IRC 338(g) Elections for Buyers of Controlled Foreign Corporation Stock in Wake of Major Changes

THURSDAY, FEBRUARY 28, 2019, 1:00-2:50 pm Eastern

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THURSDAY, FEBRUARY 28, 2019

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IRC § 338(g) Elections for Buyers of Controlled-Foreign-Corporation Stock in Wake of Major US Tax Law Changes

Impact of new §951A GILTI, §245A DRD, §1248(j) and other Purchaser and Seller Considerations in claiming an Asset Basis Step-Up via a §338(g) Election

February 28, 2019

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Agenda

I. Overview of Business and Tax Stakes in a Stock Deal v. an Assets Deal
II. Stakes in a § 338(g) Election (Overview)
III. Purchaser's Basic Business & Tax Considerations in an Acquisition
IV. The § 338(g) Election Mechanism
V. Paradigm example of § 338(g) Election with CFC Target
VI. Historical Evolution of the § 338(g) Election
VII. Mechanics of Electing § 338(g)
VIII. New 2017 Tax Act provisions & considerations in the § 338(g) calculus
IX. Comparing Results of CFC Purchase with and without a § 338(g) Election
X. Purchaser Considerations
XI. Seller Consideration (covered in depth by Speaker Will Skinner)
XII. Example: US individual Seller of CFC with and without a § 338(g) Election
XIII. § 338(g) and 338(h)(10) Election Scenarios – A quick cheat sheet as to their application

Abbreviation Guide

- Corporate Purchaser = **"P"**
- Seller = **"S"** (may be corporation, flow-through fund, or individuals)
- Corporate Target = **"T"**
- Old Target = **"Old T"**
- New Target = **"New T"**
- Foreign Target = **"FT"**
- US Corporate Target = **"UST"**
- US Corporate Parent = **"US Parent"**
- Foreign Corporate Parent = **"F Parent"**
- Assets = **Assets** (and may include corporate subs)
- Value = **"V"**
- Adjusted Basis = **"a/b"**
- Adjusted Grossed Up Basis = **"AGUB"**
- Qualified Stock Purchase = **"QSP"**

- Overview of Stakes –

Stock Deal or Assets Deal?
Taxable (or tax-deferred)?

Under U.S. tax law, there are 4 principal ways to acquire a target company:

- Taxable purchase of target corp's stock
- Taxable purchase of target's corp's assets
- "Tax free" acquisition of stock in a qualified corporate reorganization exchange
- "Tax free" acquisition of assets in a qualified corporate reorganization exchange

In any M&A analysis of a desired acquisition, there are at least 2 fundamental threshold TAX questions that need to be asked up, front apart from the overall business objectives of the client:

(1) Should it be an "assets deal" or "stock deal"?

(2) Should US tax be deferred (if that's possible), or does client want the transaction to be regarded as currently recognized for US tax purposes?

Section 338 election--including the basic §338(g) election and the more popular §338(h)(10) election--involve acquisitions that are currently "recognized" for US tax purposes—i.e., "taxable"—not just realized, but "tax deferred" through the mechanism of a carry-over tax basis to the Acquiror. § § 362(b), 334(b). If the acquisition is taxable, the Acquiror generally gets a "cost basis." § 1012.

Acquiror's tax basis – General Concept

- Under U.S. tax law, if an acquiror ***purchases*** stock or assets, it takes a fresh "cost basis" in the stock or assets equal to the sum of: (1) amount paid by the purchaser, (2) liabilities assumed by the purchaser, and (3) acquisition expenses. §1012
- Conversely, if stock or assets are acquired without recognizing gain due to use of a ***tax-deferred method***, the acquiror takes a "carry-over basis" in the stock or assets acquired (carried over from the transferor). §§ 362(b), 334(b).
- Section 338 election--including the basic §338(g) election and the more popular §338(h)(10) election--involve acquisitions that are currently "recognized" for US tax purposes—i.e., "taxable"—not just realized, but "tax deferred" through the mechanism of a carry-over tax basis to the Acquiror. § § 362(b), 334(b). If the acquisition is taxable, the Acquiror generally gets a "cost basis." § 1012.
- In general, § 338 elections are only available in taxable acquisitions in which a "qualified stock purchase" is made by the Purchaser.

- Overview of Stakes –

Purchaser's Basic Business & Tax Considerations

- From **business, legal, and administrative perspective**, the purchaser ("P") of a corporate business often prefers buying a corporation's STOCK rather than assets because
  - A stock purchase is much easier to accomplish
  - A stock purchase usually avoids disruption of Target's contractual & other relationships regarding the assets (*e.g.*, leases).
- But from **tax perspective**, a corporate P often prefers to buy T's assets because, among many factors:
  - P can obtain a higher "cost" basis in assets, which is valuable due to present value of depreciation/amortization deductions. And, post 2017 TCJA, a higher depreciable basis in tangible assets provides a QBAI cushion against imposition of the new GILTI tax under § 951A…(see in-depth analysis of this and other factors, with examples below)
- In general: If certain requirements are met, a § 338 election affords a corporate P the business & legal convenience of a stock purchase, but with the tax benefits of an asset purchase by allowing the P to elect to treat the stock purchase as an asset purchase for federal income tax purposes.

The § 338(g) Election Mechanism (p.1)

- A corporation that purchases at least 80%, by vote and value, of the stock of a Target corporation (excluding certain nonvoting preferred) within a 12-month period (*i.e.*, a "qualified stock purchase" or "QSP") **can elect *irrevocably* to treat the stock purchase as an asset acquisition.**
- **Deemed Asset Sale:** If the § 338(g) election is made, the Target Corp ("Old T") is treated (for tax purposes only) *as if* it sold all of its assets to itself (i.e., "New Target") at the close of the first day on which the Purchaser has acquired 80% of Old Target's stock (i.e., the "acquisition date").
- **The Target is then treated as a new corporation** (i.e., "New T"), unrelated to Old T, that purchases, on the day after the "acquisition date," Old T's assets at a price that reflects the price paid for T's stock, adjusted for the Target's liabilities and other items.
- **Stepped Up Asset Basis:** Thus, a principal effect of this deemed asset sale is that New Target's acquires an aggregate basis in its assets that is "stepped up" (or down) under §1012 to the FMV price that the unrelated Purchaser actually paid for Old Target's stock (adjusted for assumed liabilities and other items).
- **Allocation of Basis Required:** New T is required to allocate the deemed purchase price among its assets according to a prescribed "residual method" under IRC §1060, which can get complicated… (Must compute "adjusted grossed Up Basis").
- **Old Target's tax attributes are extinguished**, and New Target starts a new life with a clean slate of tax attributes. (Note that PTI accounts are wiped clean in a 338(g) election, which may not be good for Purchaser if there were huge PTI accounts.)

The § 338(g) Election Mechanism (p.2)

- **Price for Purchaser's Stepped Up Asset Basis:** Two levels of tax recognized transactions:

  (1) the stock sale is taxable (indeed, it is required to be a "qualified stock PURCHASE"), and

  (2) the deemed asset sale is fully recognized for US tax purposes.

- The deemed asset sale is treated as though it were a fully taxable transaction to the Target Corporation, although the gains may be offset by Target's tax attributes (e.g., NOLs). (Deemed asset sale not visible to the foreign jurisdiction...which prior to 2010 Hire Act created opportunity to hype FTCs. *But see* § 901(m)).

- Thus, unless a § 338(h)(10) election is made (*and § 338(h)(10) election is NEVER available for a non-US target*) the price for New T's basis step-up is a doubly tax recognized transaction: one level of tax incurred by S on the sale of the Target stock and another level or tax Old T's deemed sale of its assets.

- **Why can't parties elect § 338(h)(10) for a foreign target?** Because a §338(h)(1)election can only be made if Target is:

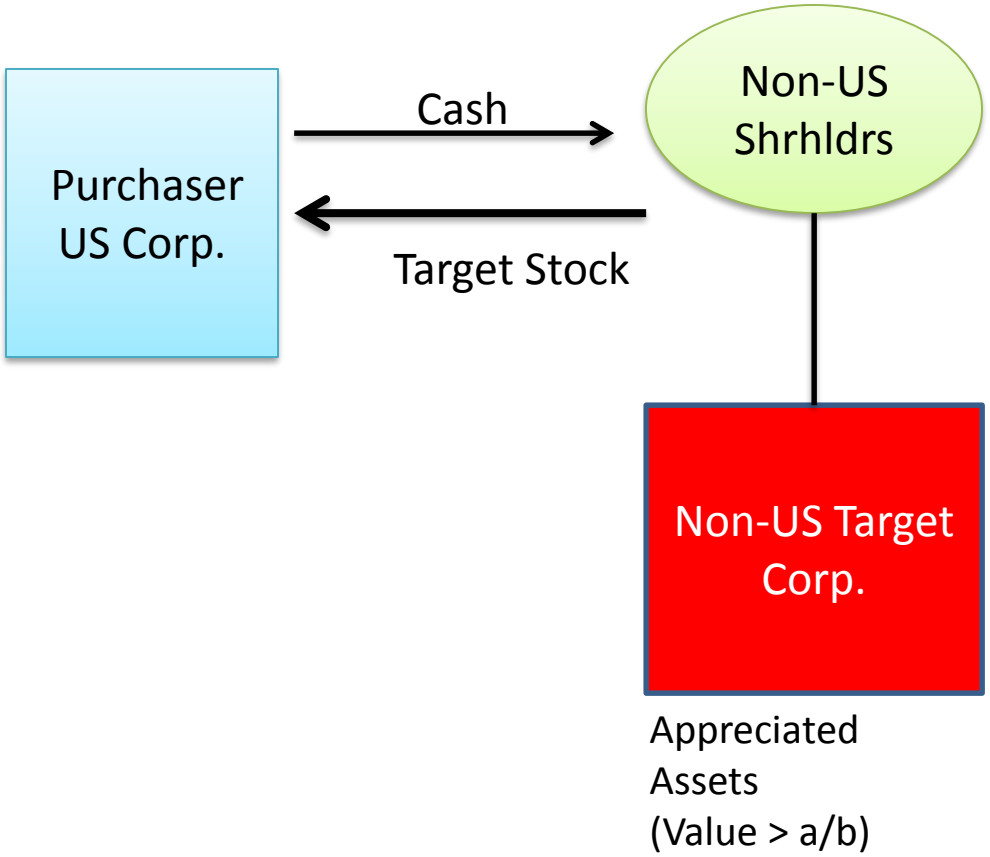
  (i) a domestic corporation that is a subsidiary member of a consolidated group,
  (ii) a domestic corporation that is a subsidiary member of an affiliated group not filing a consolidated return, or
  (iii) an S corporation (as defined in § 1361). Reg. §1.338(h)(10)-1(c)(1).

The § 338(g) Election Mechanism (p.3)

- Which party is really bearing the US Tax Burden of a § 338(g) Election?? (It depends…but new provisions of TCJA are likely to create more gain…)
- If T is a CFC, Old Target's deemed asset sale often qualify for exceptions to Subpart F income—for example, the exception to § 954(c) "Foreign Personal Holding Company Income" set forth in Reg. §1.954-2(e)(3) for depreciable T/biz assets. (Need to also test under § 954(d) for FBC Sales income.) And this is why § 338(g) elections and "Check & Sell" transactions were often used prior to the 2017 TCJA.
- **But after the 2017 TCJA, the deemed asset sale will likely give rise to GILTI income--i.e., <u>more actual GAIN</u> even if Subpart F inclusions are avoided.** GILTI income is currently recognized to §951(b) "US Shldrs") under new § 951A…with other ramifications analyzed below.
- Seller is responsible for any tax liability arising from the stock sale. The deemed asset sale triggered in a § 338(g) election occurs on the "acquisition date," and any tax liability resulting from the deemed asset sale is Old Target's (Old T's) liability (i.e., from the US tax perspective…Obviously, the deemed asset sale is not recognized for foreign law purposes!)
- **But, *absent contractual provisions to the contrary*, the US income tax liability resulting from the deemed fictional asset sale *could be borne economically by Purchaser* because it is the owner of New Target and New T inherits Old T's tax liabilities.**
- NOTE: the Purchaser makes the § 338(g) unilaterally, and yet it can have a huge effect on the Seller (who may never have agreed to it)! Thus, very important for parties (especially Seller who doesn't have the power under the Code to make the 338(g) election unilaterally) to have <u>contractual provisions in the M&A documents</u>, and on the M&A checklist. Parties need to agree on whether the §388(g) election will be made…

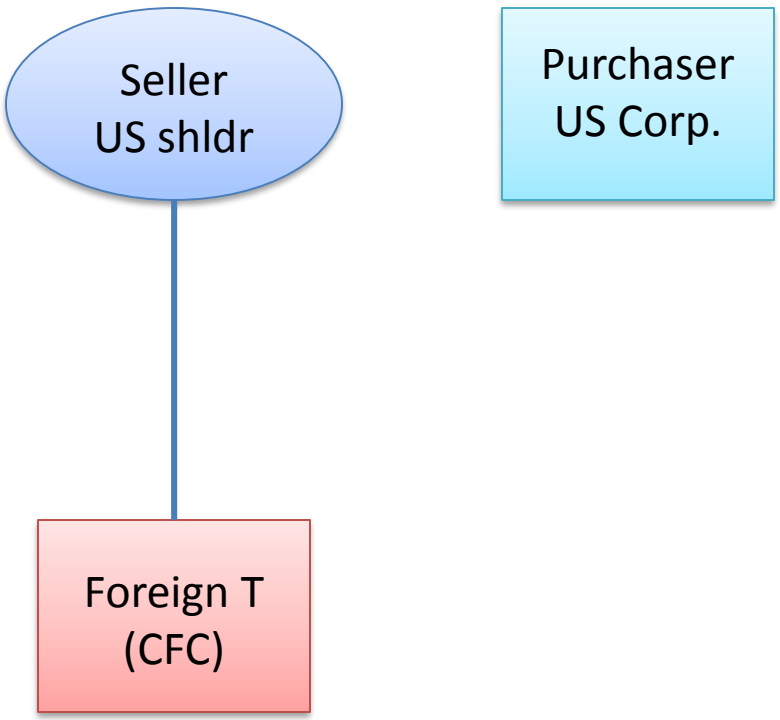
§ 338(g) Mechanism - (p.4)

- Purchasing Corp must make a "qualified stock purchase" (QSP), defined as transaction (or series of transactions) where 1 corp acquires by "purchase" 80% control of Target's stock during the 12-month "acquisition period."
- 80% control means at least 80% voting power and value
- Share acquisitions may be over 12 months, but must be by "purchase" (thus excluding shares acquired by gift, inheritance, tax-free reorgs, and certain related-person transfers, etc.).
- Purchaser must be a corporation, and cannot be an individual or a partnership.
- **However, neither Purchasing Corp nor Target need be US corporations. See IRS Chief Counsel Advice 2007-006.**
- **Purchasing Corp. may elect s338(g)** unilaterally without the consent of the Seller or Target (unless contractually bound to get consent, which should always be on Seller's M&A checklist).
- Deadline: Must elect no later than 15th day of 9th month beginning after the month in which the "acquisition date" occurs (which is the day within the 12-month period on which 80% control was acquired. (Example:
- The § 338(g) election is irrevocable.
- Procedure for late § 338 elections.

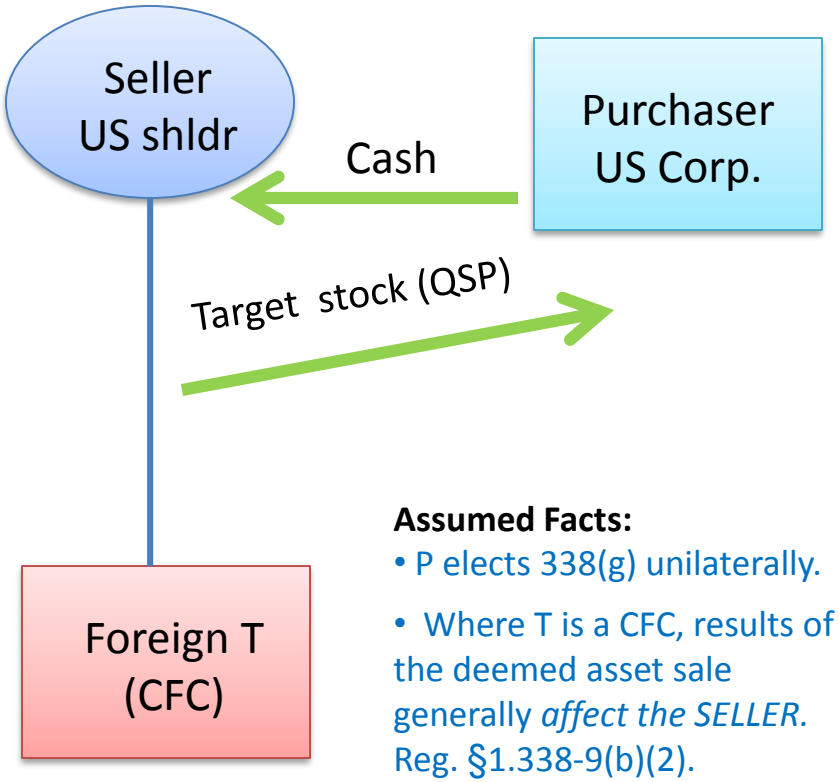


Paradigm example of § 338(g) Election with CFC Target

(1) Initial Structure



(2) T Acquisition (July 1st)

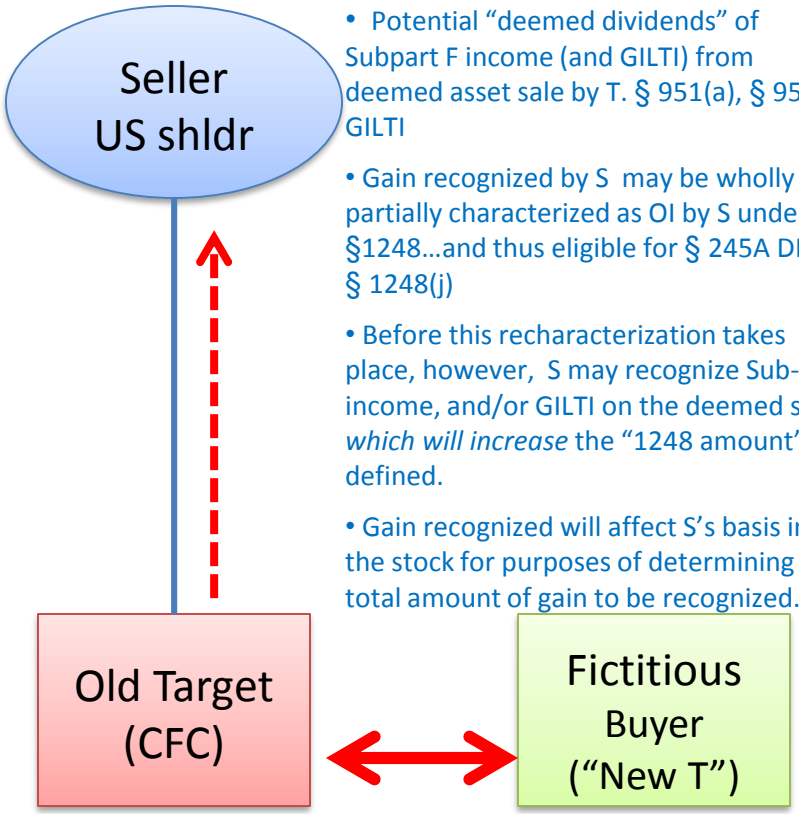


Assumed Facts:

- P elects 338(g) unilaterally.
- Where T is a CFC, results of the deemed asset sale generally *affect the SELLER.* Reg. §1.338-9(b)(2).
- If Seller does not want those effects, should so specify in the SPA, requiring at minimum, S's consent.

Paradigm example of §338(g) Election with CFC Target (cont.)

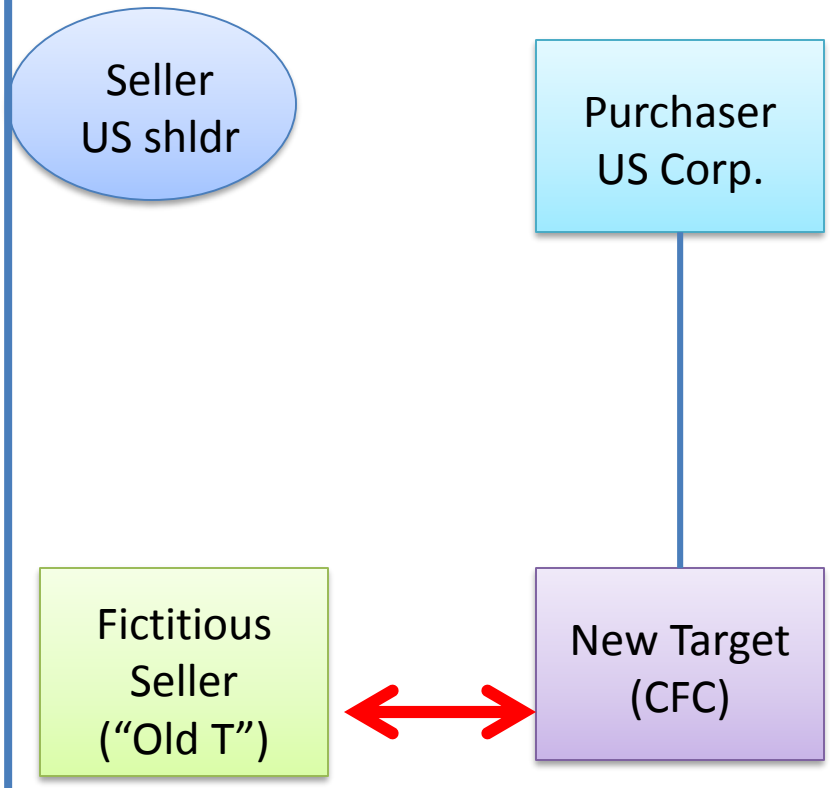
(3) Deemed Asset Sale (at close of Day, July 1st)



- Potential "deemed dividends" of Subpart F income (and GILTI) from deemed asset sale by T. § 951(a), § 951A GILTI
- Gain recognized by S may be wholly or partially characterized as OI by S under §1248…and thus eligible for § 245A DRD. § 1248(j)
- Before this recharacterization takes place, however, S may recognize Sub-F income, and/or GILTI on the deemed sale, *which will increase* the "1248 amount" as defined.
- Gain recognized will affect S's basis in the stock for purposes of determining total amount of gain to be recognized.

Old T deemed to "SELL" all of its assets to New T in a FICTIONAL ASSET SALE for cash.

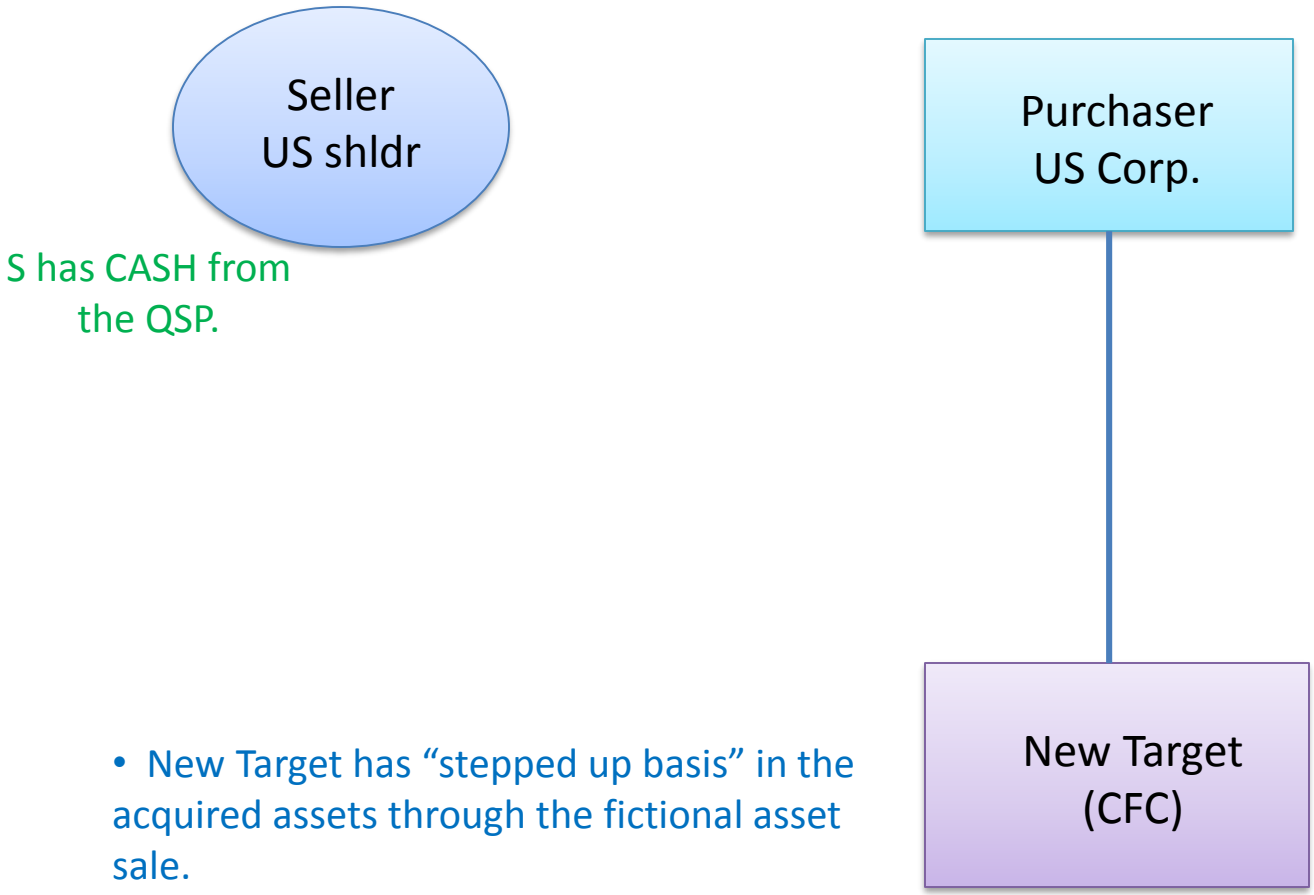
(4) Deemed Asset Purchase (Beginning of July 2nd)



New T deemed to "PURCHASE" all of Old T's assets for cash at FMV

Paradigm example of §338(g) Election with CFC Target (cont.)

(5) After Transaction



- New Target has "stepped up basis" in the acquired assets through the fictional asset sale.
- Tax attributes are purged.

(All this "deeming" seems dumb!)

Why is the § 338(g) Election so crazy and illogical?

- How did a real stock sale come to be treated as a deemed asset sale?
- Why on earth would a Purchaser want to elect §338(g)--and how could P get S to agree to the § 338(g)election in the M&A docs-- and pay TWO levels of tax up front in a transaction, when P&S could pay just one level of tax between them? (How could the present value of any depreciation & amortization deductions be worth that much?)
- **ANSWER: The deductions probably aren't worth that much (*i.e.*, unless some of the taxes are sheltered by tax attributes) …and the origin of § 338's "fictional, deemed asset sale" is found, as so often the case in tax law, in the *HISTORY* of § 338!**

§ 338(g) Election – Historical Evolution of how a Stock Sale came to be treated as a Deemed Asset Sale

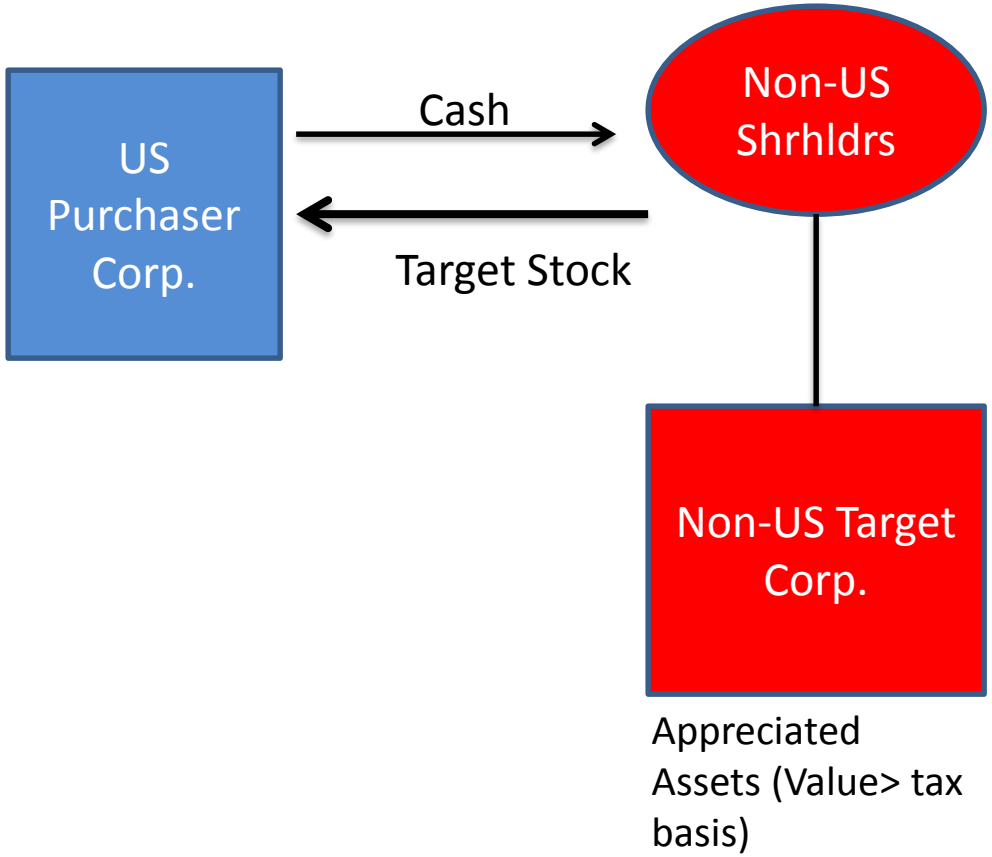
- **Pre 1954 Tax Act:** US Courts applied an elusive "intent standard."
- **1950 seminal case (no longer the law):** ***Kimbell-Diamond Milling Co. v. CIR***, 14 T.C. 74 (1950), affd. 287 F.2d 718 (5th Cir. 1951). Milling company (KD) purchased stock of a another milling company ("target" or "T") after its own plant was destroyed by fire. KD argued it should acquire a carryover basis in T's assets, since it bought T's stock. IRS argued transaction should be treated, in substance, as an asset deal—with KD getting only a "cost basis" in the assets equal to what it paid for the stock. Tax Court agreed with IRS, finding KD's sole intent was to acquire T's assets (KD liquidated T 3 days after stock purchase). **HELD:** KD (Buyer) should be treated as directly acquiring T's assets as the stock purchase was merely a transitory step in the asset acquisition. Thus, KD must take "cost basis" in the assets equal to what it paid for T's stock.
- **Kimbell-Diamond doctrine codified in 1954 as (former) §334(b)(2) in 1954 Tax Act to replace elusive "intent test" with ostensibly more "objective test."** Thus, old §334(b)(2) allowed a Parent Corp to step up basis of its sub's assets if Parent (a) acquired at least 80% of the Sub's stock in fully taxable purchase during a 12-month period and (b) caused Sub to liquidate pursuant to a plan of LQ adopted w/in 2 yrs of purchase. *Sub recognized gain on LQ as if it had sold its assets, and its tax attributes were extinguished.* Purchaser was treated as if it purchased assets—taking a cost basis approximately equal to what it paid for the T stock (rather than a transferred basis, which usually results from a complete liquidation of controlled T Sub). Old **§** 334(b)(2) was criticized as being very complex w/pitfalls.
- **1982: § 338 (election) enacted (with policy goal of simplification)** allowing Purchasing Corp to ELECT to treat certain 80% stock purchases as asset purchases, in order to allow Purchasing Corp to take a higher, depreciable tax basis in those assets…(if certain requirements were met, which were borrowed from KD doctrine).

§ 338(g) Election — Historical Evolution (Cont'd)

- **Originally, § 338(g) election triggered only ONE level of tax:** Between 1982 and 1986, §338 functioned in the context of the Gen. Utilities doctrine, as codified by (former) §337. Under old §337, a corp generally recognized no gain or loss on sale of its assets after adopting a Plan of Liquidation.
- Nonrecognition was subject to certain exceptions, the most significant of which were depreciation recapture under §1245 and §1250 and investment tax credit recapture.
- Thus, until General Utilities repeal in the 1986 Act, a sale of a target's assets followed by a LQ of Target generally resulted in only ONE level of federal income tax—i.e., the tax incurred by T shldrs on their exchange of their shares for LQ proceeds (plus target-level recapture income).
- Combined effect of §338(g) election in context of old 337 meant that Purchaser could acquire a §1012 step-up in T's asset bases, at cost of a single layer of fed income tax imposed on T's shldrs.
- Repeal of Gen Utilities doctrine in 1986 Act radically altered the impact of §338 and introduced distortions, particularly in the consistency rules.
- After 1986 Act, §338 meant double taxation (absent a §338(h)(10) election), and so 338(g) elections generally became undesirable in purely domestic context. § 338(h)(10) elections became the common tool planning tool in domestic context.
- **But § 388(g) elections were and are still viable in cross-border context—in purchases of foreign corporations (CFCs).** Recall that § 338(h)(10) cannot be elected where the Target is foreign.
- **In a 338(g) election, *neither Purchasing Corp nor Target need be US corporations*—both can be foreign. See IRS Chief Counsel Advice 2007-006.**

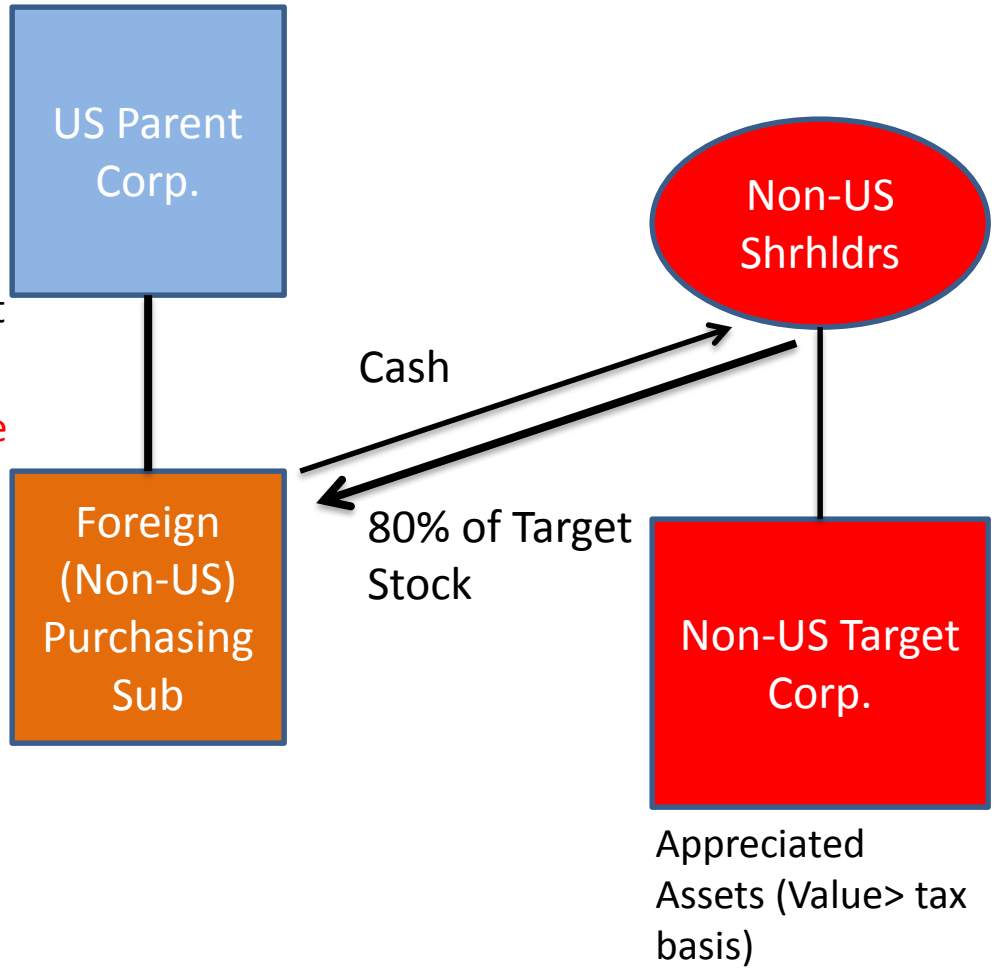
Mechanics of Electing § 338(g) – Must have a "QSP"

- **P must make a QSP:** Purchasing Corp must make a "qualified stock purchase" defined as transaction (or series of transactions) where 1 corp acquires by "purchase" 80% control of Target's stock during the 12-month "acquisition period."
- 80% control means at least 80% voting power and value
- Share acquisitions may be over 12 months, but must be by "purchase" (thus excluding shares acquired by gift, inheritance, tax-free reorgs, and certain related-person transfers, etc.).
- **Purchaser must be a corporation**, and cannot be an individual or a partnership.
- **However, neither Purchasing Corp nor Target need be US corporations. See IRS Chief Counsel Advice 2007-006.**
- **Purchasing Corp. may elect s338(g)** unilaterally without the consent of the Seller or Target (unless contractually bound to get consent, which should always be on Seller's M&A checklist).
- **Deadline:** Must elect no later than 15th day of 9th month beginning after the month in which the "acquisition date" occurs (which is the day within the 12-month period on which 80% control was acquired.
- **Use IRS Form 8023 to make the § 338(g) election.**
- The § 338(g) election is irrevocable.
- **§ 9100 Relief for LATE § 338 elections**: Rev. Proc. 2003-33 provides that in accordance with § 301.9100-3, an extension of 12 months from the date of discovery of the failure to file a timely § 338 election is automatically granted to any person described therein.



§ 338(g) Election: Purchaser may be a Non-US Corp

- **IRS Chief Counsel Advice (CCA) 2007-006** affirms a §338(g) election can be made for a Target that is a foreign (non-US) corp, even where the shareholders are foreign and the purchaser is another foreign corp.
- No requirement that the foreign target has ever been subject to US tax rules.
- Under circumstances considered in the CCA, the tax bases of the Target's assets can be stepped up to fair market value, *even though no US or foreign tax is paid on the stock sale or fictional asset sale.*
- **CCA's rationale:** assets appreciated outside US tax net, and US tax results do not ordinarily depend on whether foreign tax is incurred…(But note, this rationale may be changing…)



General Results of Taxable Stock Sale

Effect on Purchaser ("P"):

- Purchaser takes a "cost basis" in the stock equal to amount of consideration it paid + liabilities it assumed + its acquisition expenses.
- Generally, tax attributes of the Target Corporation (*e.g.*, basis in assets, tax credits, earnings & profits (E&P) accounts, NOLs (net operating losses) DO survive and carry over to the purchaser.
- However, if there is a 50 % "ownership change" (as statutorily defined), the purchaser's use of the often valuable NOLs , and other attributes, will be limited going forward (complex analysis).

Effect on Seller ("S):

- Target shareholders are taxed on the gain or loss inherent in their shares (usually capital gain or loss). Corporate sellers have no preferential capital gain rate (corp rate is 21% post TCJA). HNW individuals have a capital gain rate of 20% plus net investment sur tax of 3.8%, for total 23.8%.

General results of a Taxable Asset Sale

Effect on Purchaser:

- Buyer takes a "cost basis" in the assets, which can be advantageous if its jurisdiction allows for depreciation deductions (cost basis is usually around FMV--typically higher than a carry-over basis, but not always!)
- Tax attributes (*e.g.*, NOLs) do NOT carryover to the Buyer .

Effect on Seller:

- Target immediately recognizes full gain (or loss) on each of the assets being sold.
- Tax attributes of Target (*e.g.*, NOLs) may be used to offset gain on the asset sale.
- If target is a **U.S. C Corp**, there will generally be 2 levels of tax imposed on Seller: (1) corporate income tax at the entity level, and (2) additional tax at the shldr level, when the profits of the asset sale are distributed.
- If target is a **U.S. LLC** which elects to be taxed as a **U.S. partnership**, then only one level of tax at the LLC members' level.
- **If target is a "controlled foreign corp" (CFC),** the asset sale can trigger both Subpart F income (which is often exempted due to an exception to FPHCI for T/biz assets), and new §951(A) GILTI income—a deemed dividend, taxed currently to a *corporate* US shareholders at 10.5% due to deduction under §250. Also, there are important effects under § 1248, which can result in some of the proceeds treated as a tax-free dividend to the corporate US shareholder.

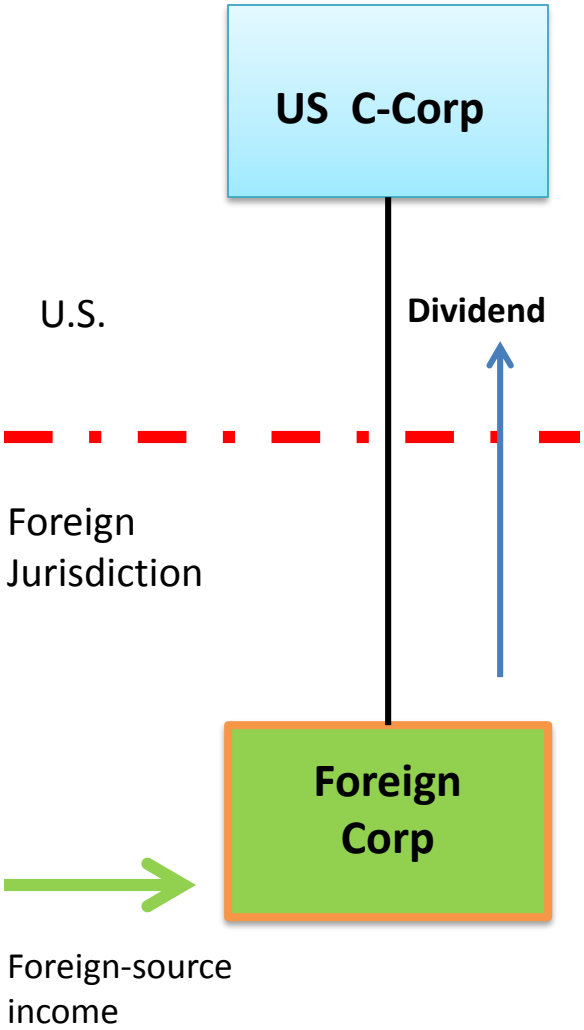
Should Purchaser Elect 338(g)?

How 2017 TCJA Overturns "Settled Principles" in Making that Decision

- The considerations & calculations in determining whether § 338(g) should be elected on acquisition (or disposition) of CFC stock have always been complex.
- The 2017 US Tax Act (formerly known as the "Tax Cuts and Jobs Act" ("TCJA") has made the calculus even more complex (and consequential) by essentially repealing the default rule that US corporate tax on foreign-source income of US shareholders earned through their off-shore corporations could be deferred unless and until those foreign earnings were either actually repatriated or deemed repatriated through an anti-deferral regime like Subpart F (or the PFIC rules, etc.).
- The 2017 US Tax Act replaced this former default rule of "deferral" with a hybrid system that (1) expands worldwide taxation of "global intangible low-taxed income" (**§951A**) and (2) implements an element of a territorial-type regime through a very limited "participation exemption." § 245A.
- Both Sellers and Purchasers of CFCs are affected by the changes, although the Seller's considerations can be more involved.
- Potentially drastic consequences can also apply in the case of a CFC that is owned by a US partnership or other pass-through entity, such as a private equity fund.

The 2017 Tax Act Drastically Changes How

Foreign Subsidiary Income of US Corporations is taxed

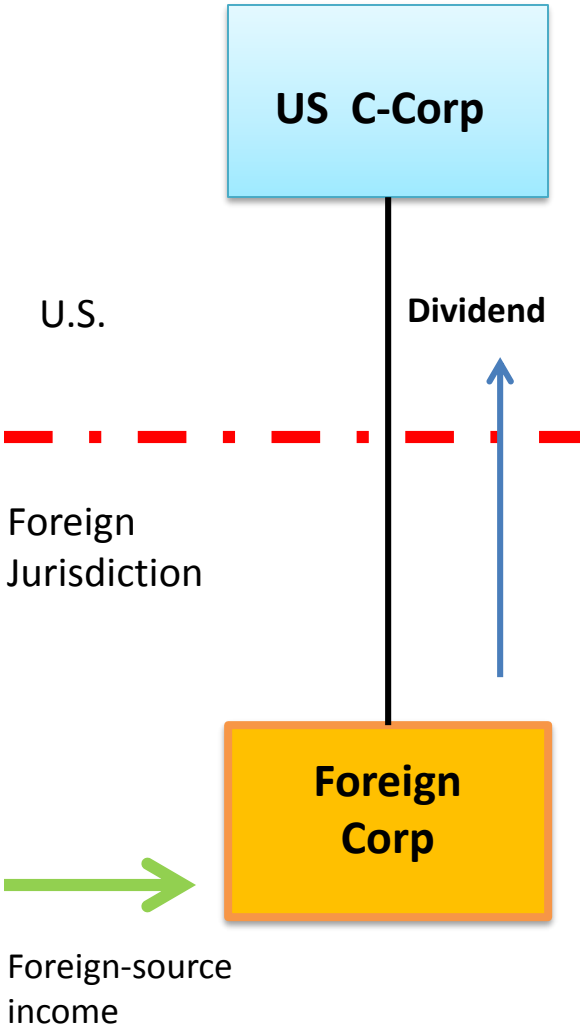


BEFORE 2017 US Tax Act

- **General Rule:** United States generally taxes US corporations on a "worldwide" basis—*i.e.,* US corporations taxed currently on both US-source income and foreign source income they receive. (Contrast with a pure "territorial jurisdiction," which taxes its resident corporations only on income earned within its borders—not on foreign-source dividends and other foreign income).
- **Policy for Worldwide ("Residence-Based") System:** Belief that capital is allocated more efficiently when investors' choices about *where to invest* are not distorted by tax considerations. Economists believe it is more efficient if investments are made on the basis of pure economic fundamentals.
- **Deferral "Privilege" Exception:** **If a FOREIGN corporate Sub (of US corporate parent- as per diagram) earns foreign-source income, US corporate tax is not imposed on the foreign Sub's income unless and *until it is repatriated* to the US—in an actual or deemed dividend. (Indefinite tax deferral is tantamount to a complete tax exemption due to time-value of money.)**
- **Policy Rationale:** US-owned foreign Subs need a "level playing field" to compete and should not have to pay both foreign and US taxes when their competitors do not. Thus, U.S. tax deferral is allowed so long as the foreign Sub can be viewed as truly competing in an active trade/business in its relevant market abroad. However, to the extent the foreign Sub receives income that is either "passive" or looks like "conduit income" (i.e., earned through an low-tax branch/tax haven), the deferral "privilege" ends w/respect to that income, which is then taxed currently to its US shareholder(s) under one of several statutory anti-abuse regimes. Rationale: Foreign Sub is just there for tax advantages—not to compete in a foreign trade/business (i.e., "capital import neutrality" policy objective no longer being served).
- **Foreign Tax Credits**: The corporate income taxes imposed by U.S. upon actual or deemed repatriation of a foreign Sub's E&P may generally be offset with the foreign taxes already paid on that E&P via a tax credit (to extent it eliminates double juridical taxation).

The 2017 Tax Act Drastically Changes How Foreign Sub Income is Taxed:

No More Deferral—Sub's E&P is either taxed currently or exempted



AFTER 2017 US Tax Act

- **General Rule:** United States still generally taxes its US corporations on a "worldwide" basis—*but* at a much lower rate—i.e., 21% (down from 35%). However, the corporate tax base is broader with more foreign Subs' E&P subject to US tax. Also, there is some foreign-source income that is completely exempt from U.S. corporate taxation . Thus, new system is still a "hybrid system" exhibiting attributes of both a residence-based AND territorial system.

- **"Deferral Privilege" Exception is formally eliminated:** Now, all income of a foreign subsidiary owned by a U.S. corporation will be either:

  - **Taxed currently by US** (either under one of the pre-existing anti-abuse regimes (PFIC or expanded Subpart F) **OR** under the new very broad category of §951A "GILTI" income (*Global Intangible Low-Taxed Income*), which functions as a minimum tax , which can reach a foreign Sub's income even if it's not passive or conduit income; **OR**

  - **EXEMPT from U.S. corporate taxation (forever).**

Three categories of foreign-source income of foreign Subs are now EXEMPT . *But these may not amount to much due to the breadth of the new GILTI minimum tax.* They include:

1. CFC's earnings attributable to the 10% notional return in the GILTI regime (QBAI), which qualifies for the § 245A DRD when repatriated:
2. Income of 10% corporate "US Shareholders" of foreign Subs that do not qualify as CFCs (but do qualify as "specified foreign corporations" and so get the § 245A DRD); and
3. Pre-1987 E&P accumulated by foreign Subs, but only to extent of the pro rata share owned by 10% U.S. CORPORATE shareholders, since the §965 Transition Tax does not apply to those earnings and the §245A DRD applies when repatriated.

- **In Sum**: U.S. still has a "hybrid system" –i.e., part Residence-based (perhaps more so now) and part Territorial. Despite its new territorial attributes, the purview of US corporate tax is probably greatly expanded… but at a much LOWER rate—21% (vs. the former 35%).

New TCJA provisions & considerations in the § 338(g) calculus

- **New lower 21% US corporate tax rate:** For post-2017 tax years, the top federal corporate income tax rate was lowered 14 points.
- **New "GILTI" tax under § 951A**: Although not technically a new category of Subpart F income, it taxes "US shs" of CFC on a sweeping new basis, functioning as sort of a residual "minimum tax." Specifically, new § 951A imposes US tax on 10% (or greater) US shldrs (as defined in amended § 951(b)) on "tested income" of their CFCs.
- **'Tested income" is:** all gross income, less allocable expenses, other than income already taxed as (i) ECI, (ii) Subpart F income, (iii) income excluded from Subpart F by virtue of the high-taxed "kick out" exception, (iv) dividends from §954(d)(3) "related persons," and (v) any foreign oil & gas extraction income.
- **GILTI may be taxed at a lower 10.5% rate (lower than capital gains of C Corps):** "US shldrs" (10%) that are "C Corps," can deduct 50% of their GILTI inclusions under new § 250, which can result in a rate of approximately 10.5% . However, all foreign taxes on GILTI income can get no more than an 80% FTC (20% is disallowed), and placed in a separate § 904 FTC basket with no carrybacks/carry-forwards.
- **GILTI inclusion = CFCs' "net tested income"** (measured at shldr level and less losses in the same tested income category) **that exceeds a fictional deemed return on investment** which is basically 10% of a CFC's aggregate tax basis in tangible property used by the CFC in producing tested income. §951A(d)(1). This type of income that can be exempted is based on **QBAI** ("qualified business asset investment"). This sliver of QBAI—the notional net deemed 10% return on tangible assets– is essentially never subject to US tax, even **when actually repatriated.**
- **Key Take Away:** Deemed asset sales, even if the gain is exempted from Subpart F, are likely to produce more total gain in the form of GILTI under new § 951A. This factor will greatly impact both "check-& -sell-assets" transactions and §338(g) deemed asset sales—both of which formerly often escaped current US taxation when T was a CFC due to exceptions for sales of T/Biz assets in Subpart F Regs.) However, because GILTI is often taxed to corporate US shareholders at effective rates as low as 10.5%, GILTI can effectively reduce the overall tax to the Seller *depending on the facts.*
- **Key Take Away:** Although "tested income" is likely to comprise a big percentage of many CFC's operating income, GILTI can only be earned by a CFC—not a 10/50 corporation. Thus, in disposing of a foreign corporation, this may raise planning opportunities (could dispose of shares or assets in a 10/50 corporation without triggering GILTI…

New 2017 Tax Act provisions & considerations (cont'd)

- **§ 902 Indirect Credit Repealed**: Prior to its repeal, § 902 allowed US Shs of CFCs that received an "dividend" to credit the foreign taxes paid on the CFC's earnings out of which the dividend was paid (or deemed paid). Deemed "dividends" under 1248 were also allowed a § 902 indirect credit. The § 902 credit was replaced by the § 245A DRD. The indirect § 960 FTC (for Subpart F deemed divs) was retained, but amended.
- **New § 245A - a limited "participation exemption":** "US shareholders" (as defined in 951(b)) that are C Corps, can deduct 100% of "dividends" received from their CFCs or "specified foreign corporations" is a one-year holding period is satisfied. (HP is 1year within the 2-yr period surrounding ex-dividend date). A "specified foreign corp" is defined as any foreign corporation that has *at least one 10% corporate shlder* that would qualify as a § 951(b) shldr if the foreign corporation were a CFC.
- **§ 245A can be material factor** for CFCs with large amounts of exempt QBAI. (Indeed, § 245A can work as an incentive for Purchasers to get higher-bases depreciable tangible assets that generate QBAI, because that sliver of notional income can be repatriated tax free.
- Because the § 245A DRD is available to Corporate shareholders (owning at least 10%) of so-called 10/50 corporations, and such non-CFCs cannot generate GILTI, a greater percentage of such 10/50 corporations' earnings may be eligible for the § 245A DRD.

New 2017 Tax Act provisions & considerations (cont'd)

- **§ 1248 retained:** Under **§1248**, gain on the Sale/Exchg stock of a foreign corporation (FC)--whether or not a CFC at time of sale--by a person who was a 10% U.S. shldr" at any time during the preceding 5 years while the FC was a CFC, **is recharacterized as a dividend** to the extent of the post-1962 accumulated E&P of the FC "attributable" to such stock and only for periods during which the 10% US shldr held the stock while the FC was a CFC. The E&P so computed is called "the 1248 amount" in the Regs.
  - Prior to elimination of the Capital Gains preference for corporations in 1986, § 1248 functioned as an anti-abuse provision to prevent Tps from turning capital gains into OI.
  - After 1986, and before the 2017 Tax Act**, § 1248 was used as a vehicle to bring up indirect foreign tax credits under § 902.**
- **New § 1248(j)**: "In the case of a sale or exchange by a domestic corporation of stock in a foreign corporation held for 1 year or more, any amount received by a domestic corporation…treated as a dividend by reason of this section shall [be eligible] for the section 245A [100% DRD]."
- **New § 964(e)**: It extends the 100% DRD of 245A to sales of lower-tier CFC stock by upper-tier CFCs where the application of 1248 and 964(e) results in a deemed dividend. (Prior to the 2017 Act, this CFC-to CFC dividend would have been excluded under 954(c)(6).) The HP requirements for 245A DRD apply, so CFC-to-CFC dividends may result in Subpart F income.

Comparing US statutory tax rates & limits on FTC utilization

	Offshore				Onshore		
	§245A DRD	§951(a) Subpart F	§951A GILTI	Foreign branch	§956 Invest US property	§250 FDII	Non-FDII
Effective rates (%)	0	21	10.5	21	21	13.125	21
Foreign tax credits (%)	None	100%	80%	100%	100%	100%	100%
FTC Carryforward	None	10-yrs	None	10-yrs	10-yrs	10-yrs	10-yrs
Other	Creates exempt income/ partially exempt asset For corps, PTI generally means little 245A	GL or passive	Separate Basket	Separate Basket	Converts Exempt Income Multiple year FTCs?	Most income U.S. source – no FTCs	Most income U.S. source – no FTCs Avoid/ get in FDII

Comparing Results of CFC purchase WITHOUT and WITH a 338(g) Election

Assume a US shareholder is selling its interest in a CFC -

Results with NO § 338(g) Election:

Gain recognized by a US corporation on its sale of CFC stock is recharacterized as a dividend under §1248 to the extent of the previously untaxed post-1962 E&P of the CFC and its subs (i.e., the "§ 1248 amount").

- The § 1248 "dividend" is eligible" for the 100% DRD under new § 245A (holding period requirement must be satisfied).
- Any remaining capital gain is subject to a 21% tax rate.
- Taxable year of Target does not close for US tax purposes.
- ***Thus, a domestic Purchaser (rather than the Seller) generally is subject to tax on any Subpart F income and GILTI of the CFC for the entire year of sale, but reduced by the amount of current year earnings treated as a dividend distributed to Seller, including any amount recharacterized as a dividend under § 1248.***

Comparing Results of CFC purchase WITHOUT and WITH a 338(g) Election (cont.)

Assume a US shareholder is selling its interest in a CFC ---
Results with WITH a § 338(g) Election:

- Target CFC is deemed to sell its all its assets to New Target. Old T recognizes any gain (and losses) resulting from the deemed asset sale.
- If Seller is a US corporation, the CFC Target's gain on non-trade/bizs may be Subpart F income; any other gains would likely be "tested income" for GILTI purposes and taxed at 10.5%.
- **CFC Target's tax year closes.**
- Target's Subpart F income and GILTI through the date of sale is includible in gross income of the US Seller (rather than the Buyer), absent contractual provisions to the contrary.
- **Basis-bump up for purposes of actual stock sale**: ***US seller will also be taxed on any gains realized on the sale of the CFC-Target's stock, with the basis of such stock first increased for the amount of any inclusions under Subpart F and GILTI for the year--including the Subpart F and GILTI income generated by the deemed asset sale.***
- Subject to holding period requirements, the stock gain will be recharacterized as a deductible dividend under sections §1248 and § 245A to the extent of the CFC's post-1962 accumulated untaxed E&P (i.e., the "1248 amount" that are not Subpart F income or tested income), as well as earnings arising from gain on the deemed sale of assets that are not subject to Subpart F or GILTI.

Example illustrating how § 338(g) election might *benefit* Seller (not just Purchaser)

Assumed Facts:

US corp sells stock in CFC for $1000 when it's a/b in the CFC stock is $700, resulting in $300 of realized gain. Assume the untaxed E&P of the CFC from prior years attributable to the Seller (i.e., "the § 1248 amount") is $100.

First, assume no § 338(g) election is made.

- $100 of the seller's gain would be recharacterized as a § 1248 dividend, and Seller would receive an offsetting $100 deduction under § 1248 and § 245A.
- And if no § 338(g) is made, Seller would pay a 21% tax rate on the remaining $200 of capital gain for a total of $42 of tax.

Now assume Purchaser elects § 338(g) for the Target CFC.

- Target recognizes $90 of gain on its deemed asset sale. Assume the gain is all "tested income" for GILTI purposes, and that the CFC has $10 of additional tested income for the current year through the date of sale.
- Because the CFC's tax year closes, Seller is generally taxed under the GILTI regime on $100 at a 10.5 % rate ($10.50 of tax), and Seller's stock basis gets bumped up by the $100. After taking into account the stock basis increase, Seller would have $200 of gain on the sale of the stock, $100 of which would be a deemed 1248 dividend eligible for the 100% DRD under 245A.
- The remaining $100 of gain recognized would be capital gain taxed at 21 percent ($21 of tax).
- With the 338(g) election, Seller's total tax costs is reduced to $31.50 of tax (rather than $42) by converting a portion of the gain to GILTI.
- **NOTE:** Of course, Seller's tax costs can also increase with a § 338(g) election, depending on the specific facts. Need to model.

Purchaser Considerations in Deciding whether to Elect § 338(g)

Potential Advantages (and possible disadvantages) to Purchaser of Electing § 338(g):

- **Advantage -- Complete Elimination of Target's tax attributes**: (This factor can actually cut both ways.)
  - On one hand, because the historic E&P accounts are wiped clean, P is able to calculate more easily (and cheaply) the character of future distributions.
  - P need not rely on historic financial records to determine source & character of pre-acquisition earnings and amounts of foreign taxes paid in pre-acquisition years.
  - P is also not at risk for audit adjustments for pre-closing periods if election is made. Further, a clean tax attribute slate removes need for cumbersome computations of accounting adjustments needed to convert statutory retained earnings of foreign T to US GAAP as required by 1.964-1(b)(1), and to convert US GAAP retained earnings to accumulated E&P.
- **Disadvantage - Complete Elimination of Target's tax attributes:**
  - The elimination of historic E&P pursuant to a §338 election can prevents P from receiving distributions of PTI free of tax (unless the 245A DRD is available).
  - If FT becomes a CFC at a time when it already had an "investment in US property," P's § 338(g) election would destroy any benefit from § 956(b)(2).
  - The "1248 amount" account of New T is eliminated if there is a 338(g) election. Thus, if P later decides to sell New Target, there will be much less/no post-1962 accumulated 1248 E&P to be characterized as a "dividend" eligible for the 100% DRD under §245A.

Purchaser Considerations in Deciding whether to Elect § 338(g)

Potential Advantages (and possible disadvantages) to Purchaser of Electing § 338(g):

- **Basis Step-up in Assets of New Target:** (This can cut both ways too.)
  - The step-up gives Purchaser of FT greater depreciation/amortization deductions for U.S. tax purposes, and reduced gain on assets sold post-acquisition. (FT's future income and E&P for U.S. tax purposes are reduced, which also reduces FT's E&P for dividend and FTC purposes. Although this has the effect of reducing future subpart F inclusions, FT will likely still be subject to GILTI.
  - Having a higher depreciable asset basis provides more QBAI, and thus a cushion against the imposition of GILTI due to having a higher net deemed tangible income return.
  - But if FT pays little or no foreign tax on its future earnings, P has less dividend income should FT ever distribute earnings. If, however, the FT pays foreign tax at a high rate, then a §338 election could increase the FT's excess FTCs because the basis step-up is not likely to be effective under the tax laws of countries in which the target operates. (This mismatch increases the effective rate of foreign tax paid by the foreign target relative to its E&P for U.S. tax purposes. Prior to enactment of §901(m), the increase in the effective foreign tax rate could generate excess FTCs when earnings were distributed or deemed distributed. Since 2010, §901(m) restricts the prior FTC benefit of making a §338(g) election for a foreign target, although in many circumstances it may remain beneficial.

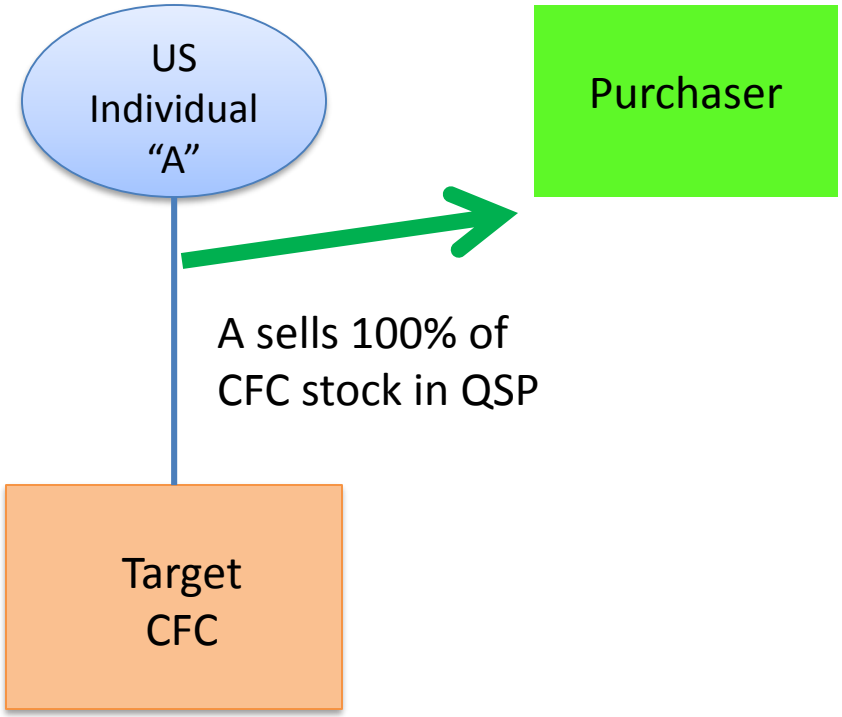
Purchaser Considerations in Deciding whether to Elect § 338(g)

Potential Advantages (and possible disadvantages) to Purchaser of Electing § 338(g):

- **Election may facilitate Post-Acquisition Restructuring:** A § 338(g) election made for a first-tier CFC would increase the basis in that Target CFC's assets—i.e., its bases in its own subsidiaries. In one fact pattern, Foreign T owned a US corp, the stock basis of which was stepped up to FMV with a § 338(g) election. This enables New Foreign Target to sell the domestic sub's stock up the ownership chain free of gain that would otherwise apply. See. Rev. Rul. 74-605.

- **Election may impair Post-Acquisition Transactions:** Because a § 338(g) election eliminates the accumulated E&P and §1238 amount accounts, PTI may not be able to be distributed tax-free to the US shareholder.

US individual Seller of CFC with and without a § 338(g) Election



With NO § 338(g) Election:

- Seller A has a § 1248 dividend for any E&P, which is taxed as a "qualified dividend" assuming conditions are satisfied (15%).
- The § 245A DRD is not available because A is not a US C Corporation.
- Residual tax is "capital gain" taxed at 23.8% (20% + 3.8% net investment tax rate)

With § 338(g) Election: **Drastic difference!**

- Seller has GILTI income on Target CFC's deemed asset sale, but the 50% deduction under § 250 is not available for individuals (nor for funds or pass-through entities).
- Seller has GILTI inclusion, which gives Seller a stock basis bump-up, so she has less gain on the stock sale, which would have been taxed at preferable capital gain rates (23.8%).
- Effect of 338(g) election: Converts capital gains into ordinary income, taxable at 40.8 % (i.e., 37% + 3.8%)
- Individuals and pass-through Sellers will usually want contractual protections to prevent Purchaser from electing § 338(g) (regardless of whether Purchaser is US or foreign).

§ 338 Election Scenarios – (Cheat Sheet)

(1) Domestic corporate seller and Purchaser and Target

- **§ 338(g) election:** Usually not done unless the target had net operating losses (NOLs) because it does not make sense to pay tax today for depreciation on the same amount to be deducted tomorrow; the gain falls on the buyer's side in a one day year of target, although the target generally can use its historic NOLs. However, now the buyer (new target, the next day) may expense part of the purchase price. Depending on the amount of expensing and the portion of the gain currently taxed, the election might make sense for the buyer.

- **§ 338(h)(10) election:** Usually done unless the asset gain is much greater than the seller's stock gain. Expensing the benefit will fall on the buyer's side and make the election more favorable.

(2) U.S. corporation sells U.S. sub to a foreign corporation

- **§ 338(g) election:** Same as (1) above.

- **§ 338(h)(10) election:** Same as (1) above.

(3) U.S. corporation sells stock of a controlled foreign corporation (CFC) to a U.S. corporation

- **§ 338(g) election:** Deemed asset sale can produce Subpart F income and global intangible low-taxed income (GILTI), which will be taxable to the seller as if the CFC's year closed on the day of the deemed sale. That inclusion will increase the seller's stock basis and create previously taxed income (PTI) for the seller, and the seller will recognize stock sale gain, Section 1248 will apply, and the dividend created will be eligible for a 245A dividends received deduction (DRD).

- **§ 338(h)(10) election**: N/A§

- **No § 338 election:** Section § 1248 gain and dividend created will be eligible for a § 245A DRD; seller will not have Subpart F or GILTI inclusion for the year because the CFC year will not close on sale.

§ 338 Election Scenarios – (Cheat Sheet)

(4) U.S. corporation sells stock of CFC to a foreign purchaser

- **§ 338(g) election:** Deemed asset sale can produce Subpart F income and GILTI, which will be taxable to the seller as if the CFC's year closed on the day of the deemed sale. That inclusion will increase the seller's stock basis and create PTI, the seller will recognize stock sale gain, and Section 1248 will apply and 245A will apply to the dividend.
- **§ 338(h)(10) election:** N/A
- **No § 338 election:** Section 1248 gain, 245A will apply to dividend; seller will have Subpart F or GILTI inclusion for the year because the CFC year will close on sale unless the foreign buyer has U.S. subs and CFC status continues.

(5) Foreign corporation sells U.S. sub to a U.S. corporation

- **§ 338(g) election**: Same as (1) above.
- **§ 338(h)(10) election:** N/A

(6) Foreign corporation sells foreign sub to a U.S. corporation

- **§ 338(g) election:** I f the target was not a CFC, the deemed asset sale cannot produce Subpart F income and GILTI; if it was a CFC, those income items would not be taxable except to the target's U.S. shareholder.
- **§ 338(h)(10) election:** N/A

(7) CFC sells CFC

- **Section 338(g) election:** U.S. shareholder of the seller CFC will include Subpart F income and GILTI generated by deemed asset sale.
- **338(h)(10) election:** N/A

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Ms. Fuller advises a wide range of clients--including private and public companies, joint ventures, private equity funds, individuals, C-Suite executives, "start-ups," and government entities--on transactional, investment, and supply-chain strategies to achieve optimal tax and business results. As a seasoned practitioner and tax technician, Ms. Fuller is accustomed to handling nuanced matters involving highly technical questions of law, policy, and procedure at the federal, state, local, and international levels. She provides sophisticated tax planning services across most industry sectors, including software & emerging digital technologies, financial services, real estate development, healthcare, pharmaceutical, construction & engineering, infrastructure, oil & energy, and retail.

Ms. Fuller is also an effective taxpayer advocate, with nearly two decades of experience resolving U.S. federal, state, and foreign tax controversies, as well as asserted tax penalties. Some of the controversies Ms. Fuller has handled have involved novel questions of law. She also has significant experience with complex *transfer pricing* issues--skills Ms.
Fuller first acquired when she clerked for the United States Tax Court, serving three consecutive 2-year terms as *Attorney Advisor* to that court's Chief Judge immediately following graduation with her Juris Doctorate (U.S.) degree.

Ms. Fuller holds an LL.M. in Tax Law from New York University School of Law, where she served as Graduate Editor of that school's international law review and completed post-LL.M. studies in international business and comparative law; a J.D. from Seattle University; and a B.A. from the University of Washington. She is admitted to practice law in several U.S. state jurisdictions and multiple federal courts, including the U.S. Tax Court.

Prior to becoming an attorney, Ms. Fuller was a business news reporter and an all- news radio anchor for a highly regarded NBC News affiliate in Seattle, Washington, covering regional, national, and transnational business and geo-political developments.

Purchases and Sales of Foreign Corporation Stock – Impact of the Section 338(g) Election

Strafford Webinar

February 28, 2019

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Emphasis:
International Tax
Tax Planning
Tax Controversy
M&A Tax Issues

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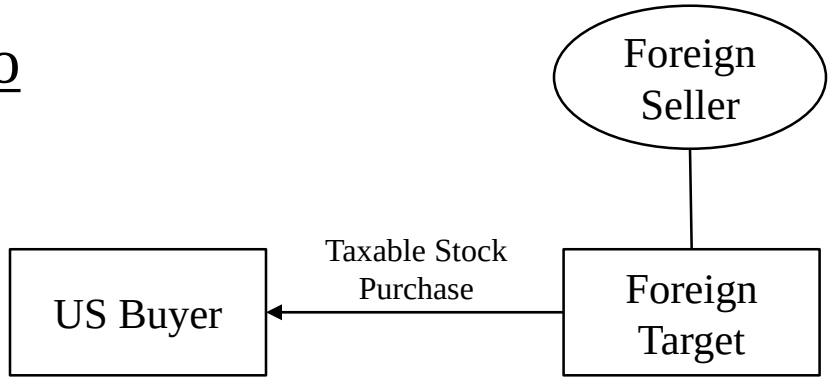
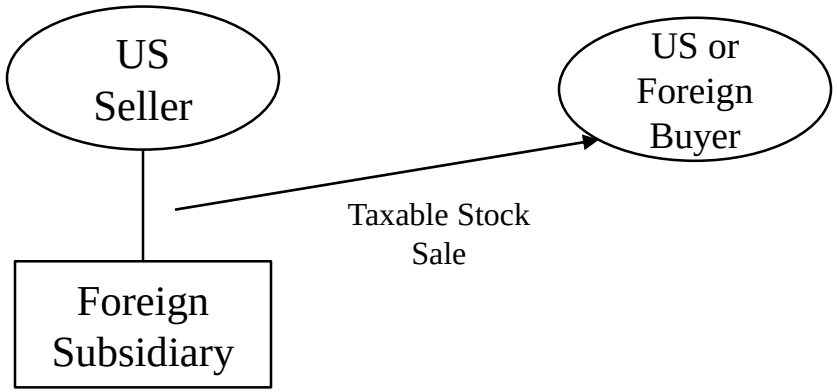
Overview of Fact Patterns

Purchase Scenario



Sale Scenario

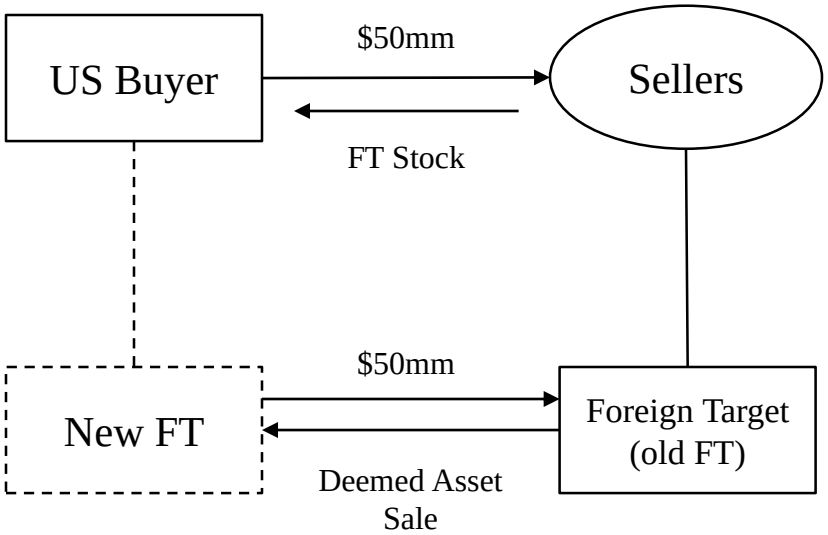


Overview of the Section 338(g) Election

Section 338(g) - Introduction

- Buyer in an acquisition of a foreign corporation's stock will typically want to make an election under Section 338(g).
- Effect of the Section 338(g) election is to cause the foreign target ("old FT"), for US tax purposes only, to be treated as if it sold all of its assets (subject to its liabilities) to a new foreign corporation ("new FT") for a deemed sale price based on purchase price of the stock.
- Potential benefits of a Section 338 election:
  - Stepped up basis in Target's assets for US tax purposes
  - Additional amortization and depreciation deductions for US tax purposes
  - Clean slate in dealing with Target tax attributes and US tax history

Section 338(g) - Example



New FT's Assets

US Tax Basis $50mm
Value $50mm

Assets

Basis $10mm
Value $50mm

- Result of Section 338 election is to cause stock purchase to be treated as a deemed asset sale for US tax purposes.

Summary of Benefits of a Section 338(g) Election – Buyer's Perspective

Depending on the scenario, the Buyer may obtain several benefits from electing Section 338(g) with respect to a purchase of foreign corporation stock:

- Starting with a clean slate / no need to reconstruct Target's US tax history for E&P purposes
- Facilitating post-acquisition integration
- US tax benefits from amortization of stepped-up basis
- Tax year cut-off for purposes of subpart F inclusion in year of sale under Section 951(a)(1)

Impact of Buyer's Section 338 Election on Seller

Impact of Section 338 Election on Seller

- CFC is treated as selling its assets in exchange for the purchase price immediately before the sale of CFC stock. If all sellers are foreign persons, or foreign target is not a CFC or PFIC as to its US shareholders, then sellers generally are indifferent to Section 338(g) election.
  - Exception – if foreign target is engaged in a US trade or business, deemed sale of assets may give rise to ECI.
- For CFCs and PFICs, however, deemed asset sale will create additional E&P and income in the Company that can have different consequences on the Seller that need to be carefully considered.
- These consequences have changed radically in light of Tax Reform.

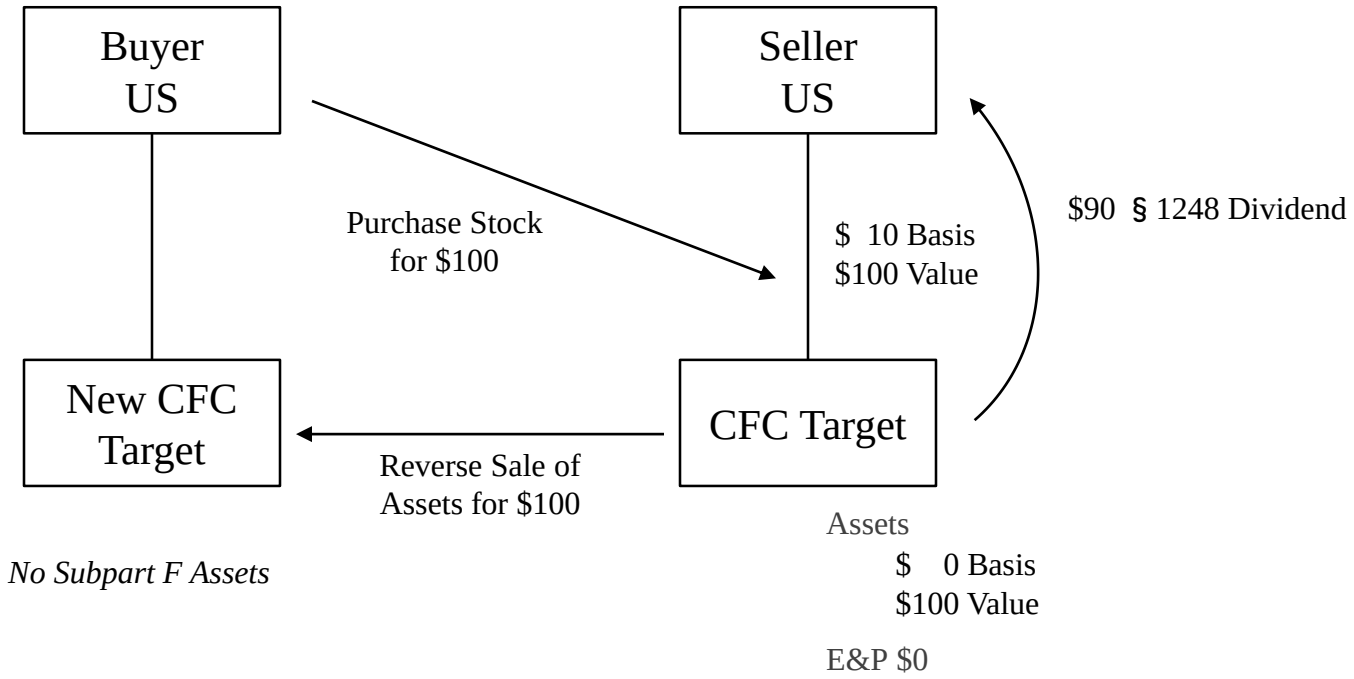
Results of Section 338(g) Election for CFC – *Pre 2018 Law*

- CFC made a deemed sale of its assets immediately before the sale of stock:
  - Any assets held for production of subpart F income created a subpart F income inclusion and increase in stock basis of the CFC
  - Other assets produced additional E&P, that to the extent of gain, gave rise to a deemed dividend under Section 1248 of the Code.
- Section 1248 deemed dividend may be qualified dividend or ordinary dividend income to individual seller depending on whether the corporation is a qualified corporation under Section 1(h)(11)(C).
- Absent subpart F income, the Section 338(g) election had no effect on Sellers' amount of gain.

Foreign Tax Credit Impact – Section 338(h)(16)

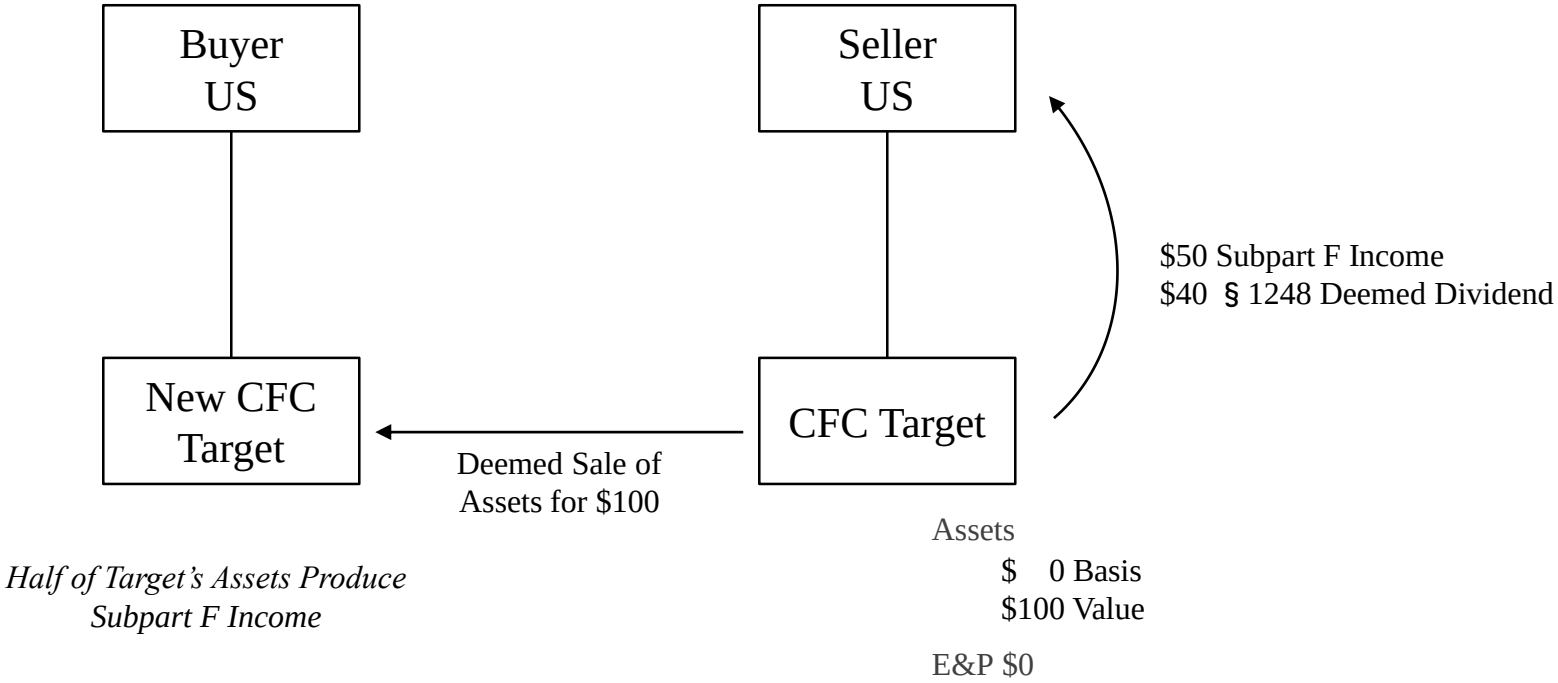
- If the taxpayer has excess foreign tax credits in the GILTI basket, the treatment of a deemed asset sale as giving rise to GILTI may allow use of foreign tax credits to shelter the gain.
- However, in the case of a Section 338 deemed asset sale, section 338(h)(16) provides that the deemed asset "shall not apply for purposes of determining the source or character of any item for purposes of [Sections 901-909] (relating to foreign tax credit)."

Example 1 - Sale of a CFC with Section 338(g) – **Pre-Tax Reform** – Corporate Seller



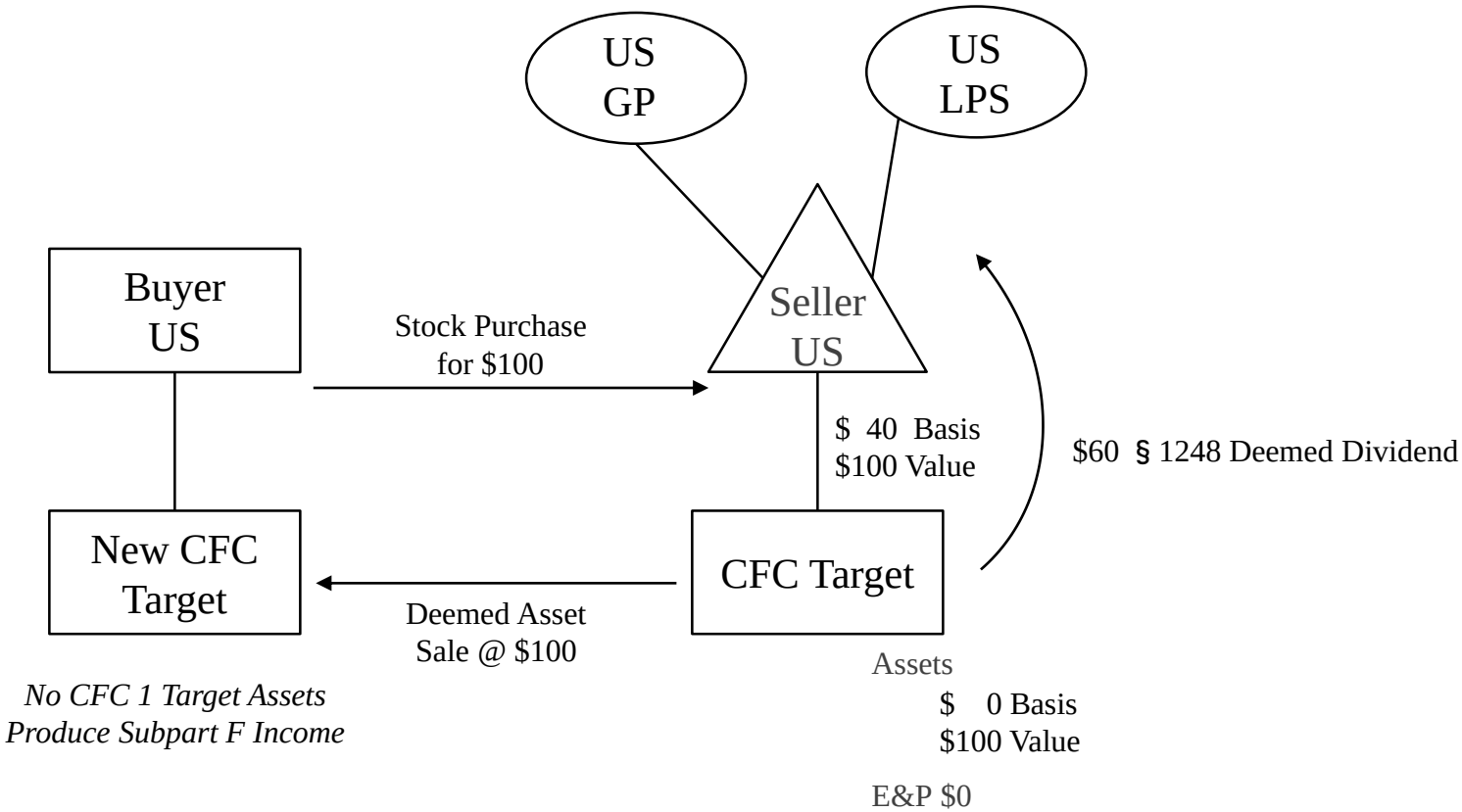
- Deemed sale produces $100 of E&P. Seller recognizes a $90 Section 1248 deemed dividend. Under Sec. 338(h)(16), the deemed sale is disregarded for source of income purposes.

Example 2- Sale of a CFC – **Pre-Tax Reform** – Corporate Seller – Assets Produce Subpart F Income



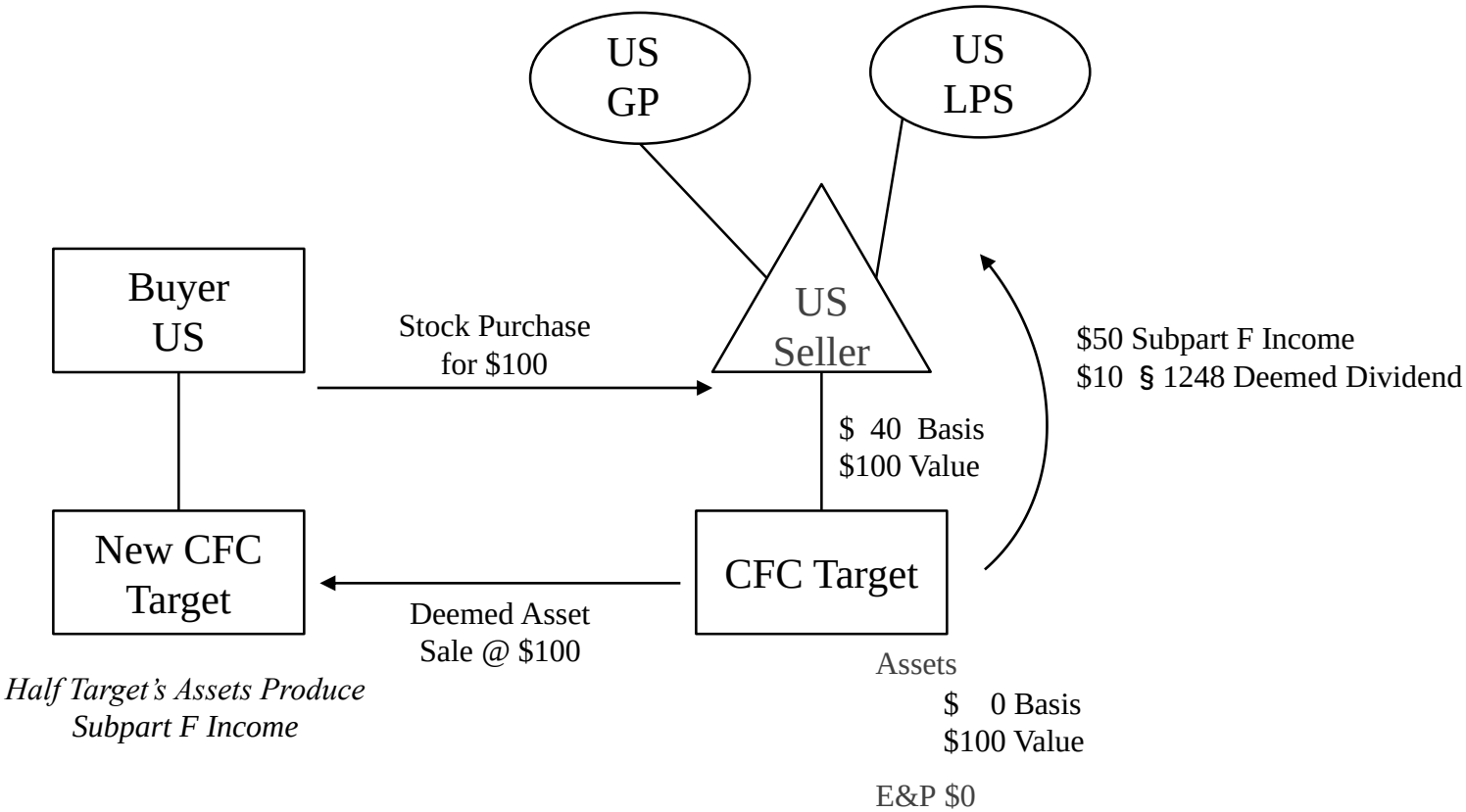
- Deemed sale produced $100 of income inside the CFC. Assume half of gain is subpart F income. Seller recognized $50 of subpart F income and under Sec. 961(a) increased stock basis to $60.
- $50 of additional E&P was created, and gave rise to a $40 Section 1248 dividend.

Example 3 - Sale of a CFC – **Pre-Tax Reform** – ***Individual*** Seller - No Subpart F Income



- As in prior slide, Sec. 338 election created E&P and additional Section 1248 deemed dividend income. This may have be QDI or OI depending on Target's status as a "qualified foreign corporation" under Section 1(h)(11)(C).

Example of a Sale of a CFC with Section 338(g) – **Pre-Tax Reform** – ***Individual*** Seller 50% Subpart F Income

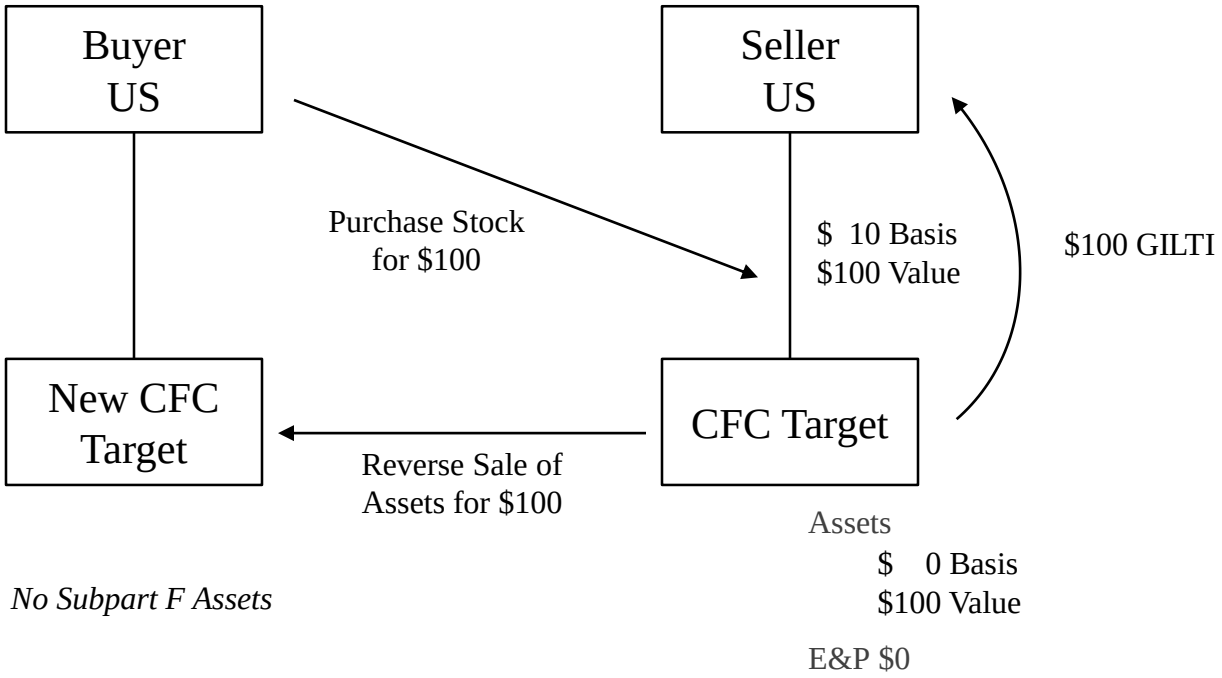


- Section 338 deemed asset sale caused Seller to recognize $50 of subpart F income, which was taxed as ordinary income, in lieu of capital gain. In this case, the Section 338(g) election had the result of increasing Seller's rate of tax. After stock basis increase, Seller recognized $10 of section 1248 dividend.

Tax Reform – Key Impacts on Sales of CFCs with a Section 338(g) Election

- Tax reform repealed deferral, replacing it with a hybrid system of worldwide and territorial taxation.
- All income of CFCs that is not subpart F income or in other limited exceptions is "tested income" taxed to US shareholders on a deemed dividend basis as Global Intangible Low-Taxed Income (GILTI).
- Limited amounts of E&P not taxed under GILTI may be distributed tax-free to US C Corporations under IRC Section 245A.
- C Corporations, but not individuals, enjoy a reduced tax rate of 10.5% on GILTI.

Example 5 - Sale of a CFC with Section 338(g) – ***Post-Tax* Reform** – Corporate Seller

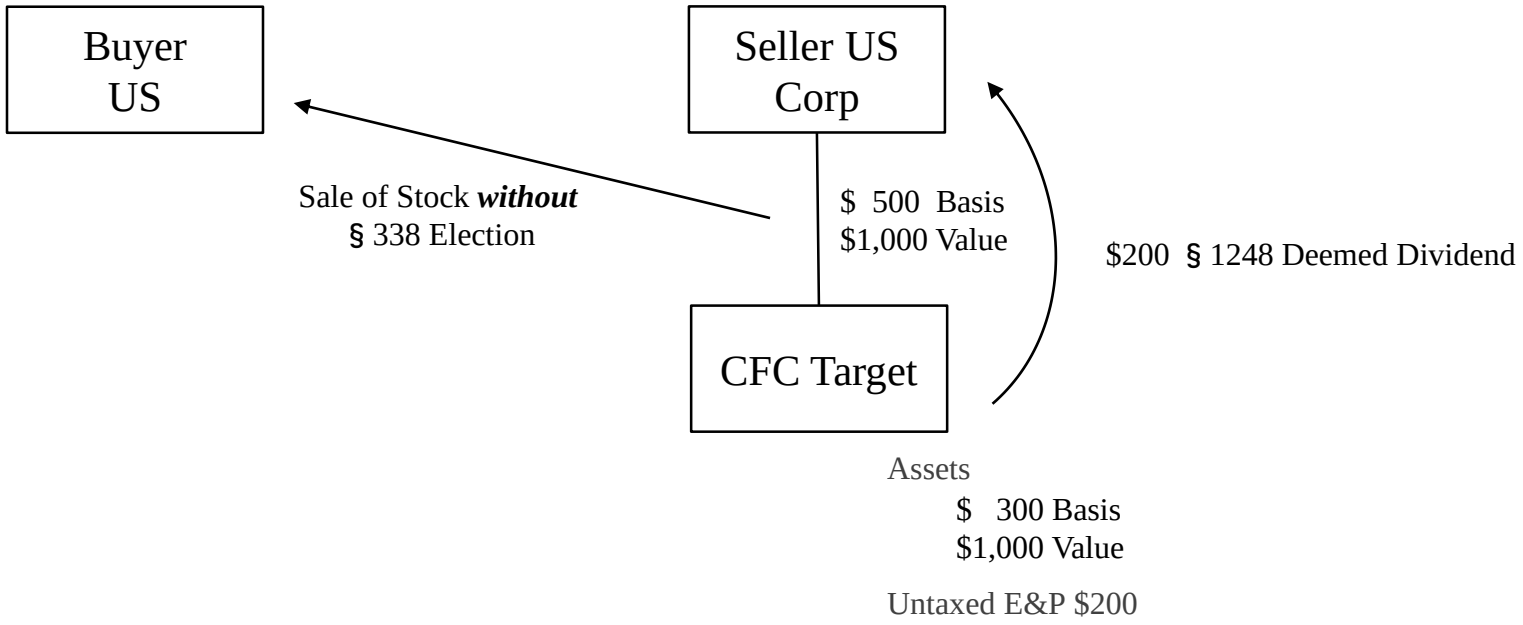


- Deemed sale now produces $100 of GILTI taxed to Seller at 10.5%. After Section 961 basis increase of $100, Seller has a $10 capital loss. Compare results of selling stock without a Section 338 election.

Tax Reform – Overlay of Participation Exemption / Untaxed E&P

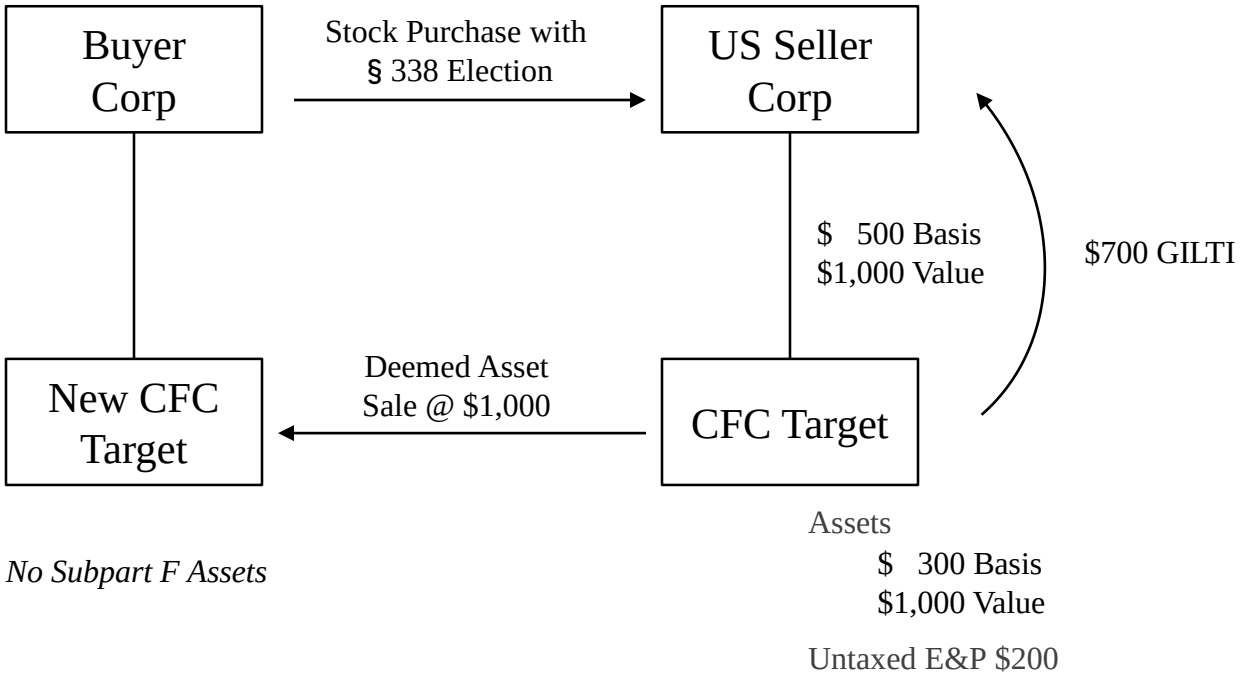
- Most E&P of CFCs now will constitute Previously Taxed Income due to GILTI, Subpart F and the Section 965 transition tax. In some cases, however, CFCs will have untaxed E&P.
  - Examples include offset of earnings by tested losses of other CFCs, QBAI exempt return, etc.
- Section 1248(j) provides that any deemed dividend out of untaxed E&P as a result of a sale of CFC stock held for at least one year <u>by a domestic C Corporation</u> is eligible for the Section 245A DRD.

Example 6 - Sale of a CFC with Untaxed E&P ***Post-Tax* Reform** – Corporate Seller – No Section 338 Election



- Sale of stock without a Section 338(g) election produces gain of $500, of which $200 is a Section 1248 deemed dividend exempt from tax under Sec. 245A and 1248(j). US Seller recognizes $300 of gain taxed at 21%. **Total tax - $62.**

Example 7 - Sale of a CFC with Untaxed E&P ***Post-Tax* Reform** – Corporate Seller

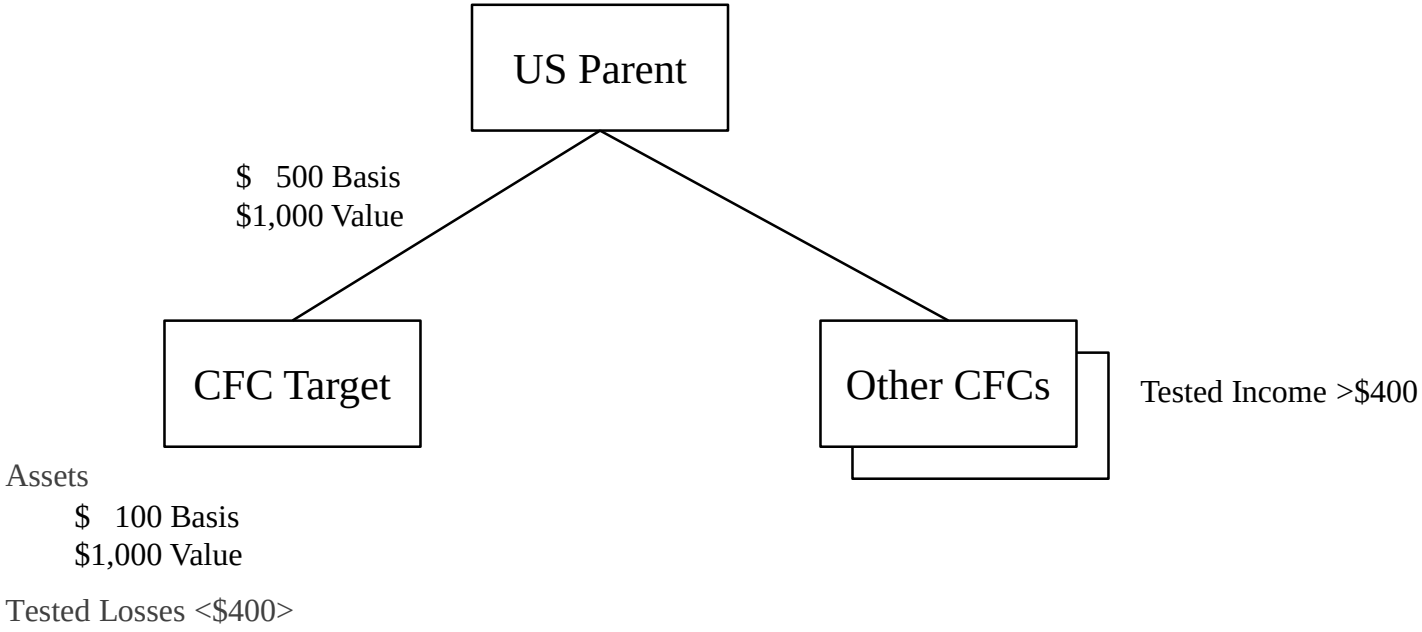


- Sale of assets produces $700 of GILTI taxed at 10.5%. **Total tax is $73.5.**
- Seller also has a $200 capital loss due to basis adjustments under Section 961.

Stock Basis Adjustments for Tested Loss

- As seen above, sale of CFC stock with and without a Section 338 election may result in different amounts of gain to the Seller to the extent the CFC's inside basis in its assets is less than the Seller's outside basis in its stock.
- Post Tax Reform, where a taxpayer has one CFC with tested losses and another CFC with tested income, losses may be used to reduce GILTI inclusions from tested income CFCs. See Section 951A(c)(2).
- Under Proposed Regulation 1.951A-6(d), the stock basis of CFCs generating tested losses that are absorbed by other CFCs is reduced to the extent of other CFCs' offset tested income.
- The reduction to stock basis should be factored into the analysis of pros and cons of an election under Section 338(g).

Example 8 - Tested Loss Adjustment

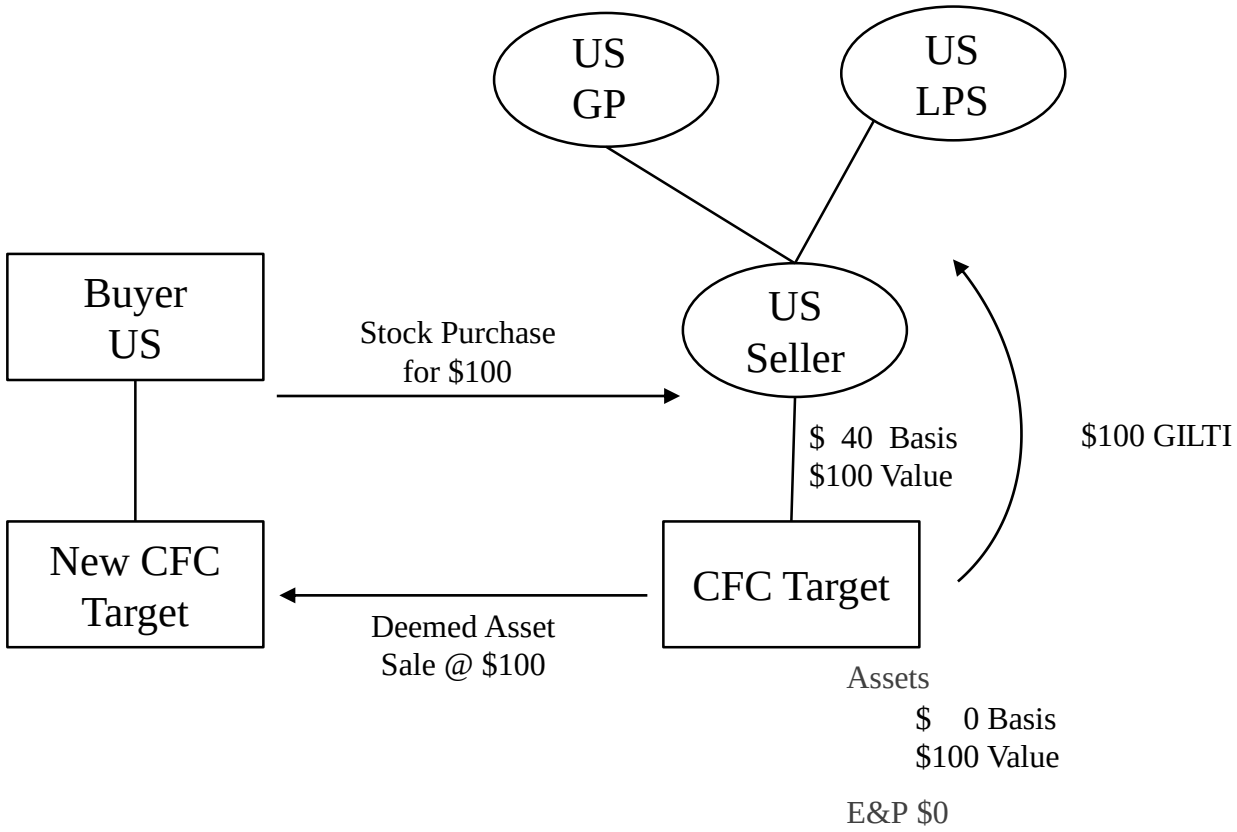


- Use of CFC Target's tested losses to reduce tested income of other CFCs results in a $400 reduction in basis under Reg. 1.951A-6(d).
- Accordingly, stock sale would result in $900 of gain at 21% **(total tax = $182)**. Asset sale would produce $900 of GILTI at 10.5% **(total tax = $94.5**).

Sale of Stock by Individual Sellers with Section 338(g) Elections – ***Post-Tax Reform***

- Foreign Sellers in CFCs continue to be unaffected by Section 338(g) elections.
- US sellers in non-CFC / non-PFICs also continue to be unaffected.
- US individual shareholders in CFCs, however, now face drastically different consequences because:
  - CFC income on sale of assets that escapes taxation as subpart F income generally will be "tested income" taxed under GILTI
  - GILTI is taxed to individuals at ordinary rates, rather than long-term capital gain / QDI, regardless of whether CFC is a Qualified Foreign Corp.
  - 50% deduction under Section 250 generally is not available to an individual US shareholder of a CFC.

Example 9 - Sale of a CFC – **Post-Tax Reform** – ***Individual*** Seller - No Subpart F Income



- As discussed on following slide, broad application of GILTI rules causes harsh results to US Seller from a Section 338(g) election.

Example 9 – Tax Consequences

	Stock Sale - No Section 338(g) Election	Section 338(g) Election
GILTI Income	$0	$90
Fed Tax @ 37%	$0.00	$33.30
Proceeds on Stock Sale	$100	$100
Stock Basis*	$40	$130
Capital Gain or Loss	$60	($30)
Fed Tax @ 23.8%	$14.28	$0.00
Total Tax	***$14.28***	***$33.30***
*$90 of GILTI created by Section 338(g) election results in additional stock basis under Section 961(a)		

Impact of a Section 962 Election by US Seller in Example 9

- Section 962(a) allows a "United States shareholder [of a CFC] that is an individual" to elect to be treated as if it were a domestic corporation with respect to subpart F income inclusions for the year. Under Section 951A(f)(1)(A), except as provided in Regulations, a GILTI inclusion is to be treated in the same manner as subpart F income for purposes of Section 962.
- Section 962(a) limits individual's tax to US corporate tax, net of indirect credit, on the GILTI inclusion.
- Under Section 962(d) and Reg. 1.961-1(a)(2), the PTI and increase in stock basis is limited to the amount of hypothetical corporate tax paid under Section 962(a).
- Earnings and profits taxed under Section 962(a) nonetheless are excluded from the CFC's Section 1248 amount.

Example 9 – Tax Consequences with Section 962 Election

	(A) Stock Sale - No Section 338(g) Election	(B) Section 338(g) Election	(C) -- Scenario (B) + Section 962 Election
GILTI Income	$0	$90	$90
Fed Tax @ 37%	$0.00	$33.30	N/A
Fed Tax @ 21% under Section 962(a)*	N/A	N/A	$18.90
Proceeds on Stock Sale	$100	$100	$100
Stock Basis**	$40	$130	$58.90
Capital Gain or Loss	$60	($30)	$41
Fed Tax @ 23.8%	$14.28	$0.00	$9.78
Total Tax	***$14.28***	***$33.30***	***$28.68***

*Assumes Sec. 250 deduction is not available for purposes of Sec. 962

**$90 of GILTI in (B) and Hypothetical Corporate Tax in (C) results in additional stock basis under Section 961(a)

PFIC Implications of Section 338(g) Election

- Apart from Tax Reform, the anti-deferral rules for ownership of a "passive foreign investment company" ("PFIC") may also have important implications for a US shareholder disposing of stock in a foreign corporation.
- Such shareholders typically make a Section 1295 "qualified electing fund" election to treat PFIC stock as a flow-through entity under Section 1293 of the Code.
- Unlike GILTI, Section 1293 permits flow-through of net capital gain and net ordinary earnings of the PFIC to the shareholder.

Detailed Mechanics and Requirements

Section 338 – Requirement of a Qualified Stock Purchase

- Section 338(g) elections are available only for a "qualified stock purchase." A "qualified stock purchase" (QSP) occurs if a corporation acquires by "purchase," in one or more related transactions over a 12 month period, stock meeting the requirements of Section 1504(a)(2) in the target corporation.

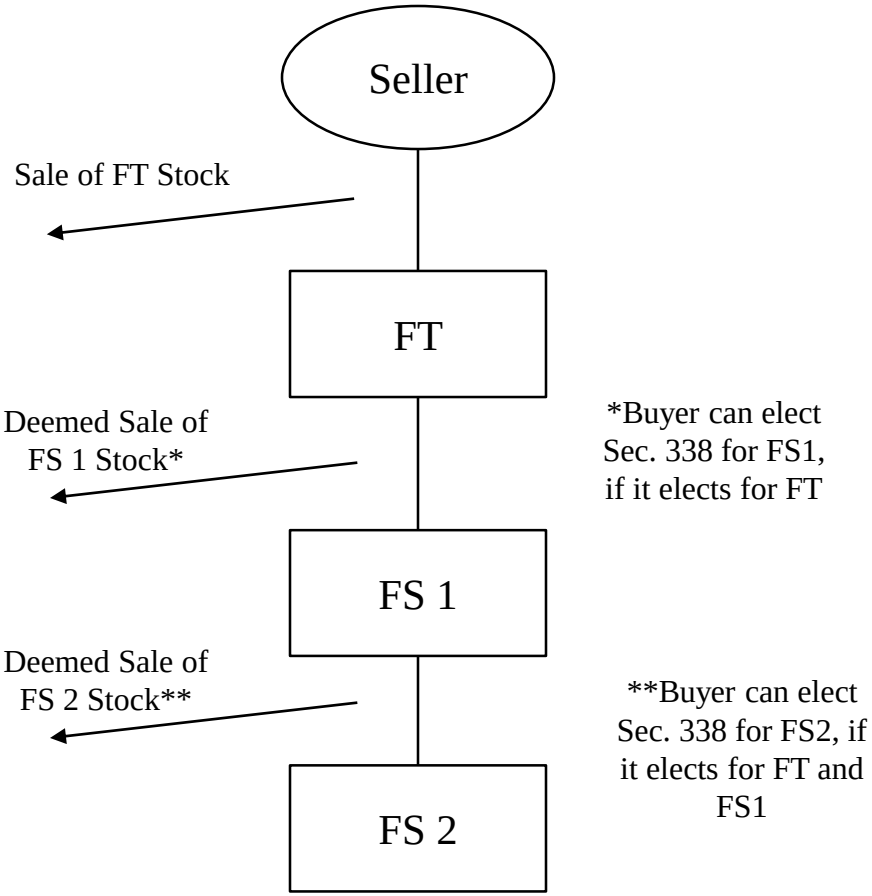
- A "purchase" is defined by § 338(h)(3) as an acquisition of stock where:
  - The acquirer's basis not determined by reference to the transferor's basis in whole or in part;
  - The exchange is not governed by Sections 351, 354, 355, or 356, or other similar transactions described in regulations; AND
  - The transferor's stock ownership would not be attributed to the acquirer under Section 318(a) (other than Section 318(a)(4)).

Section 338 – Qualified Stock Purchases

- Redemptions of stock by the target from persons unrelated to the purchaser are taken into account in determining whether a QSP has occurred.
- The Purchasing corporation can be newly formed by an individual / partnership for the acquisition, but must be respected for federal income tax purposes as the purchaser of the stock. See Regs. § § 1.338-3(b) and 1.338-3(c)(2).
- Target can be liquidated on or after the closing date without affecting the Section 338 election. See Reg. § 1.338-3(c)(1).
- Unlike in the domestic context, Section 336(e) is not available for a foreign target. See Reg. 1.336-1(b)(6).

Section 338 – Tiered Elections

- A purchase of FT stock with a section 338(g) election also results in a QSP as to FT's subsidiary.
- Thus, Section 338(g) elections can be made down a series of tiers of foreign corporations. See Reg. 1.338-4(h), Example 4.
- Same result applies if a US Target Company is purchased with a Section 338(h)(10) election; the deemed asset sale may be "tiered down" to the Target's foreign subsidiaries.



Section 338(g) – Election Mechanics

- Election is made unilaterally by the purchaser by filing Form 8023 with the IRS by the 15th day of the ninth month after the purchase.
  - Compare similar domestic elections (i.e., § 338(h)(10) and § 336 (e)) where involvement of the seller is required.
- If foreign target is a CFC or PFIC, and election has an impact on seller's subpart F income, Section 1248 amount, etc., then the Purchaser also is required to provide notice of the Section 338(g) election to US shareholders of the foreign target who may be affected by the election. See Reg. § 1.338-2(e)(4).

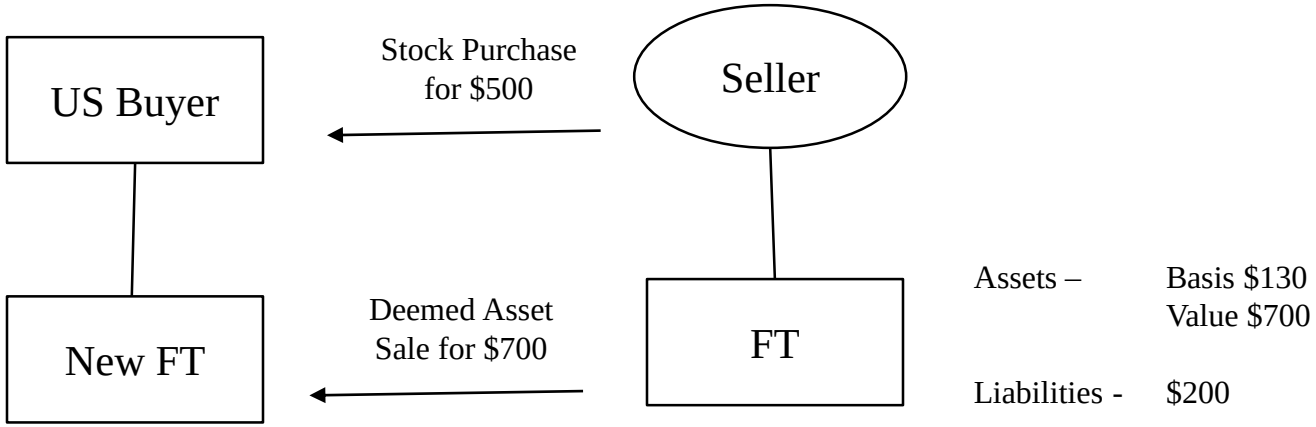
Effect of the Section 338 Election

- Foreign Target (old FT) is treated, for US tax purposes only, as if it sold its assets to an unrelated corporation (new FT). FT accordingly takes a stepped up basis in FT's assets equal to the Adjusted Grossed-up Basis (AGUB).
- New FT is generally treated as a new corporation from old FT for most substantive federal income tax purposes, including:
  - Carryover of Old FT's US tax attributes (E&P, foreign income taxes, etc.)
  - Tax Elections
  - Accounting Methods
- New FT is treated as same corporation for procedural purposes, such as liability to the IRS for Old FT's federal tax liability. See Reg. 1.338-1(b)(3).

Effect of Section 338(g) Election – Basis Step-up

- Adjusted grossed-up basis (AGUB) for target stock generally equals the amount paid by buyer, and any liabilities of Old FT that are deemed assumed by new FT. Additional special rules apply where less than 100% of Old FT's stock is purchased.
- AGUB is allocated among the seven classes of assets described in Section 1060 according to a "residual method" of allocation under Regs. 1.338-6 and 1.338-7.
- Under Section 197, purchase price allocated to intangible assets of the Target is generally amortized over 15 years for U.S. tax purposes.

Effect of Section 338(g) Election – Example of AGUB Allocation



- Assume FT has $200 of liabilities that remain in place following the transaction.
- FT has $130 of tax basis assets in its assets, which include cash, accounts receivable, inventory, and equipment / tangible property.

Effect of Section 338(g) Election – Example of AGUB Allocation

- New FT's basis in the assets is determined by allocating to each of Classes I – VI the FMV of its assets, with the balance allocated to Class VII (goodwill). Example of allocation of $700 of AGUB from prior slide ($500 purchase price + $200 assumed liabilities):

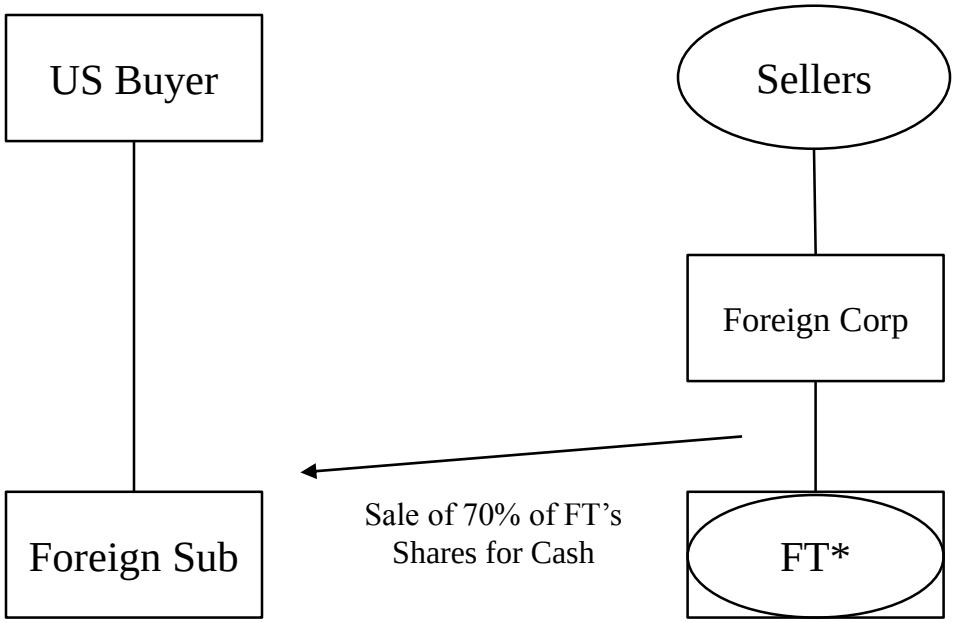
Asset Class	Book Value	FMV / Residual Method Allocation
Class I (cash)	$10	$10
Class II (other securities)	N/A	$0
Class III (A/R)	$20	$20
Class IV (Inventory)	$50	$60
Class V (tangible property)	$50	$60
Class VI (identified intangibles)	N/A	$0
Class VII (goodwill)	$0	$550

Effect of the Section 338 Election – International Issues

- Deemed asset sale gain is treated the same as if Old FT actually sold its assets. Depending on the facts:
  - Old FT may generate effectively connected income (ECI) if it is engaged in a US trade or business (see Reg. 1.338-4(h)(4))
  - Old FT's deemed asset sale may produce subpart F income for the seller if FT is a controlled foreign corporation
  - Old FT's deemed asset sale gain may affect seller's Section 1248 amount

- In Advice Memo 2007-006, the IRS confirmed that a Section 338 election is available for a QSP of a foreign target with no previous connection to the US taxing system and where the election has no US tax impact on the seller.

Example of a Check-the-Box / Deemed Asset Sale



**Assume FT has elected to be disregarded as a separate entity from Foreign Corp*

- If FT is disregarded as a separate entity for US tax purposes, sale would be treated as a partial sale of assets for US tax purposes (Rev. Rul. 99-5). Results would be similar to a § 338(g) election.

IRC Section 901(m)

Section 901(m) - Overview

- Section 901(m) was enacted as part of foreign tax credit changes in 2010 to address the favorable foreign tax credit effects of a Section 338(g) election and other similar transactions.
- Section 901(m) applies following a "covered asset acquisition," defined to include a QSP with a Section 338(g) election.
- Where it applies, Section 901(m) permanently disallows a portion of foreign income taxes as a credit under Section 901 or Section 902.

Example of a Section 338(g) Election before Section 901(m)

FT Operating Results for Year After Closing:

$200	Taxable Income
<$60>	German Tax
<$50>	§ 197 Amortization from Step-up
$90	E&P for US Tax Purposes (40% § 902 Rate)

- Section 901(m) disallows foreign income taxes following "covered asset acquisitions" to reverse out the E&P impact of a Section 338(g) election and related US tax only depreciation and amortization.

Application of Section 901(m)

- Purchase of FT's stock with a Section 338 election is a covered asset acquisition. As a result, a portion of German FT's foreign income taxes are disallowed as follows:
  - Total foreign income taxes * $\frac{\text{"Basis Difference" during the year}}{\text{Foreign Taxable Income}}$
- Intent of the rule is to reverse out, for U.S. foreign tax credit purposes, the difference between US and foreign basis created by the Section 338 election.

Other Section 901(m) Rules

- Taxes disallowed under Section 901(m) are allowable as deduction, notwithstanding that the taxpayer elects the credit for that year. See Section 901(m)(6).
- If the foreign assets are disposed of, the taxes disallowed are adjusted to reflect the amount of gain / loss recognized for foreign tax purposes on the disposition. See Section 901(m)(3)(B)(ii).
- In addition to Section 338 elections, Covered Asset Acquisitions also include:
  - Purchase of an interest in a hybrid entity / DRE
  - Purchase of a partnership interest with a Section 754 election
  - Other similar transactions prescribed by regulations

Example of a Section 338(g) Election Application of Section 901(m)

FT
Germany

	Germany	Pre-901(m)	Post-901(m)
Taxable Income	$200	$200	$200
German Tax	<$60>	<$60>	<$45> (for FTC purposes)
Amortization	$0	<$50>	<$50>
E&P	N/A	$90	$90
Tax Rate	30%	40%	33.3% ($45 / $135)

Section 901(m) Fraction: $60 * $50 / $200 = ***$15 Foreign Tax Disallowed as a Credit***

Section 901(m) New Regulations

- New temporary and proposed regulations were issued on December 6, 2016 to implement Section 901(m).
- The proposed regulations would adopt comprehensive rules on a prospective basis, including the following:
  - New types of transactions designated as covered asset acquisitions
  - Foreign basis election to compute the basis difference
  - De minimis rule
  - Computational rules
  - Rules for dispositions of assets, successor transactions, etc.