Subpart F Expansion After Tax Reform: Increased Tax Liability and Reporting Obligations

TUESDAY, DECEMBER 3, 2019, 1:00-2:50 pm Eastern

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AGENDA

I. High-Level Overview of 2017 US International Tax Reform

- TCJA Replaced the US "Corporate Tax Deferral" Regime with a "Partial Territorial Regime"
- Increased Importance of Entity Selection in Cross-Border Context
- Key International Tax Code Sections Introduced or Amended by TCJA

II. Refresher on Basics of Subpart F Application Rules (which now apply for GILTI purposes and Transition Tax purposes)

III. Six Key Ways the 2017 Tax Cuts & Jobs Act Expanded Purview of Subpart F

IV. Repeal of § 958(b)(4) and its myriad, untoward effects

- Notice 2018 provides limited relief from duty to File Form 5471
- NEW !!– Revenue Procedure 2019-40 and Set of Proposed Regulations mitigating effects of 958(b)(4) repeal
- Selected strategies to avoid both Subpart F and GILTI (E.g., High Foreign Tax Exception/Exclusion)

V. § 951A – "Global Intangible Low Taxed Income" – GILTI Overview and Updates

VI. GILTI Deduction Mechanics

- GILTI "Tested Income" and "Tested Loss"

VII. More Key Updates from the Regulations

- The Proposed "GILTI High Tax Exception"

VIII. Interaction between § 956 and § 245A

IX. GILTI Compliance: Selected Considerations from the Forms

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Ms. Fuller is an international and corporate tax attorney who advises a wide range of clients--including private and public companies, joint ventures, private equity funds, C-Suite executives, high-net-worth individuals, "start- ups," and government entities--on transactional, investment, and supply-chain strategies to achieve optimal tax and business results. As a seasoned practitioner, Ms. Fuller is accustomed to handling nuanced matters involving highly technical questions of law, policy, and procedure at the federal, state, 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.

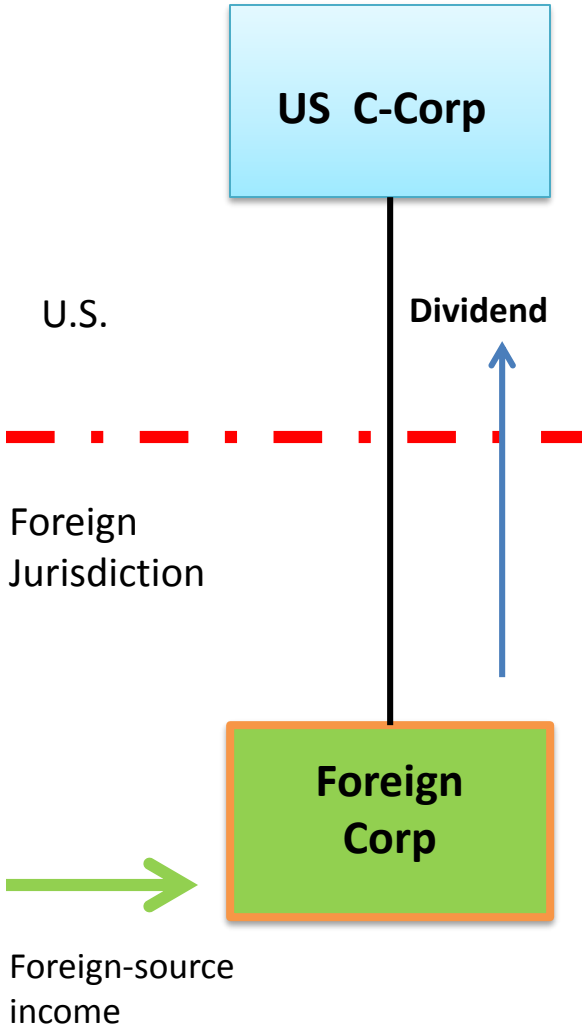
Ms. Fuller also has two decades of experience resolving U.S. federal, state, and foreign tax controversies, as well as asserted tax penalties. Some of the controversies Ms. Fuller has handled have involved novel questions of law. She also has significant experience with complex *transfer pricing issues--skills she first acquired when clerking 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.

Ms. Fuller presently chairs the American Bar Association Tax Section's Tax Policy Committee, and is a member of several international law related steering committees associated with the ABA, the New York State Bar, the New York City Bar Association, and the International Fiscal Association. Ms. Fuller is a member of the International Tax Advisory Board for Law360. She was recently recognized as one of the 100 top Women in International Taxation.

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.

The 2017 TCJA Drastically Changed How Foreign Subsidiary Income of US Corporations is Taxed

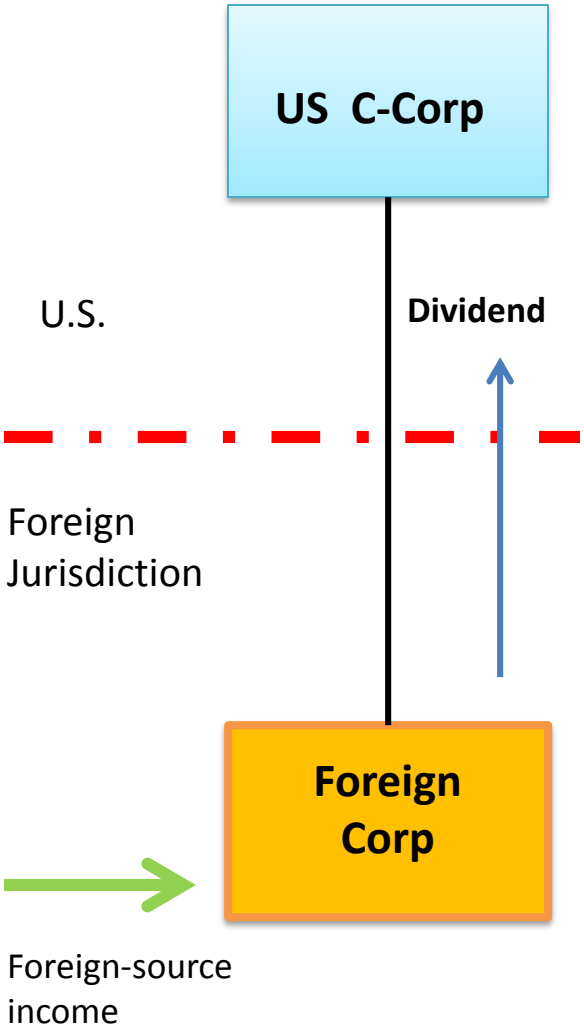


BEFORE 2017 US Tax Act

- **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 TCJA Drastically Changed 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).**

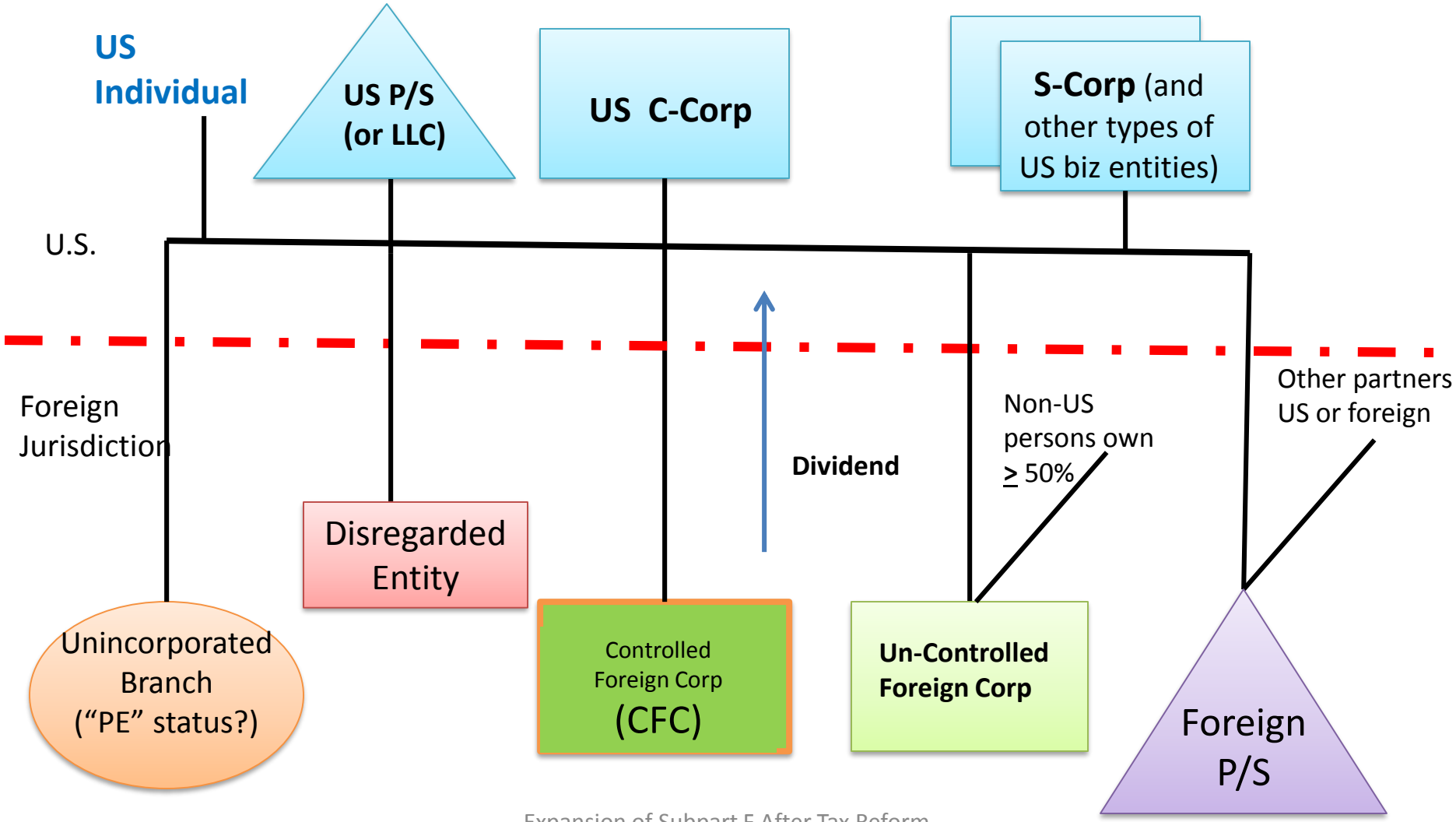
Three categories of foreign-source income of foreign Subs are now EXEMPT . *But these may not amount to much due to the breadth of the new GILTI minimum tax.* They include:

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%).

Overview of Tax Stakes in Business Entity Selection

General Rule: *When a foreign venture rises to the level of "permanent establishment" status, then foreign entity selection becomes more relevant, and a choice needs to be made. Traditionally, choice was between "foreign E&P deferral" or "no deferral."*



KEY TCJA Provisions to Consider when Structuring

- 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.
- New found importance of the § 962 Election (so that non-C Corporate US shareholders can: (1) get a lower 21% corporate rate on dividends; (2) get the 50% GILTI deduction under 250; and (3) an indirect FTC
- § 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 only 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.

More KEY TCJA Provisions to Consider when Structuring

- **§ 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 § 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.

2017 Tax Act (TCJA)- Expansion of Subpart F:

6 ways the Act expanded purview of Subpart F

1. **§ 951(b) definition of "US shareholder" was broadened to include a VALUE test** -(after TCJA, the test for "US shldr" is a US person owning at least 10% of EITHER vote OR *10% of value* of a foreign corporation (directly, indirectly through foreign entities, or constructively through modified § 318 attribution rules).

2. **Broader application of "US shareholder" definition:** Amended § 951(b) to provide that the new definition of "U.S. shareholder" applies "for purposes of this title," – (i.e., Title 26—the whole U.S. Internal Revenue Code)—instead of just for purposes of Subpart F as under pre-TCJA law.

3. **Repealed IRC § 958(b)(4),** which had turned-off the downward stock attribution rules of §318(a)(3)(A) --(C) for purposes of imputing stock owned by a foreign person to a US person (in identifying "US shareholders" and thus "CFCs." (Very consequential change!!)

4. **No more "30-day rule":** TCJA eliminated from § 951's income inclusion rule the requirement that a foreign corporation must be a CFC for at least "an uninterrupted period of 30 days" during any taxable year in order for a US shldr to be taxed. (Now a foreign corporation need only be a CFC for 1 day.)

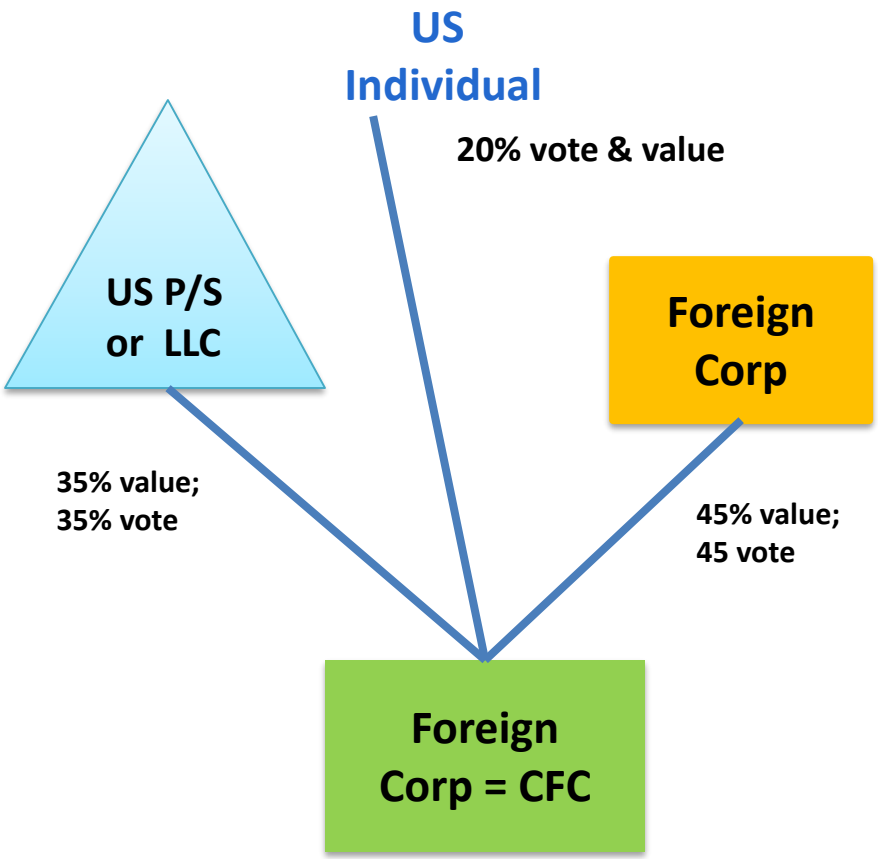
5. **Enacted § 951A GILTI:** a broad new category of income--"Global Intangible Low Taxed Income" (GILTI)--was added to Code and imposed on "US shareholders." Although § 951A GILTI is not technically within §952's definition of "Subpart F Income," GILTI 's application thresholds are basically the same, and the same definitions are used (i.e., "U.S. shareholder"; "control"; "CFC").

6. **Transition Tax was added:** New§ 965 --"Treatment of deferred foreign income upon transition to participation exemption system of taxation" (*i.e.*, the "Transition Tax") was added to the very end of the Subpart F provisions.

2017 Tax Act - Expansion of Subpart F:

Basically, when does Subpart F regime apply?

- Subpart F regime can potentially apply whenever there is a "controlled foreign corporation" (CFC).
- CFC is defined in § 958(a) as "any foreign corporation if > 50% of the total voting power OR > 50% of total value is owned by 10% "US shareholders" on any 1 day.
- For purposes of identifying "US shldrs" and testing for "CFC" status, stock ownership can be direct, indirect through foreign entities, or constructive. (Attribution rules of § 318 are incorporated by reference in Subpart F, but with modifications.)
- Beware of control premiums and value discounts ("drag along" & "tag along" rights)
- With respect to voting power, courts have looked *to power to control board of directors*. See Framatome v. *Cir.* 118 TC (2002) (because the veto powers and supermajority requirements prevented US shldr from exercising powers over Japanese corp ordinarily exercised by a domestic board of directors, US shareholder did not have > 50% voting power. Court relied on *Alumax v. Cir., 109 TC 133 (1997), aff'd 11th Cir.*



Foreign Corp is a "CFC" because the "US shareholders" (i.e., the US LLC and the US individual together own > 50% of the vote (and here, also 55% of the value). IF US individual owned only 5%, then there would be no CFC.

Expansion of Subpart F:

Repeal of "uninterrupted 30-day ownership" test

- **PRE- TCJA:** Income earned by a foreign corporation that would otherwise qualify as Subpart F income of a CFC was not subject to U.S. tax if the foreign corporation was not a "CFC" for an uninterrupted period of at least 30 days. § 951(a).
  - Example: Assume a foreign corporation with one class of stock and a December 31st year end met qualified as a "CFC" during its last month because a US person acquired more than 50% of its stock on Dec. 3rd. Because the foreign corporation would not have qualified as a CFC for an uninterrupted period of 30 days during its taxable year, the US shareholder will not have any inclusion under 951(a) for the year of the acquisition.

- *TCJA repealed this 30-day rule*. Sec. 14215(a), TCJA.
- **POST-TCJA:** Now, a US shldr will be taxed on its pro rata share of Subpart F income even if the foreign corporation qualifies as a "CFC" for only ONE DAY, provided the US owns the CFC on the last day of the CFC's tax year.
- **New rule is effective prospectively**: Repeal of the 30-day rule is effective for tax years of foreign corporations beginning after December 31, 2017, and taxable years of U.S. Shareholders in which or with which those taxable years of a foreign corporation end.

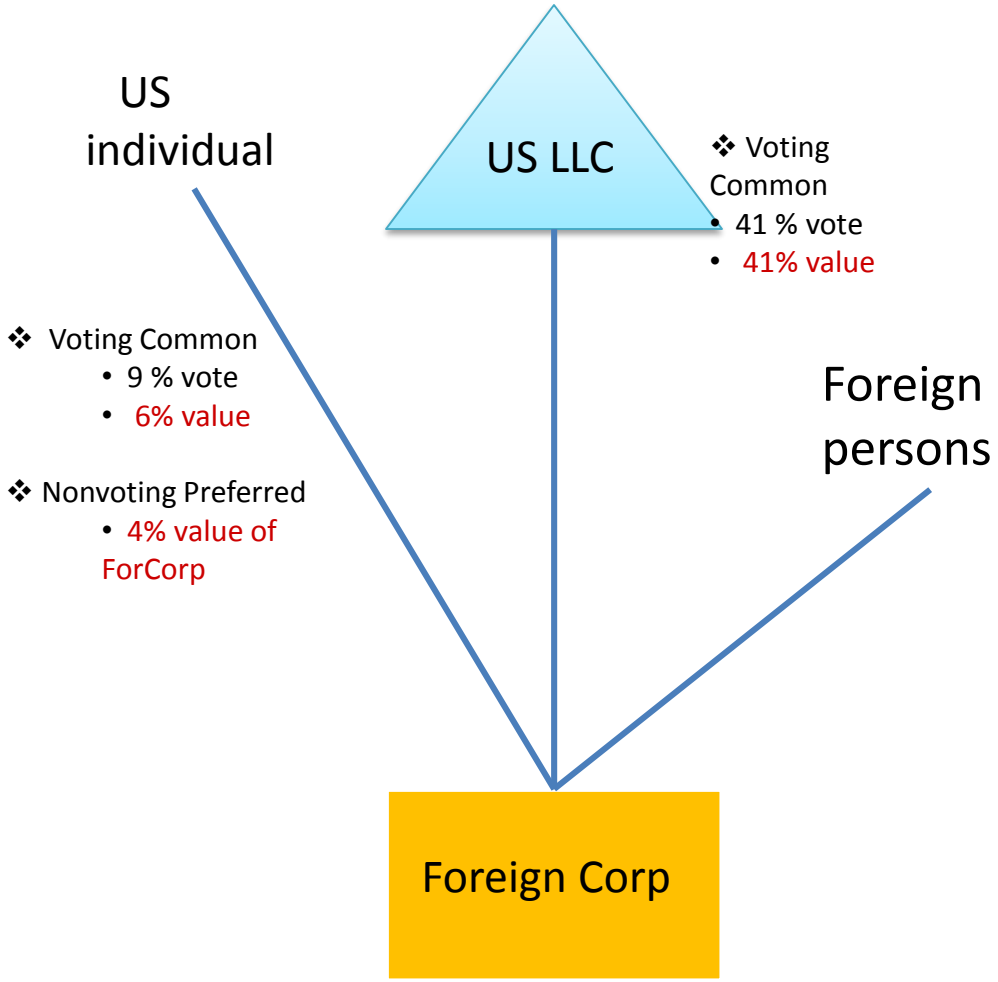
2017 Expansion of Subpart F:
"US shareholder" definition broadened to *10% vote OR VALUE*

- "US shareholder" was historically defined in § 951(b) as a "US person" that owns at least 10% of the foreign corporation's VOTING stock . VALUE WAS IGNORED.
- The 2017 Tax Act amended § 951(b) to add a value test….so that a U.S. shareholder is now defined as any "US person" that owns (directly, indirectly, or constructively) at least 10 % of foreign corp's voting stock OR 10 % of foreign corp's VALUE.
- Value test is likely to import all the judicial and administrative IRS authority regarding control premiums, minority discounts, and in some instances, "drag-along" and "tag along" rights, valuation of beneficial ownership—making process of identifying "US shldrs" in complex family trust and/or corporate arrangement more complex.
- **Effective date of new "US shldr" definition is prospective:** Applies to CFC tax years beginning after 12/31/2017,and for taxable years of US shldrs in which or with which the CFC's year ends. Sec. 14214(b), TCJA.
- **"US person**" includes US citizens, US residents, US C- corp, S Corps, partnerships formed in the US, Estates taxable in the U.S., and non-foreign trust
- For § 951(b) purposes (defining "US Shareholder"), stock ownership has always been computed, and continues to be computed, using the "direct" and "indirect through foreign entities" of § 958(a) AND the constructive attribution rules of § 958(b) (which incorporate § 318, but modifies them in significant ways)
- Although constructive ownership rules are used to identify "US shareholders" and "CFCs," income is included in proportion to each US shldr's direct and/or indirect ownership only! US shldrs are never subject to tax based on shares they own only constructively. *See* flush language of § 958,and confirmed in House Report and 2018 Notices.
  - § 965: While constructive ownership can cause § 965 to apply, only the E&P of foreign corporations attributable to shares actually owned (directly and indirect) are deemed repatriated.
  - § 951A: While constructive ownership can cause § 951A to apply, the taxable "inclusion" is based on shares of the CFC owned directly and indirectly (i.e., not constructively).

2017 Tax Act - Expansion of Subpart F:

"US shareholder" broadened to include 10% of vote ***OR VALUE***

- **PRE- TCJA law:** "US shareholder" defined as a US person owning stock representing 10% or more of the total voting power of all stock of the foreign corporation. § 951(b). (Ownership could be direct, indirect, or constructive.)
- *Thus, a US person holding nonvoting preferred shares representing 10% of the VALUE was not treated as a "US shlder."* That US person could not be counted for purposes of determining whether a foreign corporation was a CFC. And, if it was a CFC, such shldr would not be subject to US taxation under Subpart F.
- **POST-TCJA Law**: TCJA expanded definition of "US shareholder" to include a US person owning shares representing 10% or more of the VALUE of all shares of the foreign corporation (regardless of the shareholder's voting power).
- **Diagram:** US individual qualifies as a "US shareholder" of the Foreign Corp because she owns stock representing at least 10% of the foreign corporation's value.
- But IF the value of US individual's shares is only 9% of the Foreign Corp's total value (maybe due to minority discount?), then US individual is not a "US shareholder" and her shares can not be counted to determine if Foreign Corp is a CFC. (Note that she also only owns 9% of vote.)
- Here, value of US individual's shares is critical. If the value of her shares is only 9%, then Foreign Corp is not a CFC because US LLC does not own > 50% of vote or value. IF US individual's ownership could be counted (assuming she has at least 10% of total value), then together she and US LLC own shares totaling > 50% of the total value of Foreign Corp.



2017 Tax Act - Expansion of Subpart F - Attribution rules of §958 (a) and (b) : different rules and different purposes

§ 958 contains the rules for determining stock ownership. Subsections (a) and (b) serve different purposes, and contain distinct rules.

§ 958(a)(1) - General Rule: For purposes of Subpart F (other than § 960(a)(1)), stock owned means—

- § 958(a)(1) and (2):
  - **stock owned *directly*** (§ 958(a)(1) and
  - **Stock owned *indirectly* through foreign entities**, including a foreign corporation, foreign partnership, foreign trust, or foreign estate. § 958(a)(2). (Do not attribute up through domestic entities.)
- **US shlds are taxed only on their direct and indirect ownership as determined under §958(a)(1) & (2)—not on their constructive ownership. But constructive ownership IS counted for purposes of determining whether a US person is a "US shareholder" and whether a foreign corporation is a "CFC."**
- § 958(b) defines "constructive ownership" of stock, for purposes of identifying a
  - "US shareholder" defined in § 951(b);
  - "CFC" defined in § 957;
  - "related person" as defined in § 954(d)(3); and
  - US shldr(s) that has "invested in US property" under through domestic corporations, pursuant to §956(c)(2).
- § 958(b) expressly incorporates the familiar attribution rules of § 318(a), but modifies them in important ways with respect to attribution thresholds.

Family Constructive Attribution Rules of § 318: Modified in §958(b) and left UNchanged by TCJA

Family Attribution

An individual is considered to own stock that is owned, directly or indirectly, by or for

- a spouse (unless legally separated by decree of divorce or separate maintenance),
- children,
- grandchildren, and
- parents.

However, the family attribution rules under §318(a)(1) do not treat an individual as owning stock actually owned by the individual's siblings, grandparents, great-grandparents, great-grandchildren, uncles, aunts, nephews, nieces, or cousins.

- Stock constructively owned by applying the family attribution rules cannot be attributed a second time to another family member. § 318(a)(5)(B). Thus, while shares of stock owned by a child are attributed to a parent, that stock cannot be reattributed from the parent to another child.
- **NO NRA to US person attribution:** Family attribution rules do not apply for purposes of attributing stock owned by a nonresident alien individual (NRA), other than a foreign trust/estate, TO to a US person (e.g., for purposes of identifying a US shldr). §958(b)(1).
- These rules remained unchanged under the TCJA.

BEFORE the 2017 TCJA:

How did § 958(b) modify the § 318(a) attribution rules, which § 958(b) expressly incorporates ?

PRE-TCJA:

Section 958(b): Constructive attribution rules, for purposes of Subpart F, incorporate the attribution rules of § 318, but modify them as follows:

1) **NO NRA to US individual stock attribution:** In applying § 318(a)(1)(A), no stock of a non-resident alien is to be attributed to a US citizen or a US resident alien for purposes of making the US individual a "US shareholder" or § 954(d)(3) "related person" or identifying a CFC;

2) **Upward Attribution (*i.e.*, up TO owners of entities from the entities):** In applying §318(a)(2)(A) – (C), ***if*** a partnership, estate, trust, or corporation owns, directly or indirectly, more than 50 % of the total combined voting power of all classes of stock entitled to vote of a corporation, it shall be considered as owning ALL the stock entitled to vote. (Policy: effective control is assumed.)

3) **In applying § 318(a)(2)(C),** the phrase "10 percent" shall be substituted for the phrase "50 percent" used in subparagraph (C).

4) **Downward Attribution rules of 318(a)(3)(A) –(C) are turned OFF**: Such rules can never be applied so as attribute stock owned by a foreign person to a US person (*e.g.*, to make the US person a US shareholder).

BEFORE the 2017 TCJA: Example of Upward Attribution

§958(b)(2)'s modification of §318(a)(2) - The "Bump-Up Rule"

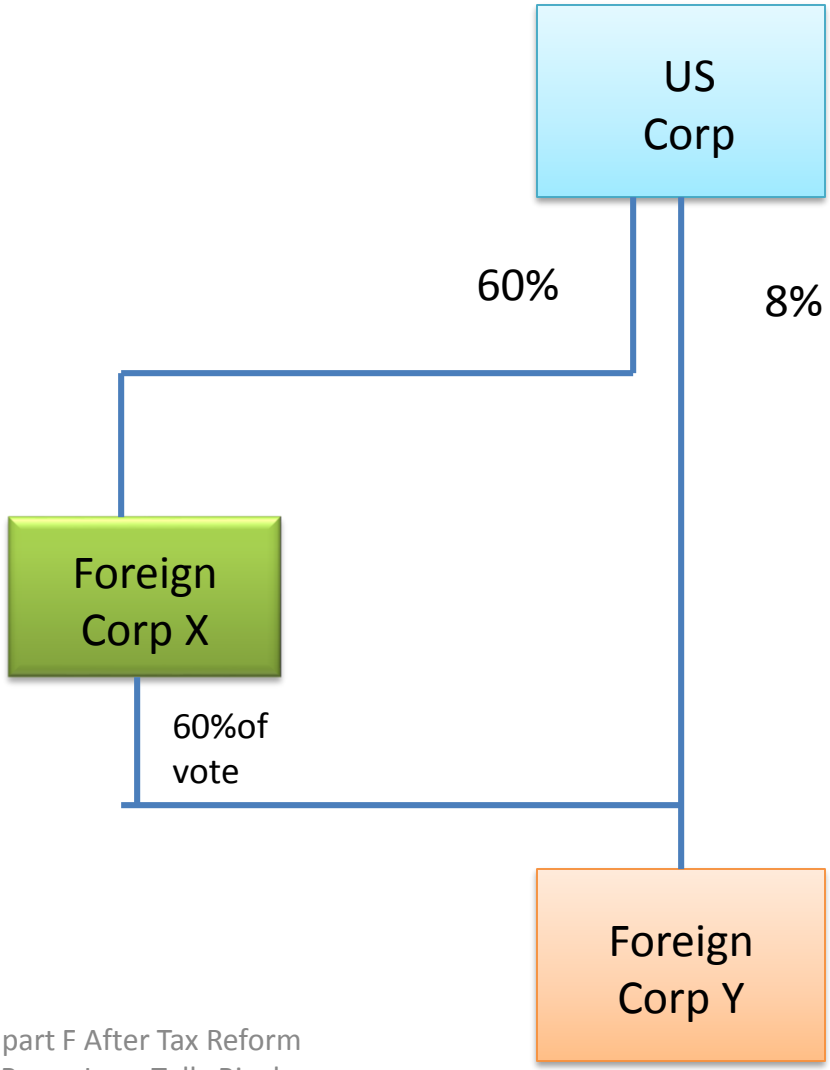
- Under § 958(b)(2) ("Bump Up Rule"), if a shlder owns >50% of the shares in a lower-tier entity (measured by VOTE), that shlder is deemed to own ALL the shares owned by the lower-tier entity (and thus 100% of what that lower tier entity owns).

- **EXAMPLE:** US Corp owns 8% of Corp Y directly, and 36% of Corp Y indirectly (*i.e.*, 60% of 60%). Thus, US Corp's total ownership based on direct and indirect ownership is only 44%. Thus, but for § 958(b)(2), Foreign Corp Y would not be a CFC. (US Corp owns only 44%, without looking at what it owns constructively.)

- However, in making the threshold determination of whether US Corp is a "US shareholder" and whether Corp Y is a CFC, Foreign Corp X is treated as owning 100% of Foreign Co Y under § 958(b)(2). Because Foreign Corp X owns > 50% of the voting power of Corp Y, it is treated as owning 100% of Corp Y (the "Bump Rule of §958(b)(2)).

- Corp Y is a CFC because US Corp (a US shareholder) owns 68% of the stock of Foreign Corp Y—i.e., 8% owned directly and 60% owned indirectly through foreign entities).

- **NOTE:** If Foreign Corporation Y generates Subpart F Income, US Corp will be taxed only on 44% of the Subpart F income—representing its direct and indirect ownership—and not with respect to shares that are constructively owned pursuant to the "Bump Up Rule" of § 958(b)(2).)



2017 TCJA - Expansion of Subpart F:

Repealed § 958(b)(4)'s limit on downward attribution

- The 2017 Act repealed IRC § 958(b)(4)…..***RETROACTIVELY.***
- This change is applicable to the last year of the foreign corporation that begins before Jan. 1, 2018 (and the taxable years of its US shareholders that end with or within the CFC's taxable year). This means that for calendar year taxpayers, the repeal of § 958(b)(4) applies retroactively—*i.e.,* to taxable years ending in 2017.

- Before its deletion from the US Tax Code, § 958(b)(4) provided:
  " Subparagraphs (A), (B), and (C) of Section 318(a)(3) shall not be applied so as to consider a United States person as owning stock which is owned by a person who is not a United States person."

  – § 318(a)(3)(A) provides for downward attribution of stock ownership **TO partnerships and estates .** (The partnership/estate is treated as owning whatever the partner or estate owns.)

  – § 318(a)(3)(B) provides for downward attribution of stock ownership **TO trusts** (exception for "remote contingent interests" in which case there is no downward attribution to the trust).

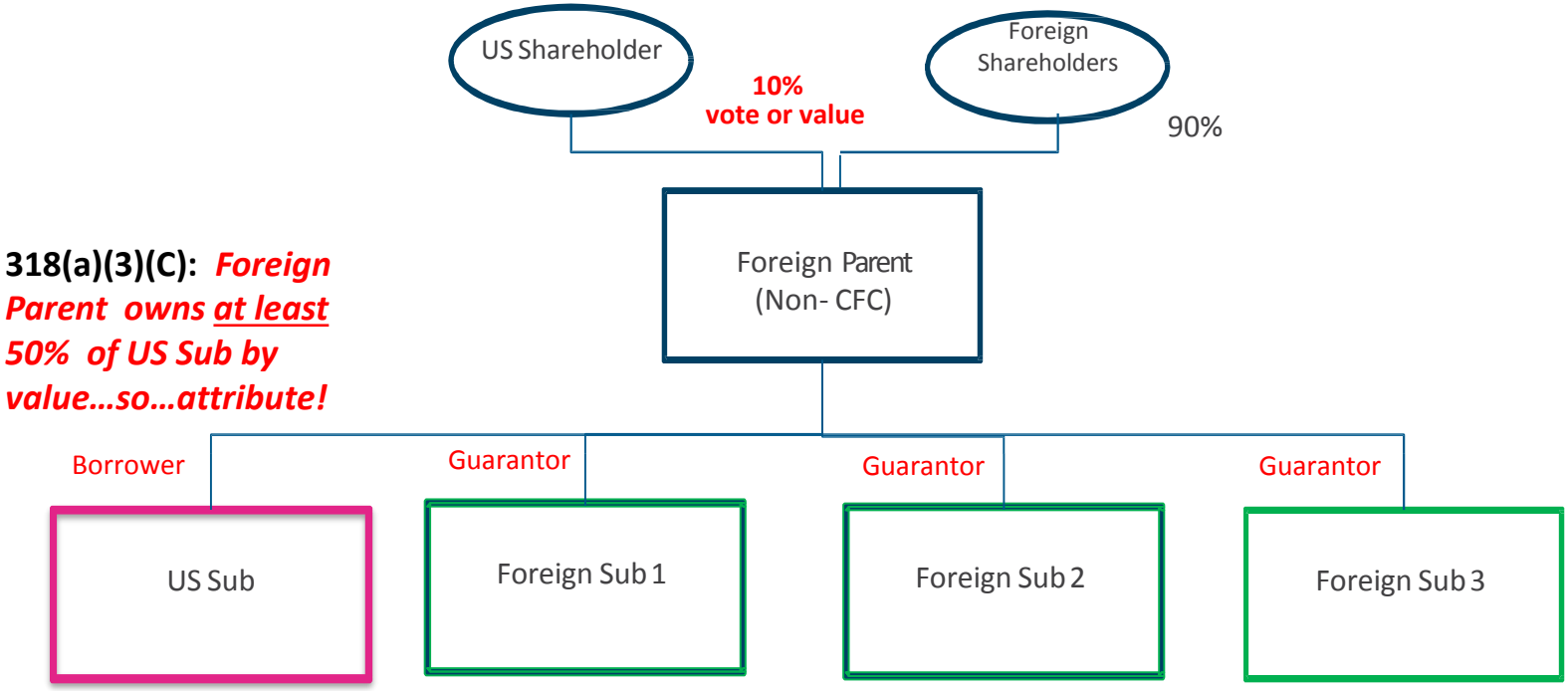
  – § 318(a)(3)(C) provides for downward attribution of stock ownership **TO corporations**:

  "If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person." *

* Note that the relevant threshold under § 318(a)(3)(C) is "AT LEAST 50%" of the value…

Repeal of § 958(b)(4) – Myriad Collateral Effects:

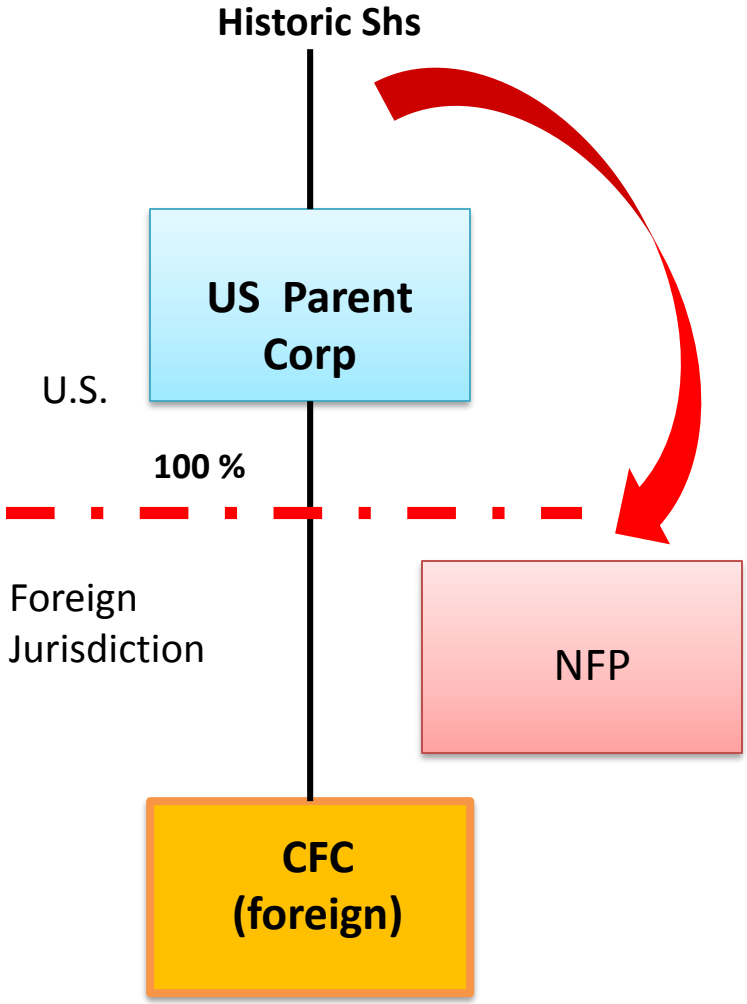
"Pop-Up CFCs" & real, substantive Subpart F tax exposure



- Prior to the TCJA, Foreign Subs 1, 2 and 3 were not CFCs
- Because Foreign Parent Co owns US Sub stock w/at least 50% total value, § 318(a)(3)(C) is triggered. Thus, ALL the stock owned by Foreign Parent is treated as owned by US Sub--making US Sub both a § 951(b) "US shlr" and Foreign Subs 1, 2, and 3 "CFCs."
- US Sub not taxed on constructive ownership (which is all it owns in this diagram).
- BUT the 10% US shlder (at the top) owns 10% of the CFC indirectly (through Foreign Corps) and thus IS taxed on its pro rata share of all Subpart F earnings of Foreign Subs 1, 2, 3. Also, the indirect US Shldr could also have tax under §§ 956 (Earnings invested in US Property); §951A (GILTI; § 965 Transition Tax (even though none of the foreign corps are "controlled" directly or indirectly by US shs.
- **Here, advisors should review income and earnings of each CFC. Also, need to review loan documentation requiring guarantees** (because under of § 956 Investment in US Property, any CFC guarantee of a U.S. obligation could trigger a deemed dividend).

2017 Expansion of Subpart F - A side note

Q: Why did Congress repeal § 958(b)(4)? A: Post-inversion schemes



Repeal of § 958(b)(4) was aimed at post-inversion de-control transactions, *but has huge collateral effects*

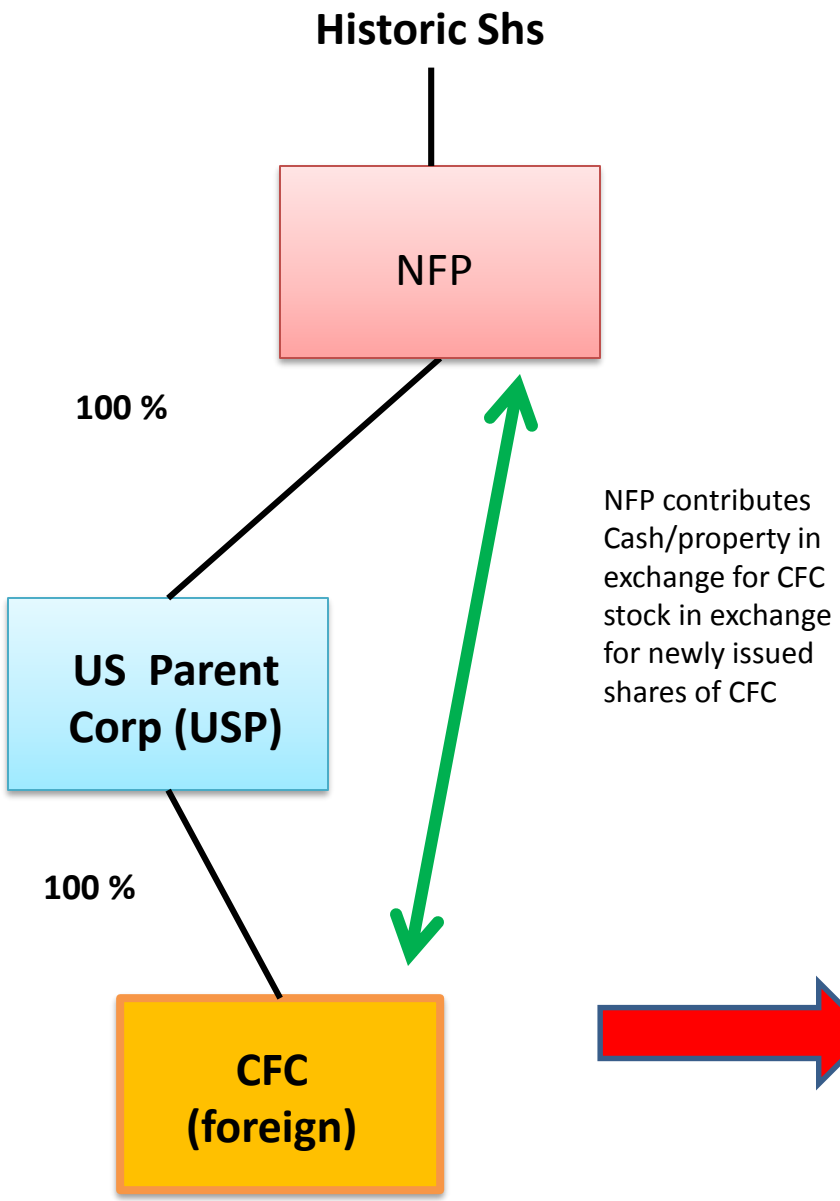
- Example of post-inversion "de-control transaction" at which §958(b)(4) was aimed.

1. Assume historic shareholders of US Parent Corp contribute their shares to a newly formed foreign corporation, which becomes new foreign parent (NFP);

2. Also assume that NFP does not qualify as a "Surrogate Foreign Corporation" under § 7874 (i.e., it is an "inversion")

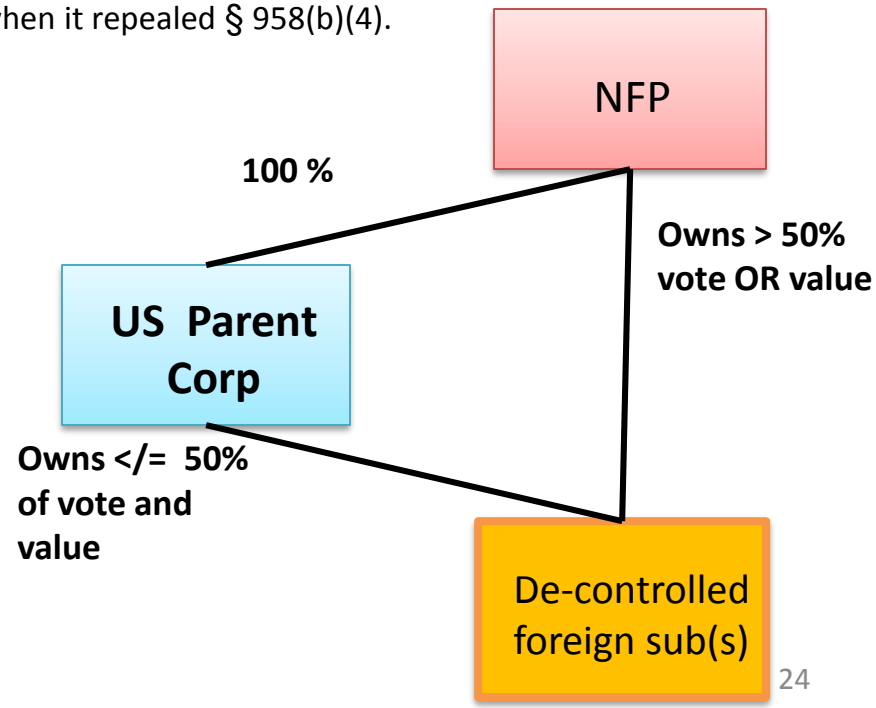
2017 Expansion of Subpart F:

Q: Why Congress repealed § 958(b)(4)? A: Post-inversion schemes (Cont.)



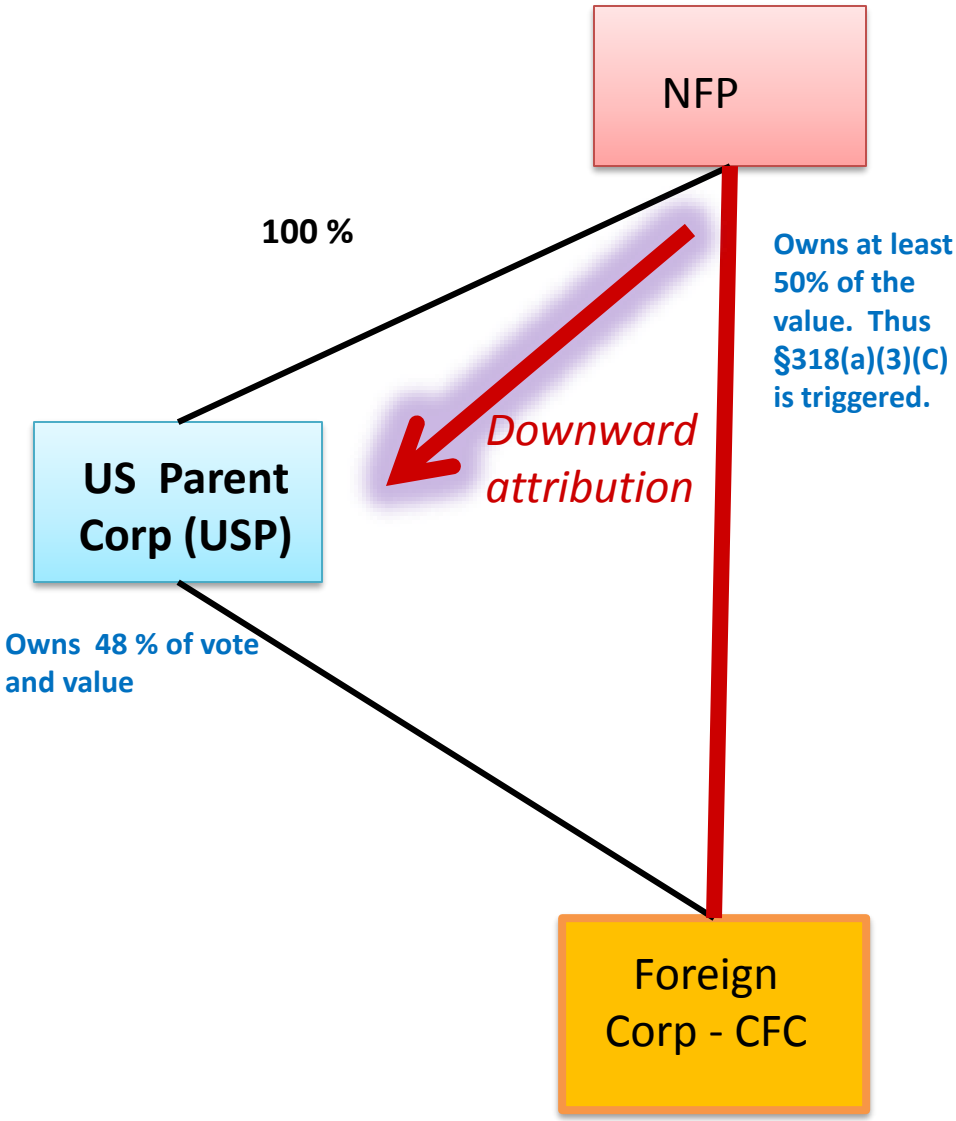
3. After the inversion, USP would like to avoid Subpart F income earned by CFC, and so….

4. Historic shareholders cause NFP to contribute cash and/or property to CFC in exchange for CFC's newly issued shares representing at least 50% of its vote and value. **USP's ownership in the foreign corp is thus diluted, and because it no longer owns > 50%, foreign corp is no longer a "CFC."** Under old § 958(b)(4), NFP's ownership in the foreign corp was not attributed to USP, because it turned off §318(a)(3)(C). It was this transaction that was in the crosshairs of Congress when it repealed § 958(b)(4).



2017 Expansion of Subpart F: Q: Why Congress repealed § 958(b)(4)?

A: To nullify post-inversion de-control of-CFC schemes



POST TCJA: After repeal of § 958(b)(4), Foreign Corp will continue to be a CFC. (Why??)

- USP directly owns 48% of Foreign Corp, and
- ***USP constructively owns whatever NFP owns in Foreign Corp (here 52%).***
- Thus, due to the application of §318(a)(3)(C), USP is treated as owning 100% of Foreign Corp, which is still a CFC.
- Under the Code, USP, as "US shareholder" of a CFC on last day of tax year, will be required to file IRS Form 5471 (as a category 5 filer) on an annual basis…. (But see liberalizing rules of Notice 2018-13).
- However, USP, a § 951(b) "US shareholder," will only be taxed on the pro rata share of Subpart F income attributable to shares it owns directly and indirectly--but not on the shares it owns through *constructive* attribution.

Congress' Repeal of § 958(b)(4):
Myriad Collateral Damage – (intended or not?)

- The TCJA repealed the § 958(b)(4) limitation on downward attribution **RETROACTIVELY !!**
- This change applies beginning in the last taxable year of a foreign corporation that begins before Jan. 1, 2018 (and the taxable years of its US shlders that end with or within the corporation's taxable year). This means that for calendar year taxpayers, the repeal of § 958(b)(4) applies retroactively—*i.e.,* to taxable years ending in 2017.
- ***This is not just an outbound issue for U.S. shareholders.***
- Without the old restriction of § 958(b)(4), a U.S. sub of a foreign parent company may be considered a U.S. shareholder of a *non-U.S*. sister subsidiary of the foreign parent (see diagram above).
- **Myriad Implications of this repeal, which were likely NOT intended by Congress:**
  - If foreign parent has a 10% direct or indirect U.S. direct or indirect shareholder (not constructive) **such shareholder could have Subpart F, §951A GILTI, IRC § 956, or other "phantom" income** (not within the scope of the post-inversion decontrol-of-CFC transactions;
  - Foreign investors in U.S. corporations may cause their non-U.S. subsidiaries to become CFCs ("Pop-up CFC");
  - Qualification for U.S. *portfolio interest exemption* for withholding is often implicated (i.e., lost! -- the foreign corporate recipient of the US-source "portfolio interest" cannot qualify for the exemption if it is a CFC receiving interest from a related person).
  - Will often wreak havoc with PFIC/CFC overlap rules. (Happily may cause the PFIC rules to not apply with respect to new § 951(b) "US shareholders"
  - May cause § 1248 to apply, triggering "dividends" that qualify for the new § 245A DRD.

2017 Tax Act - Expansion of Subpart F:

Evidence US lawmakers realized some collateral consequences of repealing § 958(b)(4)….but such evidence is not "the law."

- Senate Finance Comm. explanation of the TCJA bill (released by Senate Budget Committee) states:

  "This provision is not intended to cause a foreign corporation to be treated as a controlled foreign corporation with respect to a U.S. shareholder as a result of attribution of ownership under section 318(a)(3**)** to a U.S. person that is not a related person (within the meaning of Section 954(d)(3)) to such U.S. shareholder as a result of the repeal of section 958(b)(4)."

- Apparently realizing that the bare repeal of § 958(b)(4) (with expressly limiting its effects) could have unintended collateral consequences, Senators David Perdue (R-Ga.) and Orrin Hatch (R-Utah) placed into the Congressional Record the following colloquy:

  (PERDUE): "I would like to confirm that the conference report language did not change or modify the intended scope this statement. As you know, I filed an amendment to the Senate bill, Senate amendment No. 1666 would have codified this explanatory text of the Finance Committee report. I also want to confirm that the Treasury Department and the Internal Revenue Service should interpret the stock attribution rules consistent with this explanation of the bill."

  (HATCH): "The Senator is correct. The conference report language for the bill does not change or modify the intended scope of the statement he cites. The Treasury Department and the Internal Revenue Service should interpret the stock attribution rules consistent with this explanation, as released by the Senate Budget Committee. **I would also note that the reason his amendment No. 1666 was not adopted is because it was not needed to reflect the intent of the Senate Finance Committee** or the conferees for the Tax Cuts and Jobs Act. I thank my friend from Georgia for his leadership on this issue to ensure that the stock attribution rules operate consistent with our intent and do not result in unintended consequences. I look forward to continuing to work with him on this important issue. [Emphasis added].

- The above Senate floor "colloquy" is not codified in the Tax Code. The Conference Committee report "follows the Senate Amendment." (Does that include the Senate Finance Committee's explanation regarding the relevance of § 954(d)(3)? Maybe.)

- If Congress intended that the Code was to be interpreted in a manner that included the Senate Finance Committee's restriction to "related persons," shouldn't the Conference Committee bill language clarify that intent? (It does not so clarify.)

- Treasury officials, including Deputy Assistant Secretary (International Tax Affairs) at U.S. Treasury, L. Chip Harter, are on record (at ABA meetings, etc.) saying that US Treasury does not have the regulatory authority to "fix" the apparently unintended consequences of § 958(b)(4)'s repeal. Many say that a technical corrections bill is needed to completely fix the problem.

- **Result: Uncertainty as to the far-reaching effects of § 958(b)(4)'s repeal until we get further guidance. In meantime, repeal of § 954(b)(4) will dramatically increase the number of "US shldrs," "CFCs," and Category 5 Form 5471 Filers…**

Effect of repeal of § 954(b)(4):
Obligation to file IRS Form 5471

- Repeal of § 958(b)(4) dramatically increases the number of US shareholders who are now required to file Form 5471.
- **IRC § 6038:** If any foreign corporation is treated as a CFC for any purpose under subpart F, the Secretary of Treasury may require any US person treated as a US shareholder (or officer or director) of such corporation to file an information return on Form 5471, providing information about the entity.
- **IRS Form 5471,** entitled "*Information Return of US Persons with respect to Certain Foreign Corporations*" is normally required to be filed with the US shareholder's tax return. The US persons required to file, and the extent of the information they are required to provide on Form 5471, varied based on the person's filing "category" (e.g., Category 2, 3, 4, or 5.)
- **Under Category 5**, a Form 5471 is required to be filed for each CFC with respect to which the US person is a "US shareholder." (Form 5471 Instructions).
- **Stiff Penalties for Failure to Timely File Form 5471**: $10,000 for each annual accounting period (for each missing Form 5471). If any failure continues for more than 90 days after the day on which the Secretary mails notice of such failure to the United States person, such person shall pay [increased penalties] not exceeding $50,000 (for each foreign corp for which a Form 5471 was due). IRC § 6038(c).
- **Failure to file a Form 5471 can also result in decreased foreign tax credits.** IRC § 6038(c).
- **Repeal of 958(b)(4), as well as expanded definition of "US shareholder" dramatically increases the number of CFCs and US shldrs, and therefore the obligation to file Forms 5471 (many being obligated with respect to their 2017 taxable years).** But see "group filing exception" below.
- **Fairness Concerns:** US shldrs and US subs could get hit with substantial penalties for not reporting on the operations of foreign corporations over which they have no control and from which they will never be entitled to receive income (because their ownership is only constructive). The "Category 5" filing obligation can apply even when a US shldr is not otherwise subject to tax under subpart F.

Increased Obligation to file IRS Form 5471:

Notice 2018-13 provides limited relief

- **General Rule: Notice 2018-13 provides limited relief for "constructive US shldrs" from obligation to file a Form 5471 but only with respect to "constructive" CFCs**
- Specifically, in section 5.02 of the Notice (and echoed in Preamble or the Proposed 965 Regs) IRS announced its intent to "amend the Instructions for Form 5471 to provide an exception from Category 5 filing for a US person that is a US shareholder with respect to a CFC if:

  (1) "*no US shareholder (including such US person) owns, within the meaning of §958(a), stock (directly or indirectly) in such CFC, and*

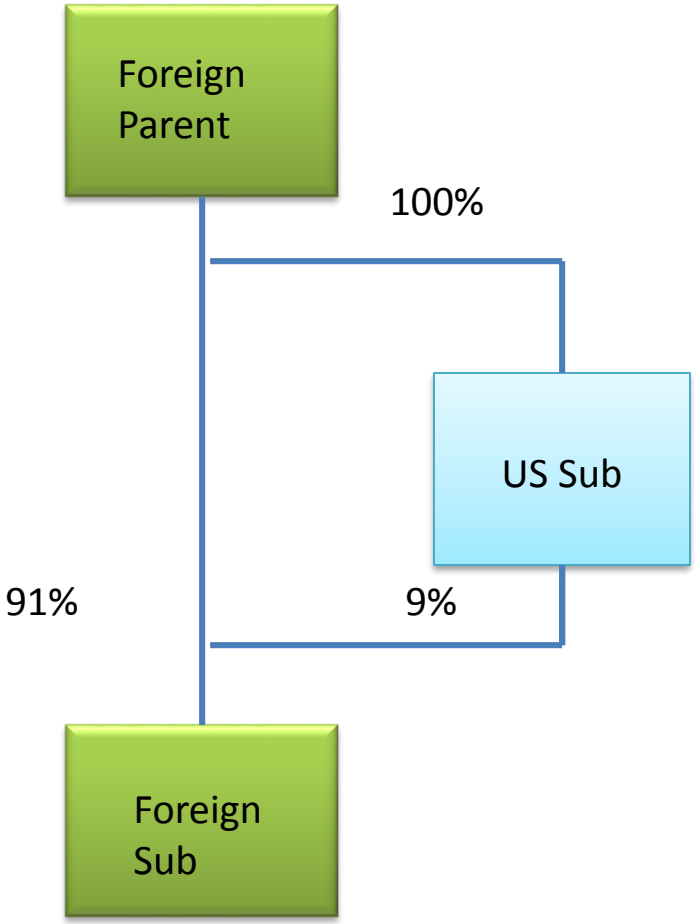
  (2) *the foreign corporation is a CFC solely because such US person is considered to own the stock of the CFC owned by a foreign person under § 318(a)(3)."*
- Thus, a very limited exception! Basically, it is a "but for" test. If the foreign corp would not be a CFC *but for* the constructive ownership of the US shareholder (who owns no stock directly or indirectly), then a Form 5471 may not need to be filed. Also, it appears from language in the Notice, that no other US shareholder may hold ANY stock directly or indirectly. So…use caution when trying to fit within this narrow exception.
- **Group filing exception to filing Form 5471:** To alleviate redundant filings, a joint ownership exception generally allows one U.S. person to file a joint 5471 on behalf of other persons required to file the same information for the same CFC. Example: Only one Form 5471 for a CFC may need to be filed by a consolidated group even when there multiple Category 5 US shldrs due to expanded § 958(b) constructive ownership rules.
- When a U.S. person files a Form 5471 on behalf of a person that is not in its consolidated return group, the person relying on the exception must attach to its return a statement that identifies the filer and provides certain other information.
- *Look for updated Instructions to Form 5471. Anticipate more guidance on Form 5471 filing obligations from IRS.*

Repeal of § 958(b)(4): **Dramatically increases exposure to §951(a), as well as <u>§ 956, § 951A GILTI, and § 965 Transition Tax</u>**

- Not only can classification of the foreign sub as a CFC under § 318(a)(3)(C) increase exposure to taxation under § 951(a) (Foreign Personal Holding Company Income, Foreign Base Company Sale & Services Income and other categories of § 951(a) "Subpart F Income," it can also trigger the application of many other tax provisions in the Code. For example:
- **§ 956 Earning Invested in U.S. Property:** Where a foreign corp suddenly becomes a "CFC," many types of transactions can be characterized as "deemed repatriations" under § 956 (e.g., loans, pledges of stock).
- **GILTI Exposure under § 951A**: applies to §951(b) "US shareholder" of a "CFC," using the same exact same definitions and ownership thresholds. But as under § 951(a), § 951A GILTI tax is computed on with respect to shares actually owned (i.e., directly and indirectly).
- **§ 965 Transition Tax:** The mandatory repatriation rules of 965 apply to "US shareholders" of "specified foreign corporations" (SPF) that have post-1986 E&P that was not previously taxed (or repatriated). A SPF is defined as a CFC or any foreign corporation that has at least one domestic C-Corp that is a § 951(b).
- **§245A participation exemption:** The DRD is denied with respect to "hybrid dividends" in certain tiered CFC structures.
- **Many other provisions can be triggered,** even though the underlying policy reasons for the application of those provisions is often not present.

Repeal of §958(b)(4):
Impact on application of §965 Transition Tax

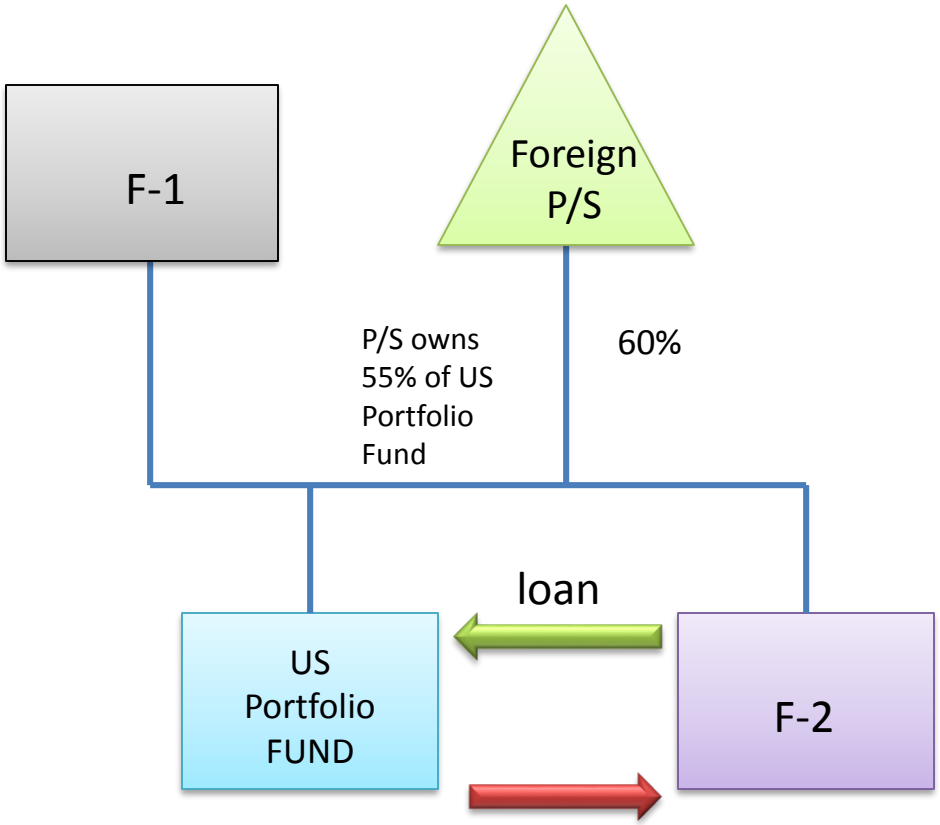
- US Sub directly owns 9% of Foreign Sub, and, under revised section § 958(b), constructively owns the remaining 91% of Foreign Sub as a result of "downward attribution" of Foreign Parent's ownership of Foreign Sub. US Sub is treated as wholly owning Foreign Sub, and Foreign Sub is an SFC for purposes of § 965.
- **Thus, US Sub would have to include in income its pro rata share of Foreign Sub's post-86 E&P under the mandatory repatriation rules of §965,** although the amount of the inclusion would be based solely on its direct and indirect ownership (9%) of Foreign Sub, and only take into account E&P earned by Foreign Sub during periods Foreign Sub qualified as an "SFC."
- FTCs: foreign income taxes paid or accrued by Foreign Sub would not be attributed to US Sub's mandatory repatriation inclusion because US Sub owns < 10% of Foreign Sub's voting stock (as determined under the relevant rules).



Repeal of § 958(b)(4) – Collateral Effects:

Could Disqualify Foreign Corporate Recipient from Eligibility for US Portfolio Interest Exemption

- **A CFC cannot qualify for the all important US Portfolio Interest Exemption if it received interest from a "related person." § 881(c)(3)(C).**
- Excluded from the definition of "portfolio interest" is interest "received by a CFC from a related person" (within meaning of §864(d)(4)/ **§** 267(b), (f).
- Because TCJA repealed §958(b)(4), the downward attribution rules of §318(a)(3) are no longer "turned off," and are operative beginning with foreign corporation's tax years beginning before 12/31/2018.
- Because Foreign Partnership owns at least 50% of the value in US Portfolio Corporate Fund, such Fund is deemed to own all the stock that Foreign P/S owns. (Same rule would apply if F-1 owned at 50% of the value). Therefore, under §318(a)(2), US Portfolio Fund constructively owns 60% of F-2, making it a "US shldr" and making F-2 a CFC.
- Suddenly, F-2 (a CFC) cannot qualify for the US Portfolio interest exemption because F-2 is a CFC receiving the interest from a "related person" within the meaning of §267(b), (f)
- A lot of restructuring has been (or must be) done to get around this sudden loss of the US Portfolio Interest Exemption…(lost retroactively for taxable year beginning before 2018).



Interest payments *(often exempted from US 30% withholding tax if they qualify as "portfolio interest")*

Repeal of § 958(b)(4) – Collateral Effects:

Could wreak havoc with PFIC/CFC overlap rules

- TCJA's removal of § 958(b)(4) from the Internal Revenue Code will cause some PFICs to become "CFCs" and subject to CFC rules, instead of the dreaded PFIC rules. (A "good thing" usually…)

- **§ 1297(d):** a foreign corporation that is a CFC as to any U.S. inclusion shareholder cannot be a PFIC. Many may find this is a happy consequence of the repeal of §958(b)(4) since it may help some avoid the horrid PFIC rules. (Some may have even tried to qualify for the CFC regime instead of the PFIC regime but failed. Application of 318(a)(3) can help in that instance.)

- **Eligibility for §245A Deduction.** Dividends from a PFIC do not qualify for the §245A deduction, but dividends from a CFC do. (Thus, where repeal of §958(b)(4) causes a foreign corp that would have been a PFIC to become a CFC, a US shlder that is a "corporation" will be allowed the deduction.

- **Pop-Up PFICs:** A foreign corporation can be a PFIC with respect to non 951(b) shldrs (owning < 10%) and a CFC with respect to § 951(b) shldrs. Under §1297(e)(2), if the foreign corporation is a CFC (and not publicly traded), it is required to apply the PFIC *asset test* of §1297(a)(2) by reference to the *adjusted basis*, rather the fair market value, of its assets. This will often cause the corporation to be treated as a PFIC when it would not have otherwise qualified had the FMV test applied.

- **PFIC Parent, CFC Sub.** Recall the simplest example of a "faux CFC" (i.e., foreign sub of a foreign parent that happens to own a US sub). Although the results in such a case might merely be annoying, like having to file Form 5471, there is a possibility that foreign parent in such a case might be a PFIC as to some U.S. shareholders, with very strange results since a PFIC would then own a "faux CFC." *

- *** See K. Blanchard, *Top Ten Reasons to Limit 958(b)(4) Repeal*, 47:6 TAX MNGMT, INT'L J. (2018)**

2017 Tax Act - Expansion of Subpart F:

More unintended consequences of § 958(b)(4)'s repeal (a non-exclusive list)

- **Qualifying for the 245A Participation Exemption**: US shareholder that sells stock in a "faux CFC" may have a §1248 "dividend" that can qualify for the §245A DRD. ("A good thing.")
- **Basis bump-ups and more PTI:** Inclusions of any extra Subpart F and/or GILTI income can give rise to positive basis adjustments under §961 and create PTI for purposes of §959 and §965. ("A good thing.")
- **Portfolio Interest Exemption**: Section 881(c)(3)(C) and §881(c)(5) limit the availability of the US Portfolio Interest Exemption as applied to interest paid to CFCs by "related persons." Clearly, the policy underlying these restrictions is not implicated in the case of a faux CFC.
- **Expatriations:** §877 provides punitive tax rules for US citizens or long-term green card holders who expatriate. §877(d)(1)(C) and §877(d)(4) punish expatriates who own or form CFCs (apparently including these "faux CFCs" that pop-up due to the repeal of § 958(b)(4).
- **Subpart F Insurance Income.** Repeal of § 958(b)(4) makes it easier to create income under § 953, which was already sweepingly broad. A US tax-exempt org may be subject to the UBIT (Unrelated Business Income Tax) if it is a shareholder of a faux CFC that has insurance income. §512(b)(17).
- **Downward E&P adjustments under § 312(m).** § 312(m) prohibits a downward adjustment to E&P of a foreign corporation that pays interest on an obligation that fails to meet the registration requirements of §163(f). This punitive rule does not apply to a foreign corporation that is not a CFC and does not have a tax-avoidance purpose. However, if a foreign corporation is a CFC, it will be subject to the punitive rule, regardless of its purpose.
- **International Shipping & Aircraft Income.** § 883 generally exempts income earned by foreign corps from intern'l ships and aircraft so long as the foreign corp is not "treaty shopping" and resides in a country granting US carriers an similar exemption. § 883(c)(2) turns off the treaty shopping restriction for CFCs.

Potential Solutions to Mitigate Unintended Tax Liability due to §958(b)(4)'s Repeal (i.e., before release of Rev. Proc. 2019-40)

1. **Convert the Foreign "Pop-Up" CFCs to "Disregarded Entities" with CTB Election**
   - Treated by US taxable "liquidations" triggering a § 1248 dividend, but the "all 1248 amount" may be zero, if E&P already picked up by the Transition Tax.
   - *This strategy would likely not avoid the 2017 imposition of the one-time Transition Tax* unless a retroactive CTB election could be made—NOT likely to be allowed under Final 965 regulations

2. **Make Maximum Use of the *High Foreign Tax Exception*** to reduce both Subpart F & GILTI income

3. **Elect § 962 to Treat the Foreign Dividends "as if" they were received by a U.S. C Corporation.** *But see Smith v. CIR*, __T.C. (2018)(no qualified dividend treatment allowed – C corp is not real….so need to have the CFC is a US tax treaty jurisdiction to get "qualified dividend" rate).

4. **Create a U.S. Irrevocable Non-Grantor Foreign Trust** (to reduce the indirect U.S. shareholder's interest to below 10% vote or value). How does this work? (If remaindermen are NRA children, might work under the § 318 attribution rules)

5. **Interpose a US C corporation between the § 951(b) individual /S-Corp US shareholder and the CFCs** (to get the 100% DRD under § 245A , and the 50% GILTI deduction under § 250). But some foreign countries forbid a foreign corporate (US) shareholder (*e.g.*, China, Lebanon if real estate)

6. **Actually liquidate the CFCs** (But usually not pragmatic…and then the "liability shield" is lost. Also expensive!)

7. **Take "Wait & See" attitude:** Wait and see if Congress adopts any Technical Corrections Bill (2 have already died in the US House of Reps). Or hope IRS/Treasury does something…

Finally, on Oct. 1, 2019, Treasury provided *Some Relief* from effects of §958(b)(4) Repeal:

IRS issued Rev. Proc. 2019-40 and Package of Proposed Regs.

- Revenue Procedure 2019-40:
  - What it does NOT do: Does NOT "undo" the substantive effects of the repeal of §958(b)(4). Thus, if a foreign corporation is a "CFC" under the downward attribution rules, it remains a CFC, and direct and indirect US shareholders will still have to report phantom income from that CFC (to the extent of shares they actually own), and will have filing requirements –i.e., Form 5471, even if the foreign corp would not have qualified as a "CFC" prior to the repeal of § 958(b)(4).
  - What it DOES do:
  - *Gives some limited relief from the due diligence requirements* in certain situations, but only if certain ownership paradigms are met with respect to a "foreign controlled CFC."
  - *Limits application of penalties* under § 6038 (for failure to file Form 5471) and under § 6662 for tax underpayments but ONLY if the taxpayer is within certain "safe harbors."
  - Eases compliance burden by providing a hierarchical list of acceptable "alternative info" in certain situations where getting the normally required info to determine E&P and QBAI proves difficult or impossible.

Revenue Procedure 2019-40:
Three Safe Harbors that reduce compliance burdens

- EFFECT: IF Tp is within the safe harbors, then penalties for NOT filing Form 5471 (when it turns out one should have been filed) or underreporting Subpart F income or GILTI of a CFC (when it turns out there was some due to §958(b)(4) repeal, are not likely to apply.
- Examples & Definitions in the Rev. Proc. are very important:
  - **"Foreign Controlled CFC":** is a foreign corp that is a CFC but would not be one if the downward attributions rules of § 318(a)(3)(A)—(C) did not apply.
  - **"§ 958(a) US Shareholder":** is, with respect to a foreign corp, a US person that owns at least some stock in the foreign corp either directly, or indirectly through foreign entities (need not be 10%).
  - **"Related person":** relies on § 954(d)(3) definition of controlled by, or commonly controlled by, another person, with "control" meaning ownership of > 50% vote or value.
  - **"Related constructive US shareholder":** US shareholder that owns shares only constructively (thru downward attribution) but is in a > 50% relationship with the foreign corp (*i.e.,* controlling, or controlled by, or they are commonly controlled by another entity).

Revenue Procedure 2019-40:
No. #1: Safe Harbor for Determining CFC Status

- Just answers question of "Did you try hard enough to find out if there was a CFC?" But does NOT turn off the substantive effects of the downward attribution rules!!
- It lessens the due diligence burden, and if Tp is in the safe harbor and turns out to be wrong, penalties are not applied.

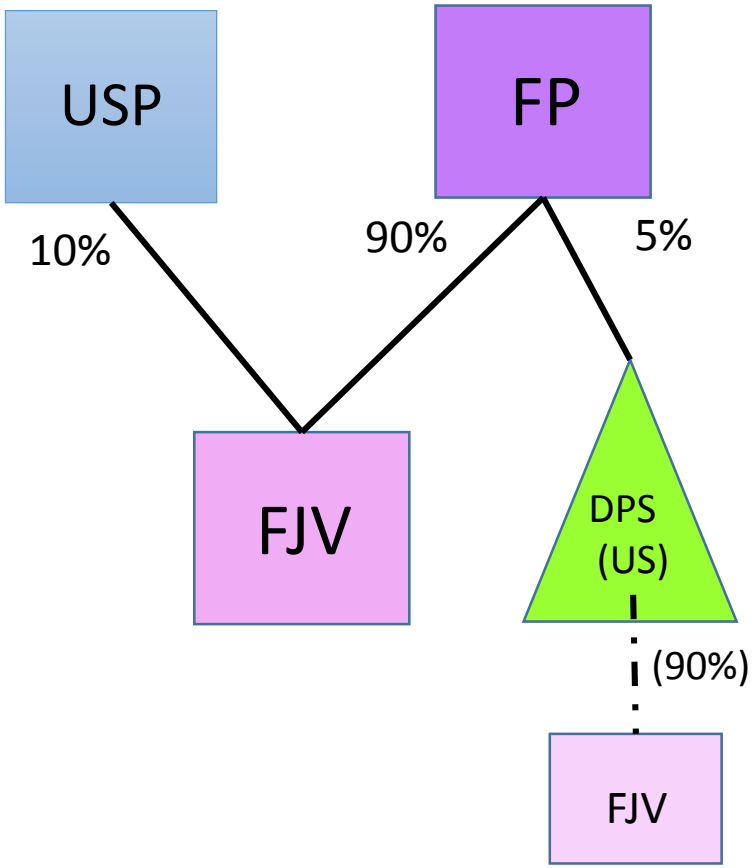
Revenue Procedure 2019-40:
No. #1: Safe Harbor for Determining CFC Status

- Two main requirements
- The IRS will accept a US person's determination that a foreign corp does not meet the § 957 ownership requirements to be a CFC if:
  - **(i)** the US person *does not have actual knowledge*, and is not deemed to have received statements and/or reliable publicly available information sufficient to make that determination, **AND**
  - **(ii)** IF the US person directly owns equity in a foreign entity (top-tier entity), the US person inquires of the top-tier entity whether it meets the ownership requirements, including whether, how, and to what extent, the top-tier entity directly or indirectly owns equity in other foreign corps or domestic entities.
- A US shareholder can rely on this Safe Harbor No. #1 without having to affirmatively ask any unrelated foreign shareholders in the foreign corp whether they own any interests in US entities to which their stock may be attributed for purposes of determining whether the foreign corp is a CFC.

Revenue Procedure 2019-40: Example of Safe Harbor #1 for Determining CFC Status

- **Facts:** In 2020, USP, a domestic corp, and FP, a foreign corp, invest in FJV, a newly formed foreign corp. USP receives 10% of the single class of stock of FJV, and FP receives the remaining 90%. Assume that FP is not a related person with respect to USP and that FP has no US shareholders. FP owns 5% of a domestic partnership, DPS, with the remainder held by unrelated persons.
- **Analysis**: DPS as an unrelated constructive US shareholder with respect to FJV. Because FP is a partner in DPS, DPS is considered to own, under §958(b) and § 318(a)(3)(A), 90% of FJV. Thus, DPS is a constructive US shareholder of FJV, and FJV is a "foreign-controlled CFC" as defined in Rev. Proc. 2019-40.
- **Further assume**: USP inquired of FJV whether FJV met the § 957 ownership requirements, and FJV did not report that it met the § 957 ownership requirements. There is no reliable publicly available information that would indicate that FJV is a CFC. USP has not received a statement indicating that FJV is a CFC. Furthermore, after making the inquiry of FJV, USP does not have actual knowledge that FJV is a CFC.
- **Analysis:** Because FJV is not a US-controlled CFC and FP is not a "related person" with respect to USP, for purposes of determining if FJV meets the § 957 ownership requirements for CFC status, USP may rely on the SAFE HARBOR described in § 4.02 of Rev. Proc. 2019-40 without inquiring of FP whether FP owns directly or indirectly (under § 958(a)(2)) or constructively owns (under § 958(b)) stock of, or an interest in, a domestic entity.
- **Further,** because there is no reliable publicly available information that would indicate that FJV is a CFC, and USP has not received a statement indicating that FJV is a CFC, and, after making an inquiry of FJV, USP does not have actual knowledge that FJV is a CFC, USP may treat FJV as not meeting the § 957 ownership requirements for CFC status.
- **If USP turns out to be wrong,--and later finds out that FJV is, in fact, a CFC--no penalties will be imposed if Tp was within this Safe Harbor #1.**

- Ex. 4 in Rev. Proc. 2019-40



DPS = "unrelated constructive US shareholder"
FJV = a "Foreign Controlled CFC" →→

Revenue Procedure 2019-40 - Safe Harbor No. #2

Safe Harbor for Using "Alternative Information

- **General Rule**: If the information necessary to accurately calculate Subpart F income and GILTI inclusions (but not Transition Tax amounts) with respect to a CFC is not readily available and there's no § 958(a) direct/indirect US shareholder that is "related" the CFC, an "unrelated § 958(a) US shareholder" generally may determine its inclusion amounts using "alternative information."
- For this purpose, "alternative information" generally means readily available separate-entity financial statements, with certain adjustments.
- Rev. Proc. Provides ordering rules that generally prefer financial statements prepared under U.S. GAAP over all else. But if US GAAP is not available, then the "next best" must be used, which is the following in descending order of preference:
  1. **US GAAP**
  2. **IFRS** (International Financial Reporting Standards):
  3. **Local-country GAAP**;
  4. **Audited financial statements** over unaudited financial statements; and
  5. **Other records** used for other tax reporting, regulatory or internal management purposes, but only if the above is not available.
- Alternative information may also be used to comply with Form 5471 reporting requirements of US shareholders with respect to any unrelated foreign-controlled CFCs that do not have related §958(a) US Shareholders.
- NOTE: Alternative information may NOT be used for claiming indirect foreign tax credits.

Revenue Procedure 2019-40 - Safe Harbor No. #3

Safe Harbor for §965 Transition Tax Amounts

- **General Rule:** IF the info necessary to accurately calculate § 965 Transition Tax amounts with respect to a "specified foreign corporation" (SFC) is not readily available and the SFC is neither:
  - a "foreign-controlled CFC" with respect to which there is a "related § 958(a) U.S. Shareholder" NOR
  - a U.S.-controlled CFC (i.e., a real CFC),
  - THEN an unrelated § 958(a) US Shareholder generally may determine its Transition Tax amounts (but not any Indirect FTCs) using "alternative information."
- **However, there are timing limitations:** This Safe Harbor No. 3 only applies to amounts reported on a return both due and filed before October 1, 2019 **OR** a return both due and filed after October 1, 2019.
  - Thus, taxpayers with returns due after Oct, 1, 2019 who filed early (i.e., on or before Oct. 1, 2019) are not able to take advantage of this safe harbor. Nor are those with returns due before October 1, 2019 who file late (i.e., after Oct, 1, 2019).
- Alternative information may also be used to comply with Form 5471 reporting requirements of US Shareholders with respect to any SFC that is neither a "foreign-controlled CFC" with respect to which there is a "related §958(a) US Shareholder" nor a "US-controlled CFC."

Revenue Procedure 2019-40

Other Relief regarding Duty to File Form 5471

- Rev. Proc. 2019-40 also states that IRS intends to narrow the Form 5471 filing obligations for "Category 5 filers" (i.e., US Shareholders who directly, indirectly, or constructively owned stock of the CFC on last day in year on which it was a CFC) in certain circumstances.
- Specifically, fewer of Form 5471's Schedules will be required by a Category 5 filer if either:
  - (i) the filer IS a §958(a) US Shrhder and NOT "related" to the foreign-controlled CFC

  OR
  - (ii) the filer is NOT a §958(a) US Shareholder but IS "related" to the foreign-controlled CFC.
- **A Category 5 filer that is not a § 958(a) direct or indirect US shareholder (i.e., constructive only) and also not "related" to the foreign-controlled CFC will not be required to file Form 5471 at all!!**
- Applicability Dates: Taxpayers generally may apply Rev. Proc. 2019-40 **retroactively** –i.e., to the last taxable year of a foreign corporation beginning before Jan. 1, 2018, each subsequent taxable year of such foreign corporation, and the taxable years of US Shareholders in which or with which such taxable years of such foreign corporation end.

Other §958(b)(4)-Repeal Relief issued on Oct. 1, 2019: Proposed Regs Mitigating Effects of Downward Attribution Rules

- **§ 267**: Prop. Regs provide that certain payments to foreign related persons eligible for treaty benefits may be deductible when accrued notwithstanding that the foreign related person is a CFC, provided that it has no §958(a) US Shareholders.

- **§ 332**: Prop. Regs deny exchange treatment to a foreign corporation that receives distributions in complete LQ of certain domestic holding companies if the foreign corp is a CFC solely because of § 958(b)(4) repeal, resulting in such distributions being governed by §301 and thus potentially taxable as dividends in whole or in part.

- **§367**: Prop. Regs expand events that trigger the recognition of gain under GRA rules by providing that §958(b) is to be applied without regard to the repeal of §958(b)(4).

- **§ 1297**: Provide that the asset test for passive foreign investment company (PFIC) status does not need to be determined by reference to the adjusted basis (rather than value) of assets for a non-publicly traded foreign corporation that is a foreign-controlled CFC.

Other §958(b)(4)-Repeal Relief issued on Oct. 1, 2019: Prop. Regs Limiting Downward Attribution (Cont.)

- **§ 672:** Limit the application of certain grantor trust rules to trusts owned by foreign corporations that are CFCs without regard to downward attribution from foreign persons (US-controlled CFCs).

- **§ 706:** In determining a partnership's tax year, disregard partners that are CFCs with no § 958(a) US Shareholders.

- **§ 863:** Limit application of the special CFC sourcing rules for space & ocean income and international communications income to US-controlled CFCs.

- **§ 904:** Limit application of the affiliated group rules in the § 904 active rents and royalties exception and financial services income rules, and certain CFC look-through rules, to US-controlled CFCs.

- **§ 6049:** Reduce the scope of foreign corporations subject to IRS Form 1099 reporting requirements and backup withholding rules by narrowing the definition of "US payor" to include only US-controlled CFCs.

- ***Effective Date*.** Final Regs are proposed to apply on or after Oct. 1, 2019. **However, a Tp can opt to apply the final regs retroactively** to to the last tax year of a foreign corp beginning before 1/1/2018, and each subsequent taxable year and to taxable years of "US shareholders" in which or with which such taxable years of the foreign corporation end.

- ***A taxpayer may rely on these proposed regulations NOW with respect to any period before the date that they are published as final regulations.***

Expansion of Subpart F:
Repeal of "uninterrupted 30-day ownership" test

- **PRE- TCJA:** Income earned by a foreign corporation that would otherwise qualify as Subpart F income of a CFC was not subject to U.S. tax if the foreign corporation was not a "CFC" for an uninterrupted period of at least 30 days. § 951(a).
  - Example: Assume a foreign corporation with one class of stock and a December 31st year end met qualified as a "CFC" during its last month because a US person acquired more than 50% of its stock on Dec. 3rd. Because the foreign corporation would not have qualified as a CFC for an uninterrupted period of 30 days during its taxable year, the US shareholder will not have any inclusion under 951(a) for the year of the acquisition.

- *TCJA repealed this 30-day rule*. Sec. 14215(a), TCJA.

- **POST-TCJA:** Now, a US shldr will be taxed on its pro rata share of Subpart F income even if the foreign corporation qualifies as a "CFC" for only ONE DAY, provided the US owns the CFC on the last day of the CFC's tax year.

- **New rule is effective prospectively**: Repeal of the 30-day rule is effective for tax years of foreign corporations beginning after December 31, 2017, and taxable years of U.S. Shareholders in which or with which those taxable years of a foreign corporation end.

Expansion of Subpart F:

EXAMPLE - Repeal "uninterrupted 30-day ownership" test

ASSUMED FACTS: A is a US green card holder and wants to become a US citizen. A's father (F) is not a US citizen, resides outside US, and owns all the stock in a large foreign holding company (HC) with highly appreciated assets.

A's sister is visiting A, and she is a non-resident alien (NRA) under US rules.

A's father dies, leaving to A the majority of the total outstanding stock in a foreign HC (classified as a "corporation" for US purposes). On date of death, father is classified as both an NRA for US income tax purposes and a "non-domiciled alien" for US estate tax purposes.

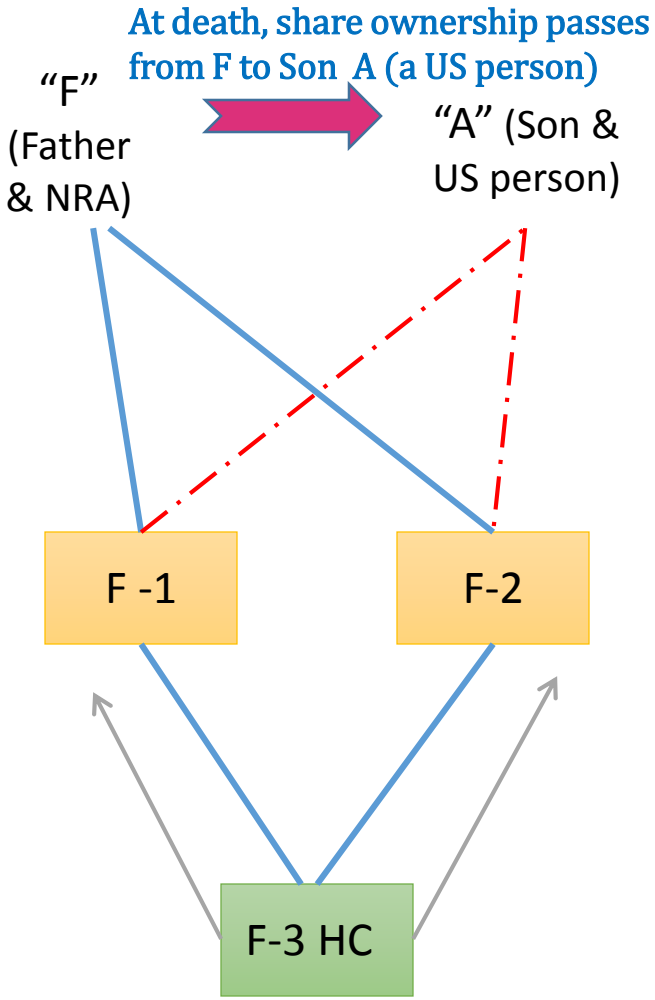
PRE TCJA: Before repeal of the 30-day rule in 951(a), A had 29 days to liquidate the foreign HC in order to avoid having the built-in gain taxed to him as Subpart F income. (Or alternatively, transfer enough shares to NRA sister to avoid having >50% vote or value….no attribution between siblings under § 318.

POST-TCJA: HC qualifies as a "CFC" on date A inherits the shares because as a US person, he owns >50% for at least ONE DAY during the corporation's tax year.

Pre-Death Planning Alternatives: (1) A transfers sufficient shares to an NRA sibling or other NRA relative to get below CFC thresholds. (But transfer of ownership must be genuine--not a loan); (2) F could sell & repurchase any marketable securities to gradually step-up assets' bases to eliminate built-in gain; (3) arrange for US persons to inherit < 50% and compensate A with other assets.

More complex planning: Arrange for foreign HC to be equally owned by two upper tier foreign HCs, and for F's estate to make a retroactive check-the-box election to liquidate the bottom HC as of a date shortly *prior* to alien F's death, thereby effecting a deemed §331 liquidation that would step up the basis of the underlying distributed US assets. Then when F1 and F2 are liquidated, there is no built-in gain.

Beware of effects of repeal of § 958(b)(4). Attribution under 318(a)(3) need not be from a foreign corporation (could be a from trust, partnership, or estate).



Consider a § 331 liquidation before F's death to step-up asset bases

Tax Strategies to Reduce Subpart F Income (and maybe GILTI)
§ 954(b)(4) – High Tax Kick-Out (HTKO) Exception

- § 954(b)(4) provides that FBC income shall not include any "item of income" of a CFC that the taxpayer establishes has been subject to an effective rate of income tax of at least 90% of the US corporate rate (i.e., 18.9%, for years beginning after Jan. 1, 2018).
- § 954(b)(4) has long provided an exception to both Foreign Base Company Income (§954) and Insurance Income (§ 953). It was not amended by the TCJA—but its function & importance were changed due to its availability for GILTI.
- **Post TCJA, the HTKO is one path to true territoriality for certain categories of income because if the exception's prerequisites are satisfied, the income is not includible as either the Subpart F income or GILTI—and yet can still be eligible for the § 245A DRD.**
- High taxed income meeting the threshold in § 954(b)(4) is excluded from "tested income" for GILTI purposes. § 951A(c)(2)(A)(i)(III).
- However, the Preamble to the GILTI Regs states that this exception from GILTI only applies to income that is excluded from Subpart F income solely by reason of the high-taxed exception.
    - Thus, high-taxed income that is eligible for another exception to FBC income, such a the active financing exception of § 954(c)(6) look-through, would still be GILTI tested income. Also, income that is high-taxed but would not fall within the general definition of FBC income is also not excluded from GILTI tested income.

Tax Strategies
§ 954(b)(4) – High Tax Kick-Out (HTKO) Exception

- However, the Preamble to the GILTI Regs states that the § 954(b)(4) exception from GILTI only applies to income that is excluded from Subpart F income ***solely*** by reason of the high-taxed exception.
  - Thus, high-taxed income that is eligible for another exception to FBC income, such a the active financing exception or the look-thru rule of § 954(c)(6), would still be GILTI "tested income."
  - Also, income that is high-taxed but would not fall within the general definition of FBC income is also not excluded from GILTI tested income.

- Identifying Income that is "High Taxed": The §954 regulations looked § 902 (now repealed), which used an E&P "pooling" convention to associate foreign taxes with the income inclusion. This allowed low-taxed income items and higher-taxed income items to be averaged or blended, resulting in more income qualifying for the HTKO Exception.

- **Post TCJA:** with § 902 repealed, and § 960 amended, the pooling convention has been replaced with an annualized tracing convention which requires that the foreign income taxes be "attributable to" the item of income. See § 960(a).

- Recently Proposed Regulations under Code Sec. 960 adopt an annual tax approach that groups Subpart F income according to each of the categories in Reg. §1.954-1(c)(1)(iii); the taxes associated with items of income in the current year are then taken into account as an indirect credit.

- The Proposed FTC Regulations require each type of FBC income , including sub-categories of § 954(c) FPHCI to be treated as its own group for purposes of the indirect credit under § 960.

- This greater degree of tracing required under § 960 and its Regs is likely to prevent some taxpayers from fully utilizing the HTKO Exception of § 954(b)(4).

Tax Strategies – Example of Pre-and Post TCJA application
§ 954(b)(4) – High Tax Kick-Out (HTKO)

- **Example:** Assume CFC owns two Disregarded Entities (DREs), each of which generates $100X of FBC income. One DRE is taxed by its home country at 25% and the other DRE is taxed at 15%. Assume the CFC as a whole has a combined $160 of net foreign base company income in the general basket and pays $40 of foreign tax for a combined tax rate of 20%.

- **Pre-TCJA:** the two DREs' income would be averaged for purposes of the high-taxed exception under the § 902 E&P "pooling" convention, and the test would be applied based on the general basket at their blended or averaged tax rate, which would be 20%. (Thus, both would qualify for the exception if the threshold were 18.9%.)

- **Proposed Regs:** the treatment now depends on whether the DREs earned the same type of Subpart F income; if both DREs earned FBC sales income under § 954(d), averaging would be permitted. But if one earned FBC Sales income, and the other FBC Services income under 954(e), or FPHCI income under 954(c), only the higher 25% rate item would be eligible to be excluded under § 954(b)(4). (No blending!)

- **In Sum:** Post-TCJA, a lower US corporate tax rate, and thus a lower 18.9% threshold for being "high taxed" (reduced from 31.5%) will make this HTKO Exception more available. But pooling limits its utility.

- **News flash - UPDATE:** *Newly Proposed FTC Regs, released June 14, 2019, EXPAND the availability of the §954(b)(4) HTKO Exception for GILTI.*

Proposed Regs (June 14, 2019)
EXPAND availability of the §954(b)(4) HTKO "GILTI Exclusion"

- **Reg. 101828-19, released on Friday, June 14, 2019, among other things, EXPANDS the "GILTI high-taxed exclusion" on an elective basis.**

- "In response to comments, the Treasury Department and the IRS have determined that the GILTI high tax exclusion should be expanded (on an elective basis) to include certain high-taxed income even if that income would not otherwise be FBCI or insurance income. ***"

- *Proposed Reg would eliminate the requirement that the income not be eligible for another Foreign Base Company Income exception, but does not mention repealing the pooling convention.*

- Preamble notes that "[t]he legislative history evidences an intent to exclude high-taxed income from gross tested income. See Senate Explanation at 371 ("The Committee believes that certain items of income earned by CFCs should be excluded from the GILTI, either because they should be exempt from U.S. tax—as they are generally not the type of income that is the source of base erosion concerns—or are already taxed currently by the United States…." The proposed regulations, which permit taxpayers to electively exclude a CFC's high-taxed income from gross tested income, are consistent, therefore, with this legislative history.

- Furthermore, an election to exclude a CFC's high-taxed income from gross tested income allows a US shareholder to ensure that its high-taxed non-subpart F income is eligible for the same treatment as its high-taxed FBCI and insurance income, and thus eliminates an incentive for taxpayers to restructure their CFC operations in order to convert gross tested income into FBCI for the sole purpose of availing themselves of section 954(b)(4) and, thus, the GILTI high tax exclusion.

- **Manner of making the Election:** CFC's controlling domestic shareholders make the election by attaching a statement to an amended or filed return in accordance with forms, instructions, or administrative pronouncements. See proposed §1.951A-2(c)(6)(v)(A). If an election is made with respect to a CFC, the election applies to exclude from gross tested income all the CFC's items of income for the taxable year that meet the effective rate test in proposed §1.951A-2(c)(6)(iii) *and is binding on all the U.S. shareholders of the CFC*. See proposed §1.951A-2(c)(6)(v)(B).

- **Effective Date:** Election is effective for a CFC for the CFC inclusion year for which it is made and all subsequent CFC inclusion years of the CFC unless revoked by the controlling domestic shareholders of the CFC. See proposed §1.951A-2(c)(6)(v)(C).

Tax Strategy:
Using the "Current E&P Limit" to Qualify for the HTKO Election

- **Key priority rule:** Rule coordinates the HTKO with the "Current E&P Limitation" and can work to expand the availability of the HTKO Exception. The rule provides that the E&P limitation is applied BEFORE the HTKO Exception. Reg. §1.954-1(d)(4)(ii).

- **EXAMPLE:** Assume a CFC earns $100 of FBC income, and pays $15 of related taxes, and has a loss of ($50) in the non-subpart F category. Under current regulations, the Current E&P limit would be applied first, resulting in net $50 of FBC income and $15 of related taxes. Result: $50 of net subpart F income after the E&P limitation is high-taxed income, and thus eligible for exclusion from Subpart F (and presumably GILTI). See Ex. in former Temp. Reg. §1.954- 1T(d)(4)(ii), TD 8618 (Sept. 6, 1995).

- **In Sum:** By providing that the current E&P limitation reduces both the numerator and denominator of the newly amended §960 credit fraction, the new proposed regulations appear to retain this result from the current regulations.

- Thus, the Current E&P limit, when it applies, appears to augment the foreign tax rate on a CFC's Subpart F income for purposes identifying income that is subject to a sufficiently high rate of foreign tax so a to qualify for the HTKO Exception of § 954(b)(4).

Key Considerations (other than foreign entity selection): Comparing U.S. international tax regimes' statutory tax rates and limits on foreign tax credit 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

GILTI Overview and Updates

Notice

The following information is not intended to be “written advice concerning one or more Federal tax matters” subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

GILTI Overview

GILTI: Overview

Global Intangible Low-Taxed Income (GILTI) Inclusion

Current Inclusion	US Shareholders are subject to current US taxation (in the form of a GILTI inclusion) based in part on their share of a CFC's net tested income
Netting	US Shareholders net "positive" tested income and "negative" tested loss from their CFCs
Tax Rate	Lower tax rate is achieved through a deduction: 50% for tax years beginning before 12/31/25 (37.5% thereafter)
	Total GILTI and foreign-derived intangible income (FDII) deduction is limited by taxable income (without regard to GILTI and FDII deduction)
	FTC may be available to corporate shareholders but subject to 20% haircut, basket limitations, section 78 gross up, and on current year basis only

Certain Components of the GILTI Analysis

U.S. Shareholder	Describes which shareholders are subject to the GILTI rules	Same rules as under Subpart F, other than CFCs owned through US partnerships
Controlled Foreign Corporation	Describes which foreign corporations are subject to the GILTI rules	Same rules as under Subpart F
GILTI inclusion	Describes the inclusion to the US Shareholder, which is calculated in part based on the CFC's income, and offset by other amounts	New rules
Pro Rata Share	Describes how much to each US Shareholder must include in gross income	Generally, same rules as under Subpart F
Deemed Paid Foreign Tax Credits	Rules that allow the US Shareholder to reduce its US tax liability on GILTI by taking a credit against US tax for foreign taxes paid by the CFC	New rules
GILTI Deduction	The mechanic that can result in a lower tax rate (10.5%) imposed on a GILTI inclusion	New rules

General Overview of GILTI

- GILTI inclusion = net CFC tested income – net deemed tangible income return (net DTIR)
  - Net CFC tested income = aggregate pro rata share of tested income – aggregate pro rata share of tested loss
  - Net DTIR = deemed tangible income return (DTIR) – “specified interest expense”
    - DTIR = 10% x aggregate pro rata share of qualified business asset investment (QBAI)
    - Specified interest expense = aggregate pro rata share of tested interest expense – aggregate pro rata share of tested interest income

General Overview of GILTI (cont.)

- Section 250 Deduction
  - Corporate shareholders allowed 50% deduction (subject to a taxable income limitation)
- Foreign Tax Credits
  - Corporate shareholders allowed 80% FTCs for CFCs with tested income, subject to limitation under section 904
- Section 962 Election
  - Individual shareholders allowed 50% deduction and 80% FTCs for their GILTI inclusion if a section 962 election is made (taxed on related PTEP distribution, to the extent it exceeds tax imposed on GILTI inclusion)

QBAI: Overview

Overview

- "Qualified business asset investment" (QBAI) is the CFC's aggregate adjusted bases in **tangible** property:
  - Used in the CFC's trade or business;
  - Of a type with respect to which a deduction is allowed under section 167 and 168 (does not include computer software); and
  - Used in the production of **tested income**
- Adjusted basis determined using **ADS** depreciation method under section 168(g)
- QBAI is calculated based on a **quarterly average**

Deemed paid foreign tax credits (FTCs)

U.S shareholders that are corporations are ***deemed to have paid*** the foreign taxes paid by the CFC that are properly attributable to GILTI. Section 960. Analog to Section 901 actually paid foreign taxes.

Section 78 Gross-Up: If a US Shareholder claims a credit for deemed paid taxes, the amount of the deemed paid tax is treated as a dividend from the CFC includable in the income of the US Shareholder.

GILTI Foreign Tax Credits

Good news:

Foreign tax credits are available to offset the US tax cost associated with GILTI. Section 960(d)

Bad news:

No FTCs for foreign income tax paid or accrued by tested loss CFCs

FTCs are haircut by 20%

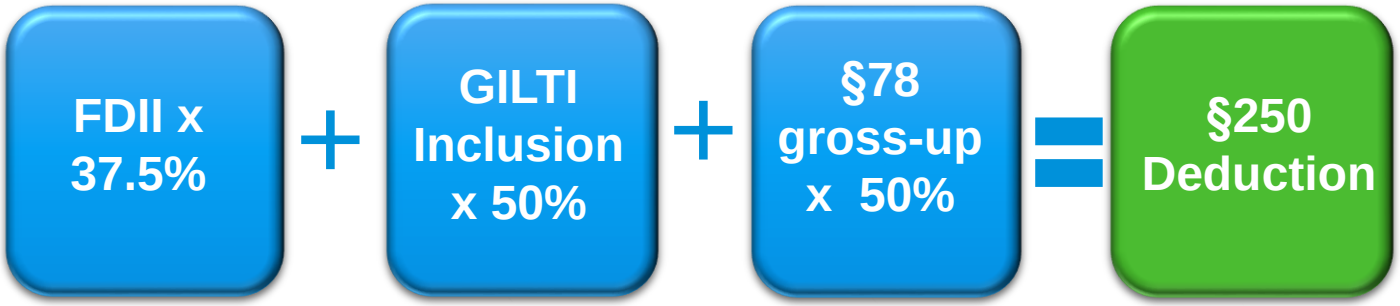
FTCs are in a separate GILTI basket

FTCs cannot be carried forward or back – Use it or Lose it!

Impact of expense allocation means that there will be lost FTCs and therefore double tax

GILTI deduction mechanics

Section 250 deduction

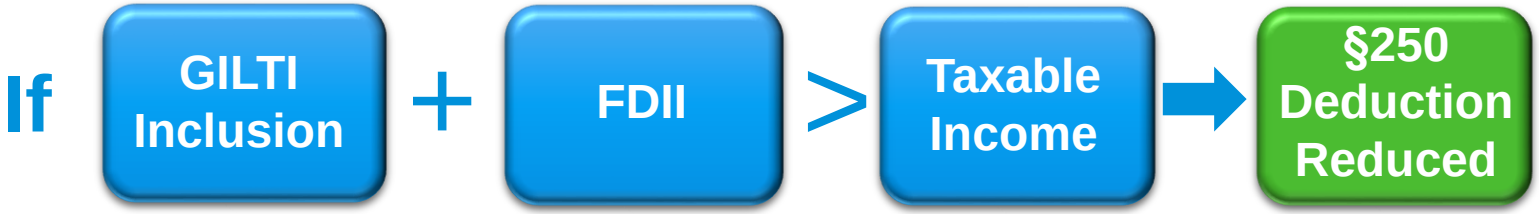


Section 250 deduction

— Subject to the taxable income limitation rule, the section 250 deduction is:

- 37.5% of “foreign derived intangible income” (FDII); plus
- 50% of GILTI inclusion; plus
- 50% of section 78 gross up

Taxable income limitation



Taxable Income Limitation

- The limitation applies when the taxpayer's GILTI inclusion plus FDII exceeds the taxpayer's taxable income
  - Calculated on a consolidated basis
  - NOLs (including carryforwards) are taken into account
- Only the GILTI inclusion and FDII amounts are reduced by any "excess", and section 250 deduction is calculated on the reduced amounts (as well as the section 78 gross-up)

GILTI: Tested income/tested loss

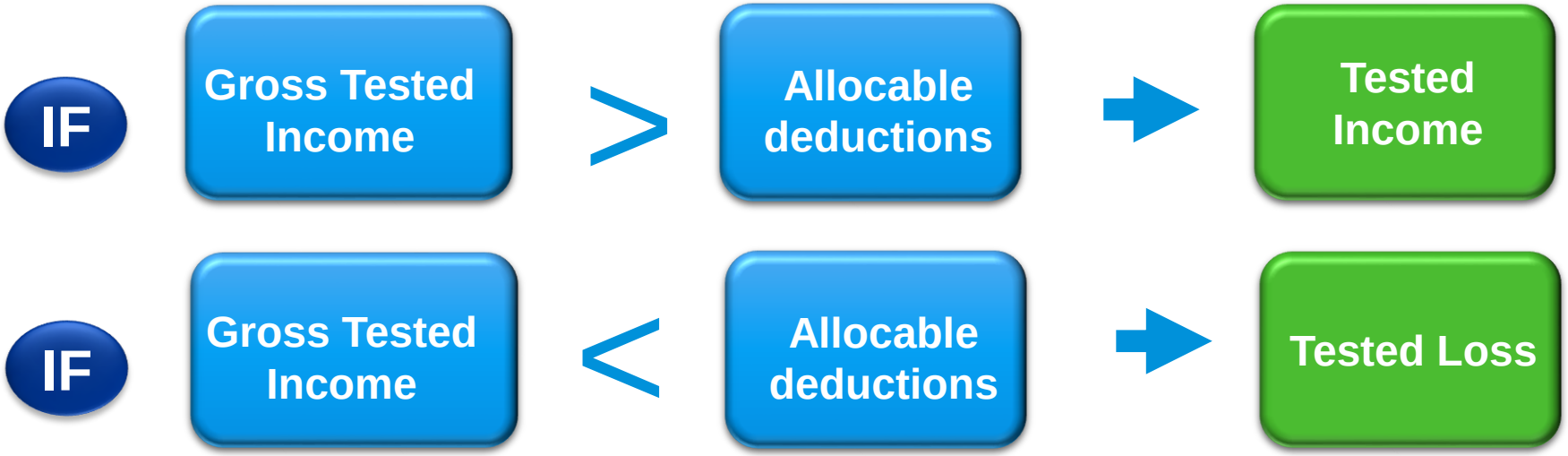
GILTI: Tested Income - “Gross Tested Income”

GROSS INCOME

Gross tested income is gross income, determined without regard to:

- Effectively connected income (“ECI”)
- Amounts taken into account in determining subpart F income
- Income excluded under subpart F high-taxed exception
- Dividends from related person
- Foreign oil and gas extraction income (“FOGEI”)

GILTI: “Tested Income” and “Tested Loss”



Important points:

— CFC’s income and deductions generally determined under **US income tax principles**

- Generally calculated as if CFC were a domestic corporation
- Deductions generally allocated under section 861 rules

— CFC’s earning and profits <u>are not</u> relevant to calculation of GILTI inclusion

Pro rata share of tested income

Allocation of Tested Income to USSH

- Pro rata share of tested income
  - Generally allocated under “pro rata share” rules
  - Special rule when tested loss was allocated to a class of a stock in a prior year under a special rule for allocating tested loss (common stock without liquidation value)
- Hypothetical distribution
  - Hypothetical distribution based on the greater of: (i) current year E&P; or (ii) sum of subpart F income and tested income

Tested Income: Subpart F High-Tax Exclusion

Subpart F High Tax Exception

- Income excluded under the subpart F high tax exclusion is not subject to subpart F or GILTI inclusion rules
  - Requires an affirmative election
- Under the GILTI final regulations, there is no general high-tax exception
  - No exclusion for amounts excluded from subpart F income under other provisions (such as section 954(c)(6) or section 954(h)) even if high-taxed
  - The GILTI proposed regulations include an elective GILTI high-tax exception (discussed later)

Tested Income: Subpart F High-Tax Exclusion

Section 954(b)(4) Subpart F High Tax Exception

- Income must be:
  - Either section 954(a) FBCI or section 953 insurance income; and
  - Subject to an effective rate of tax (ETR) greater than 18.9% (90% x 21%)
- The ETR test is applied by determining the amount of deemed paid FTC (section 960) that would be associated with the "category" of income
  - In general, aggregate all transactions that fall within a single separate category in §1.904-5(a)(1), and either falls within (i) FPHCI; or (ii) FBC sales or services, or full inclusion FBCI

Key Updates from Regulations

Recent Guidance

Guidance released over the past 12 months includes:

- GILTI final regulations (June 21, 2019)
- GILTI proposed regulations: high-tax exception (June 21, 2019)
- Notice 2019-46: allows partnerships to choose to apply GILTI proposed partnership rule (August 22, 2019)
- Other:
  - Notice 2019-01: PTEP (December 14, 2018)
  - Section 163(j) proposed regulations: prop. §1.163(j)-7 (December 28, 2018)
  - Section 250 proposed regulations: GILTI deduction (March 6, 2019)
  - Revenue Procedure 2019-40: safe harbors for determining GILTI inclusion; F.5471 category 5 filing relief (October 1, 2019)
  - Proposed regulations relating to the repeal of section 958(b)(4) (October 1, 2019)

Overview of the GILTI Regulations

- GILTI final regulations (June 21, 2019)
  - GILTI computational rules
  - Certain FTC rules
  - Section 965(n) election rules
- GILTI proposed regulations: high-tax exception (June 21, 2019)
  - High-tax exception (“HTE") for GILTI
  - Aggregate treatment of domestic partnerships for subpart F and 956 inclusion purposes

GILTI Final Regulations (June 21, 2019)

— The Final Regulations discussed the following:

- Facts and circumstances approach for “pro rata share” rule
- Pro-rata share anti-abuse rule (AAR)
- Consolidated approach for consolidated groups
- Tested income/loss
  - Tested income/loss determined under U.S. tax principles
  - Recapture amounts included in tested income, even if recaptured E&P relates to pre-reform years
  - No general high tax exception (HTE)
  - No depreciation/amortization/loss for stepped-up basis from donut period (although rule revised); does not apply for gain purposes
- Alternative depreciation system (ADS) rules for QBAI
- No QBAI for tested loss CFCs, but addition of “tested loss QBAI amount” to reduce specified interest expense
- Netting approach for specified interest expense

GILTI Guidance Still To Come

— The following questions have not been addressed, but the Treasury has indicated its intent to address in future guidance:

- Calculation of tested income/loss under §1.952-2 (NOLs, net capital losses, etc.); intend to clarify that CFCs generally can't take deductions expressly limited to domestic corporations, but still studying section 245A deduction
- Section 961(c) basis issue; concern that taking section 961(c) basis into account could inappropriately reduce the amount of stock gain subject to tax

Proposed GILTI High Tax Exclusion

Introduction to proposed GILTI HTE

- Income excluded from subpart F income under the subpart F high tax exception also is excluded from tested income for GILTI purposes
  - Income excluded under the subpart F high tax exclusion is not subject to subpart F or GILTI inclusion rules
    - High-tax income that otherwise would be subpart F income is never GILTI (whether or not election is made)
- There is legislative history that indicates an intent to exclude other high-taxed income from gross tested income
  - Conference report suggested income taxed at 13.125% or higher should be excluded
- Excluding high-taxed non-subpart F income treats this income similarly to high-taxed FBCI

GILTI HTE Proposed Regulations

- Published in the Federal Register on June 21, 2019
- Comments were due by September 19, 2019
- Proposed to apply to CFC tax years that **begin** on or **after publication of final regulations**
  - Reliance on proposed GILTI HTE election is not permitted (and there is a contrary final rule on point)
  - Potential for different applicability date in final rules?

GILTI HTE: General Overview

— The proposed regulations include an elective GILTI HTE

- Expands the final regulations' exclusion from tested income for gross income excluded from subpart F income **solely by reason of** an election under section 954(b)(4)
- Exclusion would also apply to any "tentative gross tested income item" if the "tentative net tested income item with respect to the tentative gross tested income item" is subject to high-tax
  - Applies to any item that would be subpart F income but for another exception (such as section 954(c)(6)) or an item that would not be subpart F income in the first instance
  - "Tentative gross tested income item" defined as an item that would be gross tested income (but for the exclusion) attributable to each qualified business unit ("QBU") of the CFC → test each QBU for foreign ETR greater than 18.9% (90% of 21%)

Considerations: Certain Benefits and Costs

Benefits

- Income is exempt, so no longer reliant on FTC:
  - Benefits taxpayers that cannot fully use GILTI FTCs due to NOLs, BEAT, or section 904
  - For those with section 904 limitation, removes cost of expense allocation against high-taxed GILTI; 21 cents/dollar of allocated expenses), but section 904(b)(4) requires such expenses to be added back to the denominator of the FTC limitation for GL, branch, and remaining GILTI income

Costs

- Inability to cross-credit excess taxes on high-tax GILTI income against:
  - Low-tax GILTI, or
  - Through affirmative subpart F planning, low-tax GL income (21 cents/dollar of otherwise creditable taxes)
- Lose the benefit of QBAI associated with high-taxed GILTI income
- More reliance on section 245A (rather than PTEP rules)

Interaction between section 956 and section 245A

Overview of Section 245A

- **Pre-U.S. tax reform:** U.S. shareholders generally required to include in income any dividend or other taxable distributions from a foreign corporate subsidiary's non-previously taxed E&P
- **H.R. 1:** New section 245A reflects attempt to shift toward a "territorial" system of taxation. Subject to prescribed qualification requirements, U.S. corporate shareholders enjoy a 100% DRD on foreign source distributions received from a "specified 10-percent owned foreign corporation" that are attributable to untaxed E&P of that corporation. Focus on key conditions/limitations:
  - Ownership threshold
  - Holding period requirement
  - Relief disallowed for hybrid dividends
- Applies to distributions paid beginning on 1/1/18, irrespective of CFC or U.S. shareholder's tax year.

Overview of Section 245A Temp. Regs.

- The temporary regulations apply to pre-GILTI period property transfers by CFCs or transactions that substantially reduce a U.S. shareholder's ownership of a CFC
  - 50% haircut on the section 245A DRD for dividends attributable to E&P generated from certain pre-GILTI period property transfers (favorable E&P ordering rule)
  - Section 245A DRD disallowed if a transaction substantially reduces a U.S. shareholder's ownership of a CFC and subpart F income or GILTI regime is eroded
  - Principles of the general rules are extended to dividends between CFCs by preventing the application of section 954(c)(6) "look-thru" exception to subpart F income
- Broad anti-abuse rule
- Separate guidance to address general rules relating to section 245A
- Establish information reporting requirements
- Apply to distributions occurring after December 31, 2017 (i.e., retroactive effect)

Section 245A Temp. Regs. (cont.)

- A section 245A shareholder is allowed a section 245A DRD with respect to a dividend from a 10-percent owned specified foreign corporation ("SFC") to the extent the amount of the dividend exceeds the ineligible amount
- The *ineligible amount* is equal to the *sum of:*

  50% of the extraordinary disposition amount, and

  The extraordinary reduction amount
- Explanation of each of these defined terms is beyond the scope of this discussion – but, keep in mind the broad themes outlined above that are focused on planning that may reduce GILTI/SubF or increase amounts otherwise potentially eligible for section 245A relief

**Note: The rules do not address the application of section 245A to dividends received by CFCs*

Section 956 Final Regulations

- Section 956 final regulations published on May 23, 2019
  - Final rules reduce the amount determined under section 956 with respect to certain domestic corporations that own or are treated as owning stock in foreign corporations
- Purpose – to better harmonize sections 245A and 956
  - Essentially turns off section 956 for corporate U.S. shareholders otherwise eligible for section 245A DRD
  - Does not fully eliminate application of section 956 to corporate shareholders

Section 956 Final Regulations (cont.)

- Mechanics:
  - Calculate a *tentative section 956 amount* for each CFC under existing rules
  - Reduce tentative section 956 amount by the amount that would have been eligible for the section 245A DRD had the CFC distributed its untaxed E&P (the "*hypothetical distribution*")
  - Applies to lower-tier CFCs by treating the lower-tier CFCs as if they were directly owned by the U.S. shareholder
- Existing section 956 rules still relevant:
  - Hybrid dividends not eligible for section 245A DRD
  - Certain amounts ineligible for 245A DRD under section 245 temporary regulations

GILTI Compliance: Some Selective Considerations from the Forms

GILTI: Form 5471, Schedule I-1

Schedule I-1: Information for Global Intangible Low-Taxed Income

- Report the CFC's:
  - Tested income/loss
  - Tested foreign income taxes
  - QBAI
- Report the full amount of items (USSH "pro rata" share reported on F. 8992), on a **separate category** basis
  - Most cases: general
  - Rare cases: passive, treaty resource (section 951A(f) treats GILTI inclusion as a subpart F inclusion for section 904(h)(1) purposes), or section 901(j) (sanctioned countries)
  - Apparently, no section 951A or foreign branch basket because a CFC cannot earn a GILTI inclusion or foreign branch income

Form 5471 Schedule I-1 (2018 version)

GEN, or
in rare cases: PAS, RBT, or 901j

SCHEDULE I-1 (Form 5471)

(December 2018)

Department of the Treasury
Internal Revenue Service

Information for Global Intangible Low-Taxed Income

▶ Attach to Form 5471.
▶ Go to *www.irs.gov/Form5471* for instructions and the latest information.

OMB No. 1545-0123

Name of person filing Form 5471		Identifying number
Name of foreign corporation	**EIN (if any)**	**Reference ID number** (see instructions)

Separate Category (enter code—see instructions) ▶

				Functional Currency	Conversion Rate	U.S. Dollars
1	Gross income		1			
2	Exclusions					
a	Effectively connected income	2a				
b	Subpart F income	2b				
c	High-tax exception income per section 954(b)(4)	2c				
d	Related party dividends	2d				
e	Foreign oil and gas extraction income	2e				
3	Total exclusions (total of lines 2a–2e)		3			
4	Gross income less total exclusions (line 1 minus line 3)		4			
5	Deductions properly allocable to amount on line 4		5			
6	Tested income (loss) (line 4 minus line 5) (see instructions for line 6)		6			
	Other Amounts (see instructions)					
7	Tested foreign income taxes		7			
8	Qualified business asset investment (QBAI)		8			
9	Interest expense		9			

Tested income/ loss

For Paperwork Reduction Act Notice, see instructions. Cat. No. 71400M **Schedule I-1 (Form 5471) (12-2018)**

Interest expense included in line 5

Lines 7 & 8 (tested foreign income taxes and QBAI) will be "0" if CFC has a tested loss on line 6

GILTI: Form 8992

GILTI inclusion calculation reported on Form 8992

- The 2018 version of the F.8992 did not reflect the GILTI final regulations (including consolidated approach)
  - As needed, taxpayers generally attached statements to explain reporting based under GILTI final rules with their 2018 F.8992
- GILTI inclusion reported on line 17 of Schedule C to Form 1120 (aggregated with other items on line 23a of Schedule C; flows to page 1, line 4 of F.1120)

Form 8992 Part I & II (2018 version)

Form **8992**

(December 2018)

Department of the Treasury
Internal Revenue Service

U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI)

▶ Go to *www.irs.gov/Form8992* for instructions and the latest information.

OMB No. 1545-0123

Attachment Sequence No. **992**

Name of person filing this return	A Identifying number
Name of U.S. shareholder	**B Identifying number**

Part I **Net Controlled Foreign Corporation (CFC) Tested Income** (see instructions)

1	Sum of Pro Rata Share of Net Tested Income (total from Form 8992–Schedule A, line 1, column (e))	1	
2	Sum of Pro Rata Share of Net Tested Loss (total from Form 8992–Schedule A, line 1, column (f))	2	( )
3	Net CFC Tested Income (combine line 1 and line 2) (if zero or negative, stop here)	3	

Part II **Calculation of Global Intangible Low-Taxed Income (GILTI)**

1	Net CFC Tested Income (from Part I, line 3)			1	
2a	Pro Rata Share of QBAI multiplied by 10% (total from Form 8992–Schedule A, line 1, column (g))	2a			
b	Specified Interest Expense (total from Form 8992–Schedule A, line 1, column (i))	2b			
c	Net Deemed Tangible Income Return (DTIR) (subtract line 2b from line 2a) (if zero or less, enter -0- here)			2c	
3	GILTI (subtract line 2c from line 1) (see instructions)			3	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 37816Y Form **8992** (12-2018)

Net CFC Tested Income − **Net DTIR** = **GILTI**

Part I, line 3 — Part II, line 2c — Part II, line 3

Form 8992 Schedule A (2018 version)

CFC's tested income/loss reported in columns (c)/(d)

USSH's "pro rata" share of CFC tested items reported on lines (e) through (h)

Specified interest expense is calculated at USSH level, not CFC

Form 8992 (12-2018) Page 2

Schedule A Schedule A for U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI)

Name of person filing this form | A Identifying nu

Name of U.S. shareholder | B Identifying nu

			Calculations for Net Tested Income (see instructions)						GILTI Allocated to Tested Income CFCs (see instructions)	
(a) Name of CFC	(b) EIN or Reference ID	(c) Tested Income	(d) Tested Loss	(e) Pro Rata Share of Tested Income	(f) Pro Rata Share of (Tested Loss)	(g) Pro Rata Share of Qualified Business Asset Investment (QBAI) Multiplied by 10% (0.10)	(h) Pro Rata Share of Interest Expense	(i) Specified Interest Expense	(j) GILTI Allocation Ratio (Divide Col. (e) by Col. (e), Line 1 Total)	(k) GILTI Allocated to Tested Income CFCs (Multiply Form 8992, Part II, Line 3, by Col. (j))
			( )		( )					
			( )		( )					
			( )		( )					
			( )		( )					
			( )		( )					
			( )		( )					
			( )		( )					
			( )		( )					
			( )		( )					
			( )		( )					
1. Totals (see instructions)			( )		( )					

Totals on line 1 should include the totals from any continuation sheets.

Form **8992** (12-2018)

GILTI allocation ratio calculated with respect to consolidated CFCs (if following consolidated approach in proposed regulations)

GILTI Form: GILTI Deduction

GILTI Deduction Reporting

- Calculated on F.8993 (taxable income limitation)
  - The 2018 version of the F. 8993 did not include the section 250 deduction based on the GILTI section 78 gross-up
- Reported on line 22 of Schedule C of F.1120 (aggregated with other items on line 24c of Schedule C; flows to page 1, line 29b of F.1120)
  - Include section 250 deduction based on GILTI section 78 gross up on line 22 of Schedule C (even though Instructions state that line 22 should equal the amount calculated on F.8993; the 2018 version of the F.8993 calculated only the portion of the deduction based on FDII and GILTI)

Form 8993 (2018 version)

Taxable income limitation

Form **8993** (December 2018) Department of the Treasury Internal Revenue Service

Section 250 Deduction for Foreign-Derived Intangible Income (FDII) and Global Intangible Low-Taxed Income (GILTI)

▶ Go to *www.irs.gov/Form8993* for instructions and the latest information.

OMB No. 1545-0123

Attachment Sequence No. 933

Name of person filing this return | Identifying number

Part I **Determining Deduction Eligible Income (DEI)** (see instructions)

1	Gross Income		1
2	Exclusions		
a	Income included under section 951(a)(1)	2a	
b	Income included under section 951A (from Form 8992, Part II, line 3)	2b	
c	Financial Services Income	2c	
d	CFC Dividends	2d	
e	Domestic Oil and Gas Extraction Income	2e	
f	Foreign Branch Income	2f	
3	Total Exclusions (add lines 2a through 2f)		3
4	Gross Income less Total Exclusions (subtract line 3 from line 1)		4
5	Deductions properly allocable to the amount on line 4		5
6	Deduction Eligible Income (DEI) (subtract line 5 from line 4)		6

Part II **Determining Deemed Intangible Income (DII)** (see instructions)

1	DEI (from Part I, line 6, above)	1
2	Deemed Tangible Income Return (10% of QBAI)	2
3	Deemed Intangible Income (DII) (subtract line 2 from line 1)	3

Part III **Determining Foreign Derived Ratio** (see instructions)

1a	DEI derived from sales, leases, exchanges, or other dispositions (but not licenses) of property to a foreign person for a foreign use (see instructions)	1a	
b	DEI derived from a license of property to a foreign person for a foreign use (see instructions)	1b	
c	DEI derived from services provided to a person or with respect to property located outside of the United States (see instructions)	1c	
2	Foreign Derived Deduction Eligible Income (FDDEI) (add lines 1a through 1c)		2
3	Deduction Eligible Income (DEI) (from Part I, line 6, above)		3
4	Foreign Derived Ratio (FDDEI / DEI) (divide line 2 by line 3)		4

Part IV **Determining FDII and/or GILTI Deduction** (see instructions)

1	Deemed Intangible Income (DII) (from Part II, line 3)	1
2	Foreign Derived Ratio (from Part III, line 4)	2
3a	FDII (multiply line 1 by line 2)	3a
b	Global Intangible Low-Taxed Income (GILTI) Inclusion (see instructions for line 3b)	3b
c	Total FDII and GILTI (add lines 3a and 3b)	3c
4	Taxable Income (see instructions for line 4)	4
5	Excess FDII and GILTI over Taxable Income (subtract line 4 from line 3c). If zero or less, enter -0- here and on lines 6 and 7	5
6	FDII Reduction (divide line 3a by line 3c; multiply by line 5)	6
7	GILTI Reduction (subtract line 6 from line 5)	7
8	FDII Deduction (see instructions for line 8). (Enter here and on Form 1120, Schedule C; see instructions for information on other tax forms)	8
9	GILTI Deduction (see instructions for line 9). (Enter here and on Form 1120, Schedule C; see instructions for information on other tax forms)	9

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 37817J Form **8993** (12-2018)

Thank you

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