and royalties received or accrued by a CFC from a related foreign corporation that is determined to be a CFC solely because of Section 958(b)(4) repeal. The Preamble requests comments as to the extent to which Section 954(c)(6) look-through treatment should apply when a foreign corporation both is a CFC due to Section 958(b)(4) repeal and has an inclusion to a US shareholder under Section 958(a).

Regulations under Section 367(a) relating to outbound transfers of domestic stock

Treas. Reg. Section 1.367(a)-3(c)(1) provides certain rules on the outbound transfer of the stock of a domestic corporation (the US target) to a foreign corporation under Section 367(a). To qualify for non-recognition treatment, the following conditions, among others, must be met:

(1) US transferors receive, in aggregate, 50% or less of both the total vote and total value of the stock of the transferee foreign corporation (TFC) in the transaction.

(2) US persons that are officers or directors of the US target or are 5% target shareholders (as defined in regulations) own, in aggregate, 50% or less of each of the total vote and total value of the of TFC's stock immediately after the transfer.

(3) Either the US person is not a 5% transferee shareholder (as defined in regulations) or the US person that is a 5% transferee shareholder enters into a GRA with respect to the US target stock exchanged.

(4) The active trade or business test provided in the regulations is satisfied.

For purposes of these tests, the attribution rules of Section 318, as modified by Section 958(b), apply.

Absent regulation, and due to Section 958(b)(4) repeal, an outbound transfer of a US target that previously would have qualified for non-recognition treatment under the requirements previously described may no longer meet such requirements. Because the repeal of Section 958(b)(4) could treat the US person as owning an interest it would not have owned when the regulations were originally promulgated (before Section 958(b)(4)'s repeal), the proposed regulations would generally disregard the repeal of Section 958(b)(4) for purposes of the tests described previously. The exception in the proposed regulations would continue to take into account the repeal of Section 958(b)(4) for purposes of determining whether a US person is a 5% transferee shareholder. In this regard, the determination that a US person is a 5% transferee shareholder that must enter into a GRA on the outbound transfer of a domestic corporation's stock under Treas. Reg. Section 1.367(a)-3(c)(1) would remain consistent with the determination that a US person is a 5% transferee

shareholder that must enter into a GRA on the outbound transfer of a foreign corporation's stock under Treas. Reg. Section 1.367(a)-3(b)(1).

Effective dates of the final and proposed regulations

The final regulations generally apply to tax years of a foreign corporation ending on or after 1 October 2019 (or to relevant transfers or payments made or accrued on or after 1 October 2019). However, taxpayers may generally apply the final regulations to a foreign corporation's last tax year beginning before 1 January 2018, and each subsequent year of the foreign corporation (before the first tax year that is subject to the final regulations), provided that the taxpayer and related US persons (within the meaning of Sections 267 or 707) consistently apply the relevant rule to all foreign corporations.

The proposed regulations under Section 954(c)(6) generally would apply to payments or accruals of dividends, interest, rents and royalties made by a foreign corporation during tax years of the foreign corporation ending on or after 21 September 2020. The proposed regulations under Section 954(c)(6) would also apply to a foreign corporation's tax years ending before 21 September 2020 and resulting from an entity classification election or a change in the foreign corporation's tax year under Section 898 that was effective on or before 21 September 2020 but filed on or after that date. The proposed regulations under Section 367(a) would apply to transfers occurring on or after 21 September 2020. Taxpayers may also rely on the proposed regulations for tax years before the date the regulations are finalized, provided that they (and related persons under Sections 267 or 707) consistently rely on the relevant proposed regulation for all foreign corporations.

Implications

The final regulations provide welcome relief by allowing certain provisions to continue to apply in a taxpayer-favorable manner following Section 958(b)(4)'s repeal (e.g., limiting the application of Section 267(a)(3)(B) to the deduction for accrued income of a CFC with a US inclusion shareholder). However, the final regulations balance this relief by modifying other provisions to prevent a result that would be inconsistent with the result preceding Section 958(b)(4)'s repeal (e.g., a liquidation of an applicable holding company to a foreign corporation under Section 332).

Citing a lack of statutory and regulatory authority, the final regulations decline to provide rules mitigating the adverse impact of Section 958(b)(4)'s repeal on the US withholding tax exemption for certain interest paid by a US person to a related foreign corporation that is a CFC because of Section 958(b)(4)'s repeal.

The proposed regulations that would deny Section 954(c)(6) look-through treatment for dividends, interest, rents and royalties received by a CFC from a foreign corporation that is a CFC because of Section 958(b)(4)'s repeal was somewhat expected given the other rules that were modified by Treasury and the IRS to take Section 958(b)(4)'s repeal into account. However, the proposed rule's retroactive application to amounts paid or accrued by a foreign corporation for its tax years ending on or after 21 September 2020, is somewhat of a surprise. Taxpayers should carefully assess the Section 954(c)(6) treatment of payments that have been received by a CFC from a related foreign corporation and have already occurred (e.g., before 21 September 2020, for a tax year ending on 31 December 2020) in light of the proposed rule.

Endnotes

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
2. This income may be foreign branch basket income if derived by the US shareholder through a foreign branch.

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