21 June 2019

Global Tax Alert

US temporary and proposed DRD regulations reflect GILTI-centric view of international tax rules enacted under TCJA

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Executive summary

On 14 June 2019, the United States (US) Treasury Department (Treasury) and the Internal Revenue Service (IRS) released proposed and temporary regulations (REG-106282-18) under Internal Revenue Code[1] (IRC) Sections 245A and 954(c)(6). The regulations deny, in whole or in part, the Section 245A dividends-received deduction (DRD) to dividends sourced from earnings and profits (E&P) generated from certain transactions occurring after 31 December 2017, but before the close of a tax year to which the provisions of Section 951A do not apply (the GILTI gap period). They also deny, in whole or in part, the Section 245A DRD to dividends sourced from E&P generated from tested income or subpart F income that would have been included in a US shareholder's income under Sections 951(a) or 951A(a), but for the transfer or dilution of that shareholder's direct or indirect interest in a CFC. The regulations extend these provisions to dividends received by an upper-tier CFC from a lower-tier CFC by denying the Section 954(c)(6) exception to foreign personal holding company income to similarly sourced dividends. The regulations apply retroactively to dividends paid after 31 December 2017.

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Detailed discussion

Subject to certain limitations, Section 245A allows a domestic corporation to deduct 100% of the foreign-source portion of any dividend received from a specified 10%-owned foreign corporation (SFC) (Section 245A DRD).

Extraordinary dispositions

The temporary regulations deny the Section 245A DRD for 50% of the dividends paid by an SFC to the extent attributable to E&P from extraordinary dispositions that occurred in the GILTI gap period. An extraordinary disposition is a disposition of property by an SFC:

- To a related party
- That occurs during the SFC's GILTI gap period
- That is outside of the SFC's ordinary course of business
- That would have resulted in tested income if gain were recognized outside of the disqualified period

Whether a disposition is outside of the SFC's ordinary course of business is a facts-and-circumstance determination. However, dispositions undertaken with a principal purpose of generating E&P during the gap period or dispositions of intangible property, as defined in Section 367(d)(4), are per se outside of the ordinary course of the SFC's business. A de minimis rule (of $50 million or 5% of the gross value of the SFC's property) applies.

Taxpayers must maintain extraordinary disposition accounts. The Section 245A shareholder's extraordinary disposition account with respect to an SFC at any time equals its percentage of the stock, by value, in the SFC *multiplied* by the amount of the E&P resulting from extraordinary dispositions, *minus* extraordinary disposition amounts already received by the shareholder.

A dividend is first considered paid out of non-extraordinary disposition E&P and then paid out of the shareholder's extraordinary disposition account. Only 50% of any dividends treated as paid out of the extraordinary disposition account, however, is eligible for the Section 245A DRD.

In the Preamble, Treasury and the IRS explain that the denial of the Section 245A DRD is limited to 50% to reflect the fact that taxpayers would have been eligible for the 50% deduction under Section 250(a)(1)(B) if the earnings had been included under the GILTI provision at the time of the extraordinary disposition.

There are successor rules for extraordinary disposition accounts, and the Treasury and IRS are asking for comments on how to apply the rules to consolidated groups and transfers of SFCs to partnerships.

Extraordinary reductions

The temporary regulations deny the Section 245A DRD for certain dividends paid in a tax year in which an extraordinary reduction occurs, which is a transaction in which either (1) a "controlling IRC Section 245A shareholder" transfers more than 10% (by value) of its CFC stock (at least 5% of total CFC stock) or (2) there is a greater than 10% change (by value) in the controlling Section 245A shareholder's overall ownership of the CFC (and at least 5 percentage points). A controlling Section 245A shareholder is a shareholder of the CFC that, including through attribution, owns more than 50% of the CFC's stock.

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

A de minimis rule applies if the CFC's subpart F income and tested income for the year do not exceed the lesser of $50 million or 5% of the CFC's total income.

Election to close the CFC's tax year

The temporary regulations 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. The Preamble indicates that the consequence of this election is to generally convert dividend income that is fully taxable by reason of the extraordinary reduction rule into tested income or subpart F income, thereby allowing foreign tax credits and the Section 250 deduction. Transactions subject to these rules, however, may have relied on E&P created after the extraordinary reduction, such as a taxable Section 331 liquidation after the extraordinary reduction but before the close of the CFC's tax year. In these circumstances, this election would not convert the gain to tested income or subpart F income.

The temporary regulations also allocate foreign taxes paid or accrued by the CFC between the periods split by the election under the rules of Treas. Reg. Section 1.1502-76(b), which is consistent with the manner in which the foreign tax credit regulations under Section 901 allocate taxes paid by disregarded entities that are transferred during a year.

The Section 245A shareholder must make this election with its tax return for the applicable tax year. If multiple ownership reductions occur under a plan or series of related transactions that constitute an extraordinary reduction, the Section 245A shareholder must make the election consistently for all years in which the extraordinary reduction occurs. For extraordinary reductions occurring before the regulations are finalized, an election is timely filed if attached to an original or amended return for the year of the extraordinary reduction.

Denial of exclusion for related CFCs

Relying on the authority granted to Treasury by Congress in Section 954(c)(6), the temporary regulations deny the Section 954(c)(6) exclusion for certain transactions. If a lower-tier CFC distributes a dividend to an upper-tier CFC and that distribution is attributable to an extraordinary disposition or an extraordinary reduction with respect to the lower-tier CFC, the Section 954(c)(6) exclusion is denied.

When the dividend is attributable to an extraordinary disposition, the exclusion is denied for 50% of the portion of the dividend that would be an extraordinary disposition amount if the Section 245A shareholder received its pro-rata share of the dividend from the lower-tier CFC directly. The Section 245A shareholder's pro-rata share is based on its portion of the stock in the upper-tier CFC that is owned by a US tax resident on the last day of the CFC's tax year.

When an extraordinary reduction exists with respect to a lower-tier CFC and the lower-tier CFC distributes a dividend to an upper-tier CFC in the same year, the Section 954(c)(6) exclusion will not apply to the portion of the dividend attributable to the lower-tier CFC's subpart F and tested income before the extraordinary reduction (the tiered extraordinary reduction amount). The tiered Extraordinary Reduction Amount generally equals the lower-tier CFC's subpart F and tested income for the year multiplied by the percentage of stock owned immediately before the extraordinary reduction transaction, minus the pro-rata share of the subpart F and tested income attributable to the lower-tier CFC's shares acquired by a US resident during the tax year.

Ordering and other special rules

Ordering rules are provided to coordinate the application of the hybrid dividend provisions in Section 245A(e) with the temporary regulations' ineligible amount provisions. Under the ordering rules, the Section 245A(e) hybrid dividend rules apply first, then the Extraordinary Reduction Amount rules, and finally the extraordinary disposition amount rules. The temporary regulations do not, however, modify the ordering rules under Section 959(c) (i.e., previously taxed E&P is accessed first on a last-in-first-out basis), which in many cases should defer application of these new provisions.

If an SFC or a CFC pays more than one dividend during its tax year, the rules of the temporary regulations apply based on the order in which the dividends are paid. The temporary regulations do not distinguish between distributions that are attributable to current-year earnings or to accumulated earnings attributable to prior years.

Reporting considerations

Taxpayers must report ineligible amounts, tiered extraordinary disposition amounts and tiered extraordinary reduction amounts on the appropriate information reporting form under Section 6038. Even if transactions occurred in tax years for returns that were filed before issuance of the temporary regulations, taxpayers must report the required information on the first return filed following the issuance of revised forms, instructions or other guidance.

Implications

The temporary regulations apply retroactively to distributions made on or after 1 January 2018 (the effective date of the Section 245A DRD). This effective date will likely have detrimental and unexpected consequences for certain taxpayers.

The temporary regulations also greatly expand the circumstances under which Section 956 inclusions might result. The recently finalized regulations under Section 956 (T.D. 9859) reduce a corporate US shareholder's Section 956 inclusion to the extent a distribution from the CFC with the US property is eligible for an Section 245A DRD. Under the Section 956 regulations, an otherwise taxable "tentative IRC Section 956 amount" is reduced by the amount of the Section 245A DRD that a corporation's US shareholder is allowed based on a "hypothetical distribution." If the Section 245A DRD is denied on this hypothetical distribution, an investment in US property may result in an Section 956 inclusion.

The temporary regulations apply to CFC earnings derived during the "gap" or "disqualified" period, however, only if those earnings result from dispositions outside the ordinary course of business (including those dispositions deemed outside the ordinary course of business, such as sales of intangible property to related persons).

A large portion of the Preamble is dedicated to explaining the extraordinary nature of these anti-abuse rules. That explanation focuses, in large part, on framing the Section 245A DRD as a component of a tightly-constructed, GILTI-centered international tax regime. Among other provisions, the Preamble argues that the Section 245A DRD should be interpreted in the context of the following:

- The Section 965 transition tax rules, which required an inclusion of SFCs' previously deferred foreign earnings that accumulated as of 31 December 2017
- The GILTI regime, which taxes certain CFC foreign earnings that accrued in a CFC's tax years beginning after 31 December 2017
- Section 245A, which applies to dividends paid on or after 1 January 2018, to the extent that the earnings are not subject to the GILTI or subpart F regimes, and are not otherwise subject to US tax

In this telling, the Section 245A deduction must not be seen as a mechanism to avoid taxes on earnings that fall in the gap between the Section 965 transition tax and the new GILTI regime; even then, Treasury appears to view the deduction as playing a small role in the new international regime and subordinate to the GILTI and subpart F income provisions. That may be an accurate representation of how the international provisions enacted under the *Tax Cuts and Jobs Act* (TCJA) will apply in practice.

The legislative history cited in the Preamble, however, frames the international tax regime in a different — indeed arguably opposite — manner. That history generally describes the international tax regime enacted by the TCJA as primarily a territorial regime, with the Section 245A DRD as the headline provision. The GILTI regime is described as a backstop that, together with the foreign-derived intangible income regime, was intended to reduce the impact of tax considerations from economic investment decisions and to discourage aggressive transfer pricing practices.

Notwithstanding this legislative history, the Preamble describes the extraordinary disposition and extraordinary reduction rules as, effectively, anti-abuse rules that backstop the tightly-constructed, GILTI-centered international tax regime. Extraordinary dispositions and extraordinary reductions are viewed as anomalies that permit certain earnings to escape taxation under the GILTI provisions. In a tightly-constructed, GILTI-centered international tax regime, the Preamble argues, these anomalies represent impermissible tax-planning. But if the new international tax rules are instead viewed simply as a territorial regime like so many others in the world, with the GILTI rules acting as a backstop to dampen the distortive effect of taxes on economic decisions, it is less clear whether these anomalies undermine that regime. In particular, it is less clear that curtailing these anomalies, on a retroactive basis and without notice and comment, would change taxpayers' incentives around investment decisions and transfer pricing policies.

Finally, the Preamble appears to express concern that the application of Section 951(a)(2) reduces a US shareholder's pro-rata share of subpart F income and the GILTI inclusion when the CFC pays dividends to other persons during the year. To be sure, this "dividend offset rule" was enacted pre-Section 245A. The TCJA, however, expressly applied this rule to the GILTI regime without modification. It also extended the Section 245A DRD to Section 1248 dividends, which are expressly treated as dividends for the dividend offset rule. Given these facts, it is questionable whether Treasury's perceived problems with this rule can be addressed absent legislation.

Endnote

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

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EYG no. 003027-19Gbl

1508-1600216 NY
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