Mergers & Acquisitions in 2019

David H. Schnabel, Esq.
Davis, Polk & Wardwell LLP, New York, NY

Pamela Lawrence Endreny, Esq.
Skadden, Arps, Slate, Meagher & Flom LLP, New York, NY

Lawrence M. Garrett, Esq.
Ernst & Young LLP, Washington, DC

John J. Merrick, Esq.
Internal Revenue Service, Washington, DC

Kara L. Mungovan, Esq.
Cravath, Swaine & Moore LLP, New York, NY

Robert H. Wellen, Esq.
Internal Revenue Service, Washington, DC

M&A in 2019

This panel will discuss various issues impacting M&A, including the new expensing rules under Section 168(k), the new slate of rules relevant when buying or selling a CFC, and guidance relating to spin-offs and private letter rulings.

Panel Chair: **David H. Schnabel**
Davis Polk & Wardwell LLP
New York City

Panelists: **Pamela Lawrence Endreny**
Skadden, Arps, Slate, Meagher & Flom LLP
New York City

Lawrence M. Garrett
Ernst & Young LLP
Washington, DC

John Merrick
Senior Level Counsel, Associate Chief Counsel (International)
Internal Revenue Service
Washington, DC

Kara L. Mungovan
Cravath, Swaine & Moore LLP
New York City

Robert H. Wellen
Associate Chief Counsel (Corporate)
Internal Revenue Service
Washington, DC

Representative Authorities

1. Expensing
    a. NYSBA Report No. 1405, Report on Proposed Regulations Under Section 168(k) Relating to Immediate Expensing of Capital Investments (11/2/2018)
    b. Preamble to REG-104397-18, Proposed Regulations: Section 168(k) Bonus Depreciation

2. GILTI
    a. NYSBA Report No. 1406, Report on Proposed GILTI Regulations (11/26/2018)

3. Spin-off Guidance
    a. Rev. Proc. 2018-53 (providing updated representations, information and analysis relating to assumption and satisfaction of Distributing's obligations in divisive reorganizations)

Report No. 1405

New York State Bar Association Tax Section

Report on Proposed Regulations Under Section 168(k) Relating to Immediate Expensing of Capital Investments

November 2, 2018

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New York State Bar Association
Tax Section

Report on Proposed Regulations Under Section 168(k) Relating to Immediate Expensing of Capital Investments

This report[1] of the Tax Section of the New York State Bar Association (the "**NYSBA**") provides comments on the proposed regulations (the "**Proposed Regulations**")[2] issued under Section 168(k) of the Internal Revenue Code of 1986, as amended (the "**Code**").[3] Section 168(k), as amended by "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," P.L. 115-97 (the "**Act**"),[4] generally permits a taxpayer to deduct 100% of the cost of certain "qualified property" placed in service after September 27, 2017 and before January 1, 2023 (and lesser percentages for subsequent years prior to phasing out with respect to most property placed in service on January 1, 2027 or after).[5] The Treasury Department ("**Treasury**") and the Internal Revenue Service (the "**Service**") requested comments on all aspects of the Proposed Regulations, including how many years a taxpayer should be required to look back in determining whether the taxpayer previously held an interest in an item of property.[6]

We commend Treasury and the Service for quickly releasing proposed regulations addressing most taxpayer questions regarding the implementation of Section 168(k) under the Act. This report is intended to highlight areas of the Proposed Regulations that we believe warrant modification or clarification, and to offer specific recommendations where possible. Part I of this report summarizes our comments on the Proposed Regulations. Part II provides a summary of Section 168(k) and the existing regulations thereunder (the "**Prior 168(k)**

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1 The principal drafters of this report are Richard M. Nugent, Sean E. Jackowitz and L. Matthew Waterhouse, with substantial contributions from William D. Alexander, Phillip J. Gall, Scott H. Rabinowitz and Eric B. Sloan. Helpful comments were received from Andrew H. Braiterman, Timothy J. Devetski, Lucy W. Farr, Lawrence M. Garrett, John C. Hart, Shane J. Kiggen, Stephen B. Land, Steven J. Lorch, Andrew W. Needham, Deborah L. Paul, Michael L. Schler, Michael B. Shulman, Karen Gilbreath Sowell and Sara B. Zablotney. This report reflects solely the views of the Tax Section of the NYSBA and not those of the NYSBA Executive Committee or its House of Delegates.

2 *See* Additional First Year Depreciation Deduction, REG–104397–18, 83 Fed. Reg. 39,292 (Aug. 8, 2018) [hereinafter *Proposed Regulations*].

3 The Proposed Regulations also cite Section 7805 as a source of authority. Unless otherwise indicated, all references herein to "Section" or "§" refer to the Code, and references to the Treasury Regulations are to those in effect as of the date of this Report.

4 *See* An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. 115-97, 131 Stat. 2054 (2017) [hereinafter *Act*].

5 The deduction available under Section 168(k) is sometimes referred to by certain other names, such as "additional first-year depreciation," "immediate expensing" or "bonus depreciation," which this report generally uses interchangeably with "Section 168(k) deduction."

6 *See Proposed Regulations*, *supra* note 2, 83 Fed. Reg. at 39,295, 39,299.

Regulations"),[7] the Act's 2017 amendments to Section 168(k)[8] and the Proposed Regulations. Part III discusses and explains our comments in greater detail.

I. SUMMARY OF COMMENTS

A. Partnership-Related Comments

1. The final regulations generally should adopt an aggregate approach in evaluating whether basis adjustments to qualified property held by a partnership[9] are "used by the taxpayer" and meet the requirements of Section 179(d)(2)(A), (2)(B), (2)(C) and (3).
2. The final regulations should permit immediate expensing of excess book basis under the remedial allocation method in Treasury Regulations Section 1.704-3(d) and corresponding remedial allocations of income and depreciation.[10]
3. Consistent with the Proposed Regulations, the final regulations should retain the availability of immediate expensing to the extent Section 743(b) basis adjustments are allocable to qualified property.
4. Consistent with the Proposed Regulations, the final regulations should deny immediate expensing to the extent basis adjustments under Section 732(b) and Section 734(b)(1)(B) are allocable to qualified property.
5. The government should consider permitting immediate expensing of basis adjustments under Section 734(b)(1)(A) allocable to qualified property, together with its consideration of the proposed regulations under Section 751(b) and Section 755.
6. Treasury Regulations Section 1.743-1(j)(4)(i)(B)(2) should be modified to permit a partnership to elect to claim immediate expensing with respect to the portion of a Section 743(b) adjustment that is allocable to Section 704(c) built-in gain (including "reverse" Section 704(c) gain).
7. The provisions contained in Proposed Regulations Section 1.168(k)-2(f)(1)(iii) should be revised in the final regulations to provide that a partnership interest is treated as a depreciable interest in the partner's proportionate share of the underlying qualified property solely for purposes of applying such section.
8. The final regulations should require consistency for elections under Section 168(k)(7) with respect to Section 743(b) adjustments.

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[7] *See* Treas. Reg. § 1.168(k)-1; *see also* NEW YORK STATE BAR ASSOCIATION TAX SECTION, REPORT # 1045 COMMENTING ON PROPOSED REGULATIONS UNDER INTERNAL REVENUE CODE SECTIONS 168 AND 1400L RELATING TO ADDITIONAL FIRST YEAR DEPRECIATION ALLOWANCES (2004), *reprinted in*, 2004 TNT 5-7 (Jan. 8, 2004) (commenting on early temporary regulations under Section 168(k)).

[8] *See Act*, *supra* note 4, at § 13201.

[9] For purposes of this report, references to a partnership generally include a limited liability company or other entity or arrangement that is classified as a partnership for U.S. federal income tax ("**U.S. tax**") purposes.

[10] For this purpose, "book" refers to the books of the partnership maintained under Treasury Regulations Section 1.704-1(b)(2)(iv).

9. If the final regulations permit immediate expensing of remedial allocation deductions, the special rule contained in the penultimate sentence of Proposed Regulations Section 1.168(k)-2(f)(1)(iii) should be removed.
10. If the final regulations do not permit immediate expensing of remedial allocation deductions, the special rule contained in the penultimate sentence of Proposed Regulations Section 1.168(k)-2(f)(1)(iii) should be retained, but, as discussed below, the government may wish to revisit certain aspects of the rule.
11. The final regulations should clarify that an asset acquired through a transaction described in Revenue Ruling 99-5[11] (Situation 1) is placed in service by the buyer even though it is treated as being immediately contributed to the relevant partnership in a Section 721(a) transaction.

B. Other Comments

1. The final regulations should include an exemption providing that qualified property previously used by a taxpayer and reacquired in a purchase that otherwise satisfies the requirements of Section 168(k)(2)(E)(ii) is eligible for immediate expensing notwithstanding that the taxpayer previously used the property, unless the taxpayer's reacquisition is part of a plan that includes the prior use or disposition of the qualified property.
2. Any safe harbor or other exemption provided in the final regulations to the requirement in Section 168(k)(2)(E)(ii)(I) that a taxpayer acquiring used qualified property must not have previously used the property should also apply to analogous provisions of the final regulations that require one person to determine if another person previously used an item of property, such as the rules in Proposed Regulations Sections 1.168(k)-2(b)(3)(iii)(B)(3)(i), -2(b)(3)(iii)(B)(3)(ii), and -2(f)(1)(iii).
3. The final regulations should provide a definition of the phrase "depreciable interest."
4. The government should consider defining the term "predecessor" in the final regulations.
5. The government should consider clarifying the application of the phrase "series of related transactions" in Example 22 or more generally.
6. The final regulations should clarify how Proposed Regulations Section 1.168(k)-2(b)(3)(iii)(C) is intended to apply.
7. The final regulations should incorporate an example clarifying that where one consolidated group acquires qualified property and stock of a target corporation from another consolidated group, the acquired qualified property is eligible for immediate expensing, provided the acquired target corporation never directly held such property.
8. The government should issue guidance clarifying the tax treatment of transactions in which a member of a consolidated group sells qualified property to a buyer corporation within the same consolidated group and the buyer corporation is itself purchased by an

[11] 1999-1 C.B. 434.

acquiror (and similar transactions involving an actual or deemed sale within a consolidated group, followed by the buyer corporation's departure from the group pursuant to a distribution described in Section 355 of the Code) and addressing in particular (i) whether any Section 168(k) deduction in the above scenarios can be claimed by the buyer corporation or its consolidated group, or by the selling consolidated group, and (ii) the amount of any Section 168(k) deduction and the tax treatment thereof under the consolidated return rules and Section 168(i)(7).

9. Consistent with the Proposed Regulations, the final regulations should amend Treasury Regulations Section 1.179-4(c)(2) to expressly provide that assets deemed transferred in connection with a Section 336(e) election under Treasury Regulations Section 1.336-2(b)(1) should be treated as acquired through a qualifying "purchase." The government also should consider issuing guidance addressing whether qualified property transferred in a Section 355(d) or 355(e) distribution for which a Section 336(e) election is made is eligible for immediate expensing, notwithstanding the "sale-to-self" model in Treasury Regulations Section 1.336-2(b)(2).

10. The government should consider providing in the final regulations that Section 181 deductions for qualified television productions and qualified live theatrical productions are taken before any Section 168(k) deduction applicable to the same production.

II. BACKGROUND

A. Background on Section 168(k)

Under pre-Act law, Section 168(k) permitted taxpayers to deduct 50% of the adjusted basis of any newly purchased "qualified property" in the year in which the taxpayer placed the qualified property in service.[12] Any such taxpayer would reduce the adjusted basis of its qualified property by the Section 168(k) deduction amount to compute regular depreciation deductions for the year the property was placed in service and the years following.[13] A taxpayer could elect out of Section 168(k) for any taxable year, but only on a class-by-class basis as opposed to a property-by-property basis.[14]

"Qualified property" included (i) property to which Section 168 applied with a recovery period not exceeding 20 years, (ii) computer software depreciable under Section 167(a) (rather than Section 197), (iii) water utility property and (iv) "qualified improvement property,"[15] so

[12] *See* I.R.C. § 168(k)(1) (prior to amendment by the Act).

[13] *See* I.R.C. § 168(k)(1)(B). The percentage of cost allowed as a deduction under Section 168(k) was to be phased down to 40% for qualified property placed in service in 2018 and to 30% for qualified property placed in service in 2019. *See* I.R.C. § 168(k)(6) (prior to amendment by the Act).

[14] *See* I.R.C. § 168(k)(7) (prior to amendment by the Act). Subject to special rules, a corporate taxpayer could elect to accelerate its use of alternative minimum tax credits instead of taking depreciation under Section 168(k). *See* I.R.C. § 168(k)(4) (prior to amendment by the Act).

[15] *See* I.R.C. § 168(k)(2)(A)(i) (prior to amendment by the Act). Qualified improvement property generally is any improvement to an interior portion of a building that is nonresidential real property if such improvement is placed in service after the date the building was first placed in service. *See* I.R.C. § 168(e)(6); I.R.C § 168(k)(3)(A) (prior to amendment by the Act).

long as "original use" of the property began with the taxpayer, and the taxpayer placed the property in service before January 1, 2020.[16] "Original use" generally was "the first use to which the property is put, whether or not that use corresponds to the use of the property by the taxpayer."[17] The deadline for placing property in service was extended to December 31, 2020 for certain property having longer production periods, namely, property that met the definition of "qualified property," was acquired by the taxpayer before January 1, 2020 (or acquired pursuant to a written contract entered into before January 1, 2020), had a recovery period of at least 10 years or was property used in the trade or business of transporting persons or property, and had an estimated production period exceeding one year and a cost exceeding $1 million (collectively, "**LPP property**").[18] Subject to additional rules, certain aircraft also qualified (and continue to qualify) as LPP property.[19]

B. Act Changes to Section 168(k)

The Act made several changes to the above rules. Most significantly, the new law increased the allowable Section 168(k) depreciation amount to 100% for qualified property acquired and placed in service after September 27, 2017 and before January 1, 2023.[20] The 100% Section 168(k) depreciation period for placing qualified LPP property in service extends to December 31, 2023.[21] Under the Act, the applicable Section 168(k) depreciation percentage decreases by 20% each year for qualified property placed in service after December 31, 2022 (or December 31, 2023 for LPP property) until sunsetting for qualified property placed in service after December 31, 2026 (or December 31, 2027 for LPP property).[22] A taxpayer may elect to apply a 50%, rather than 100%, Section 168(k) deduction for qualified property placed in service and acquired during the taxpayer's first taxable year ending after September 27, 2017.[23] For property acquired before September 28, 2017 and placed in service after September 27, 2017, the Act retained the existing 50% depreciation rate and the existing phase down to 40% and 30% that were already in place.[24] In addition, property is not treated as subject to the Act's new provisions if a written binding contract for its acquisition was entered into before September 28, 2017.[25]

Second, the Act expanded the definition of qualified property to include "qualified film or television productions" and "qualified live theatrical productions." A qualified film or

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16 *See* I.R.C. § 168(k)(2)(A)(ii), (iii) (prior to amendment by the Act).

17 *See* Treas. Reg. § 1.168(k)-1(b)(3)(i).

18 *See* I.R.C. § 168(k)(2)(B) (prior to amendment by the Act). Self-constructed property could qualify if the taxpayer began constructing the property before January 1, 2020.

19 *See* I.R.C. § 168(k)(2)(C).

20 *See* I.R.C. § 168(k)(6)(A)(i).

21 *See* I.R.C. § 168(k)(6)(B). The Act permits a Section 168(k) deduction for specified plants planted or grafted before January 1, 2027. The phasedowns are the same as for qualified property. *See* I.R.C. § 168(k)(6)(C).

22 *See* I.R.C. § 168(k)(6)(A), (B). The applicable percentage for LPP property acquired after September 27, 2017 and placed in service in 2027 is 20%. *See* I.R.C. § 168(k)(6)(B)(v).

23 *See* I.R.C. § 168(k)(10).

24 *See* I.R.C. § 168(k)(8).

25 *See Act*, *supra* note 4, at § 13201(h)(1).

television production, generally and subject to additional specific requirements, is a film or television production, at least 75% of the total compensation incurred in the production of which is for services performed in the United States by actors, directors, producers and other relevant production personnel.[26] A qualified live theatrical production generally is a live staged production of a play, with or without music, which is derived from a written book or script in an applicable venue, so long as it meets the same compensation test.[27]

Third, the Act excludes from Section 168(k) property used in certain of the trades or businesses that are not subject to the limitation on interest expense under Section 163(j).[28] In particular, excluded from the definition of qualified property under the new law is property primarily used in the trade or business of furnishing electrical energy, water or sewage disposal services, gas or steam through a local distribution system, or transportation of gas or steam by pipeline, if any such trade or business is subject to regulation.[29] Also excluded is any property used in a trade or business that has floor plan financing indebtedness if the interest related to such indebtedness is exempt from the new interest limitation rules of Section 163(j) pursuant to Section 163(j)(1)(C).[30]

Fourth, the Act amended the requirement that the original use of property commence with the taxpayer.[31] As amended, Section 168(k) now requires that either (i) the original use of the property in question begin with the taxpayer or (ii) the taxpayer acquire the property in a transaction satisfying the requirements of Section 168(k)(2)(E)(ii). Section 168(k)(2)(E)(ii), in turn, requires that (i) the taxpayer did not use the property at any time prior to its acquisition (as amended by the Proposed Regulations, the "**No Prior Use Test**"),[32] and (ii) the acquisition was a qualifying "purchase" under Section 179(d)(2) and (d)(3) (the requirements of Section 179(d)(2)-(3), collectively, the "**Unrelated Purchase Test**").[33] Section 179(d)(2), in turn, imposes three separate requirements. First, the property must not have been acquired from a person whose relationship with the taxpayer is described in Section 267 or Section 707(b).[34] In the case of two corporations, this rule generally requires that the corporations not be members of the same "controlled group" as defined in Sections 267(f) and 1563(a). Second, the property cannot be acquired by one component member of a controlled group from another component member of

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26 *See* I.R.C. § 168(k)(2)(A)(i)(IV) (cross-referencing I.R.C. § 181(d)).

27 *See* I.R.C. § 168(k)(2)(A)(i)(V) (cross-referencing I.R.C. § 181(e)).

28 After the Act, Section 163(j) generally limits interest deductions to 30% of a taxpayer's adjusted taxable income. *See* I.R.C. § 163(j)(1). For our report on Section 163(j), see NEW YORK STATE BAR ASSOCIATION TAX SECTION, REPORT # 1393 ON SECTION 163(J) (2018), *reprinted in*, 2018 TNT 62-1 (Mar. 30, 2018).

29 *See* I.R.C. § 168(k)(9)(A) (cross-referencing I.R.C. § 163(j)(7)(A)).

30 *See* I.R.C. § 168(k)(9)(B). "Floor plan financing indebtedness" is indebtedness used to finance the acquisition of motor vehicles held for sale or lease and secured by the inventory so acquired. *See* I.R.C. § 163(j)(9)(B).

31 *See* I.R.C. § 168(k)(2)(A)(ii).

32 As described in Part III.B.2.b, below, the Proposed Regulations provide that prior use by either the taxpayer *or a predecessor of the taxpayer* prevents the taxpayer from receiving a Section 168(k) deduction; the statute does not mention predecessor.

33 *See* I.R.C. § 168(k)(2)(A)(ii), (E)(ii).

34 *See* I.R.C. § 179(d)(2)(A). For this purpose, Section 179(d)(2)(A) modifies the rules of Section 267 such that the family of an individual includes only his or her spouse, ancestors and lineal descendants. *See id.*

the same controlled group, a technical requirement that overlaps significantly with the first requirement.[35] Third, the basis of the acquired property cannot be determined by reference to the transferor's basis in the property (*i.e.*, the property must be acquired in a taxable transaction).[36] Finally, Section 179(d)(3) provides that the cost of property does not include so much of the basis of such property as is determined by reference to the basis of other property held at any time by the person acquiring such property.[37]

C. Background to Proposed Regulations

Treasury and the Service published the Proposed Regulations in the Federal Register on August 8, 2018. Proposed Regulations Section 1.168(k)-2 generally updates the Prior 168(k) Regulations to reflect the Act's amendments to Section 168(k) and the effective date under Section 13201(h) of the Act. The Proposed Regulations also include conforming changes to certain other existing regulations, including those regarding the rehabilitation tax credit, the determination of earnings and profits, maintenance of capital accounts, contributions of property under Section 704(c) and basis adjustments under Section 743(b).

Proposed Regulations Section 1.168(k)-2(b) lists four requirements for depreciable property to constitute qualified property eligible for a Section 168(k) deduction. First, the property must be of a type described in Section 168(k)(2)(A)(i) or Section 168(k)(5)(B) and not subject to Section 168(k)'s various exclusions.[38] Second, the original use of the depreciable property must commence with the taxpayer or, if the property was previously used, the acquisition of the property must satisfy the No Prior Use Test and Unrelated Purchase Test. Third, the property must have been placed in service (within the meaning of the Proposed Regulations) by the taxpayer after September 27, 2017 and before January 1, 2027 (or, for LPP property and certain aircraft, January 1, 2028). Fourth, the property must be acquired by the taxpayer after September 27, 2017 or pursuant to a written binding contract entered into by the taxpayer after September 27, 2017.

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35 *See* I.R.C. § 179(d)(2)(B).

36 *See* I.R.C. § 179(d)(2)(C).

37 *See* I.R.C. § 179(d)(3). Thus, upon any like-kind exchange, involuntary conversion or similar carryover basis transaction, Section 168(k) applies only with respect to the portion, if any, of the acquired property's basis produced by the acquiring taxpayer's payment of cash or other taxable transfer of property. *See* Treas. Reg. § 1.179-4(d).

38 For this purpose, qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property may constitute qualified property if acquired and placed in service by the taxpayer after September 27, 2017 and before January 1, 2018. *See* Prop. Reg. § 1.168(k)-2(b)(2)(i)(A). Qualified improvement property, a new statutory term added to Section 168 by the Act to cover these categories of depreciable property but not assigned a recovery period in an apparent drafting error, is not eligible for a Section 168(k) deduction if acquired on or after January 1, 2018. *See* Letter from Members of the Senate Finance Committee to Steven T. Mnuchin, Secretary of the Treasury, and David J. Kautter, Assistant Secretary of the Treasury for Tax Policy and Acting Commissioner of the Internal Revenue Service (Aug. 16, 2018). Some predict that, during the lame duck session following the 2018 elections, Congress will pass an extenders package that will contain technical corrections for the Act, including an amendment to address the above issue. *See*, *e.g.*, Stephen K. Cooper & David Van Den Berg, *Costly Extenders on Lawmakers' Lame Duck Action List*, 2018 TNT 208-5 (Oct. 26, 2018).

The Proposed Regulations contain several provisions clarifying and interpreting the No Prior Use Test and Unrelated Purchase Test. Under the Proposed Regulations, the acquired property cannot have been used by the taxpayer or a predecessor at any time prior to its acquisition.[39] For this purpose, property is treated as used by the taxpayer or a predecessor prior to its acquisition if the taxpayer or the predecessor had a depreciable interest in the property, whether or not the taxpayer or the predecessor claimed depreciation deductions for the property.[40] The Proposed Regulations also contain rules for applying the No Prior Use Test and Unrelated Purchase Test in special situations. In the case of a "series of related transactions," for purposes of applying the No Prior Use Test and Unrelated Purchase Test, property is treated as directly transferred from the original transferor to the ultimate transferee, and the relation between the original transferor and the ultimate transferee is tested immediately after the last transaction in the series (the "**Direct Transfer Recast Rule**").[41]

Several additional rules apply the No Prior Use Test and Unrelated Purchase Test within consolidated groups. As a general rule, the Proposed Regulations indicate that consolidated corporations are treated as separate taxpayers.[42] However, Proposed Regulations Section 1.168(k)-2(b)(3)(iii)(B)(3)(i) provides that, where a member of a consolidated group uses or previously used an asset while a member of the consolidated group, the group is treated as having previously used the asset for purposes of the used property acquisition requirements of Section 168(k)(2)(E)(ii)(I), and, accordingly, the acquisition of the same asset by any other member of the consolidated group will not produce a Section 168(k) deduction (the "**Group Prior Use Test**"). In addition, the Proposed Regulations deny a Section 168(k) deduction where, as part of a "series of related transactions," a member of a consolidated group acquires qualified property and a corporation that previously used that property becomes a member of the consolidated group (the "**Stock/Asset Acquisition Rule**").[43] Finally, for purposes of the Group Prior Use Test and the Stock/Asset Acquisition Rule, where as part of a "series of related transactions" a member of a consolidated group both acquires property and the transferee ceases to be a member of the consolidated group, the taxpayer's membership in the consolidated group is tested immediately after the last transaction in the series.[44]

For partnerships, whether certain basis adjustments satisfy the No Prior Use Test and Unrelated Purchase Test depends on the Code section at issue. A basis adjustment under Section 743(b) that is attributable to qualified property is eligible for immediate expensing so long as the transferee partner (or its predecessors) did not have any depreciable interest in the portion of the property to which the Section 743(b) adjustment is allocated, and the acquisition of the partnership interest meets the requirements of the Unrelated Purchase Test by testing relatedness at the partner level.[45] Moreover, the preamble explains that this treatment is appropriate

39 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(1).

40 *See id.*

41 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(C).

42 *Proposed Regulations*, 83 Fed. Reg. at 39,295.

43 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(3)(ii).

44 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(3)(iii). We assume that, notwithstanding the use of three different nouns, the "member," the "transferee" and the "taxpayer" are all the same entity, which acquires property while a member of a consolidated group and then leaves the group.

45 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iv)(D).

notwithstanding that the transferee partner may have an existing interest in the underlying partnership property, because the transferee's existing interest is "distinct" from the interest transferred.[46] The Proposed Regulations exclude all basis adjustments under Section 732 and Section 734(b) and remedial allocations under Section 704(c).[47]

The Proposed Regulations also contain rules for applying the requirement found in Section 13201(h) of the Act that property must be acquired after September 27, 2017. The Proposed Regulations provide that qualified property does not include property acquired pursuant to a written binding contract entered into before September 28, 2017. The definition of a "binding contract" is consistent with the current one in Treasury Regulations 1.168(k)-1(b)(4)(ii). Self-constructed property may be qualified property if the taxpayer begins manufacturing, constructing or producing the property after September 27, 2017, unless the taxpayer has engaged another person to perform such manufacturing, construction or production pursuant to a written binding contract entered into before September 28, 2017.[48]

Proposed Regulations Section 1.168(k)-2(e) provides guidance on various elections available under Section 168(k). The rules for electing out of Section 168(k) are largely consistent with current Treasury Regulations Section 1.168(k)-1(e). In addition, the Proposed Regulations provide that a Section 743(b) adjustment attributable to a class of qualified property is eligible for immediate expensing without regard to whether the partnership elects out of immediate expensing under Section 168(k)(7) ("a **Section 168(k)(7) Election**") for all other qualified property in the same class of property and placed in service in the same taxable year.[49] Similarly, a partnership may make a Section 168(k)(7) Election for a Section 743(b) adjustment in a class of qualified property, and this election will not bind the partnership to such election for all other qualified property of the partnership in the same class of property and placed in service in the same taxable year.[50]

Finally, the Proposed Regulations contain special rules for qualified property placed in service and disposed of in the same taxable year, redeterminations of basis, depreciation recapture and other situations.

The Proposed Regulations generally will be effective when finalized, but a taxpayer may rely on the Proposed Regulations for qualified property acquired and placed in service after September 27, 2017, during taxable years ending after September 27, 2017, and ending before the taxpayer's taxable year that includes the date on which the Proposed Regulations are adopted.

III. COMMENTS

We appreciate the government's efforts to issue regulatory guidance on the Act's changes to Section 168(k) both promptly and in sufficient detail to address most taxpayer questions. Our comments below address a number of specific items in the Proposed Regulations and are, like

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46 *Proposed Regulations*, 83 Fed. Reg. at 39,296-97.
47 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iv)(A) – (C).
48 *See* Prop. Reg. § 1.168(k)-2(b)(5)(iv)(A).
49 *See* Prop. Reg. § 1.743-1(j)(4)(i)(B)(1).
50 *See* Prop. Reg. § 1.168(k)-2(e)(1).

the Proposed Regulations themselves, highly varied. Broadly speaking, our comments fall into two categories: (i) partnership issues and (ii) definitional, consolidated group and other miscellaneous issues.

At the outset, we note that a fairly large number of our comments relate to the No Prior Use Test described above. Accordingly, it will be helpful to explain our understanding of that provision's purpose. The legislative history evinces a concern that taxpayers could abuse the used property acquisition option in Section 168(k)(2)(A)(ii).[51] We view the No Prior Use Test as a form of anti-abuse rule that is not aimed at a particular contemplated abuse[52] but rather at a class of transactions (acquisitions of used qualified property by previous users) that is likely to contain a higher percentage of abusive transactions than acquisitions of used qualified property generally. We agree with this determination and appreciate that Section 168(k)(2)(E)(ii)(I) requires no prior use without any qualifications. At the same time, however, we agree with the government's decision, in seeking comments on a possible safe harbor, to effectively exempt certain transactions in this suspect class where the risk of abuse is low. Unlike some other areas of the tax law in which anti-churning rules apply, such as Section 197, Section 168(k) applies to a broad range of assets that are relatively fungible and tradable in secondary market transactions. Given the volume of sales of qualified property that occur in the marketplace and the breadth of the definition of qualified property, it seems to us that it is inevitable that taxpayers on occasion will repurchase previously used qualified property. In our view, where a taxpayer that has previously used qualified property reacquires the property and seeks to obtain a Section 168(k) deduction, the reacquisition warrants additional scrutiny, but not always automatic disqualification, especially if the disposition of the property and the reacquisition do not occur pursuant to a plan or are separated by a significant period of time.[53]

A. Partnership Issues

The Proposed Regulations generally limit eligibility for immediate expensing to basis adjustments resulting from Section 743(b) adjustments and thus deny immediate expensing in the case of adjustments under Section 732(c) or Section 734(b) as well as with respect to notional depreciation deductions available in the case of partnerships that utilize the remedial allocation method under Treasury Regulations Section 1.704-3(d). According to the preamble, remedial allocations cannot satisfy the (i) No Prior Use Test because the partnership already has a depreciable interest in the contributed property at the time the remedial allocation is made, or (ii)

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51 *See* H.R. REP. NO. 115-466, at 353 (2017) (Conf. Rep.) ("The provision removes the requirement that the original use of qualified property must commence with the taxpayer. Thus, the provision applies to purchases of used as well as new items. To prevent abuses, the additional first-year depreciation deduction applies only to property purchased in an arm's-length transaction.").

52 Neither the legislative history of the Act nor the Proposed Regulations appear to identify specific abuses relating to the No Prior Use Test.

53 *See* Treas. Reg. § 1.197-2(h)(5)(ii) (acquisition of intangible asset that was amortizable in seller's hands is exempt from the "anti-churning" rules in Section 197, provided that such transaction is not part of a series of related transactions that included the seller's prior acquisition).

the Unrelated Purchase Test because the partnership's basis in the contributed property is determined by reference to the contributing partner's basis in the property.[54]

In the preamble, the government explained that a Section 734(b) basis adjustment is ineligible for immediate expensing because the adjustment is made to the common basis of partnership property (*i.e.*, non-partner-specific basis) and the partnership used the property prior to the partnership distribution giving rise to the basis adjustment.[55] Therefore, the government concluded that a Section 734(b) basis adjustment fails both the original use requirement in Section 168(k)(2)(A)(ii) and the No Prior Use Test.[56] These rationales indicate that, outside of Section 743(b) adjustments, the government generally adopted an entity view of partnerships when assessing the eligibility of basis adjustments under Subchapter K for immediate expensing.[57]

Subchapter K treats a partnership as an aggregate of its partners for some purposes and as a separate entity for others.[58] As discussed in detail below, we believe that the aggregate theory of partnership taxation is the appropriate analytical approach for evaluating the transactions underlying the various basis adjustments (*i.e.*, the transactions should, for this purpose, be analyzed as transfers of qualified property between the applicable partners). That approach, which is effectively the approach the government adopted in the Proposed Regulations for Section 743(b) adjustments, is, we believe, the appropriate one in which to apply the No Prior Use Test and Unrelated Purchase Test for purposes of remedial allocations and Section 734(b) adjustments. Moreover, such an approach would largely parallel the approach adopted in the "anti-churning" rules for intangible property under Section 197.[59]

Adopting an aggregate approach to evaluating these Subchapter K issues does not, however, fully answer the question of whether immediate expensing is available. The question then becomes whether the transactions, as conceptualized under that approach, satisfy the requirements for immediate expensing. The government has already concluded that immediate expensing may be available in the case of some Section 743(b) adjustments. As the preamble indicates, in determining whether a Section 743(b) basis adjustment satisfies the No Prior Use Test, each partner is treated as having owned and used the partner's proportionate share of partnership property. Therefore, in the case of a transfer of a partnership interest, this test will be

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54 *See Proposed Regulations, supra* note 2, 83 Fed. Reg. at 39,295-96.

55 *See id.* at 39,295-96.

56 *See id.*

57 The Proposed Regulations also would modify current Treasury Regulations Section 1.704-1(b)(2)(iv)(g)(3), which provides that, in the case of zero basis property, book depreciation, for purposes of maintaining partners' capital accounts, may be determined under any reasonable method selected by the partnership. The Proposed Regulations deem immediate expensing not to be a reasonable method, s*ee* Prop. Reg. § 1.704-1(b)(2)(iv)(g)(3), and the preamble explains that the government's approach results from the potential for shifting built-in gain among partners. *See Proposed Regulations* 83 Fed. Reg. at 39,296.

58 *See, e.g.*, Andrew W. Needham, *Bonus Depreciation: Basis Adjustments Under Subchapter K*, 160 TAX NOTES 41, 44-45 (July 2, 2018).

59 *See also* AMERICAN BAR ASSOCIATION TAX SECTION, COMMENTS ON SECTION 168(K) AS AMENDED BY P.L. 115-97 ON DECEMBER 22, 2017 (2018), *reprinted in*, 2018 TNT 111-17 (June 8, 2018) (suggesting that government adopt principles similar to those of Treasury Regulations Section 1.197-2(h)(12) with respect to treatment of Subchapter K basis adjustments for purposes of Section 168(k)).

satisfied if the partner acquiring the interest (or a predecessor of such partner) has not used the portion of the partnership property to which the Section 743(b) adjustment relates at any time prior to the acquisition, notwithstanding the fact that the partnership itself has previously used the property. Similarly, the Unrelated Purchase Test will be satisfied if the partner acquiring a partnership interest is not related to the partner who is transferring the partnership interest.

As discussed below, we believe that application of the aggregate approach in the remedial allocation method context should permit immediate expensing in many cases. By contrast, we do not believe that Section 734(b) basis adjustments should qualify for immediate expensing. While the transactions underlying those adjustments often bear meaningful economic resemblance to other adjustments that qualify (or that we think should qualify) for immediate expensing, we think that those adjustments raise additional issues and concerns because of the nature and allocation of Section 734(b) basis adjustments. Therefore, we cannot recommend unconditionally that the final regulations permit immediate expensing of those adjustments.

In addition, we propose that the government make several clarifications in the final regulations. Although we agree with the government's decision to evaluate Section 743(b) adjustments under an aggregate approach, the Proposed Regulations raise several issues regarding the proper application of the immediate expensing rules to those adjustments. We also recommend clarification of certain aspects of elections under Section 168(k)(7) as applied to partnership basis adjustments.

Finally, under the penultimate sentence of Proposed Regulations Section 1.168(k)-2(f)(1)(iii) (the "**Transferor Allocation Rule**"), if qualified property is transferred in a Section 721(a) contribution to a partnership that has as a partner a person (other than the transferor) who previously used the qualified property in the same taxable year that it is placed in service by the transferor, the Section 168(k) deduction is allocated entirely to the transferor, as opposed to having the partnership and the transferor share the deduction in accordance with Section 168(i)(7). While the Transferor Allocation Rule has advantages and disadvantages, we think that, on balance, permitting immediate expensing of remedial allocation deductions would largely obviate the need for the Transferor Allocation Rule. If the government does not permit immediate expensing of remedial allocations, we recommend certain changes to the approach in the Proposed Regulations.

Each of these topics is addressed in detail below.

1. Basis Adjustments Under Subchapter K

a. Section 743

There generally is no adjustment to the basis of partnership property when a partner transfers its interest in a partnership to another person.[60] However, if a partnership has properly made a Section 754 election (or there is a substantial built in loss), the partnership must adjust the basis of partnership assets upon a partner's sale or exchange of a partnership interest to provide the transferee with the equivalent of cost basis in its allocable share of the partnership's

[60] *See* I.R.C. § 743(a).

assets, just as though the transferee acquired a direct, undivided interest in the partnership assets. If the Section 754 election is in effect, the adjustment equals the difference between the transferee's basis in its partnership interest and the transferee's share of the adjusted basis of the partnership's assets.[61] The basis adjustment is an adjustment to the basis of the partnership's assets with respect to the transferee partner only and does not impact the partnership's computation of items of income, deduction, gain or loss at the partnership level or on other partners.[62] The basis adjustment generally is allocated first to property ("**ordinary income property**") other than capital assets and Section 1231(b) property (capital assets and Section 1231(b) property, collectively, "**capital gain property**")[63] to the extent of the income, gain or loss that would be allocated to the transferee in a deemed sale of the ordinary income assets for cash equal to their fair market value.[64] Any remaining basis adjustment generally is allocated to capital gain property.[65]

When a positive basis adjustment is allocated to depreciable property, the increase in basis is treated "as if it were newly-purchased recovery property placed in service when the transfer occurs."[66] Any applicable recovery period and method are used to determine the allowable depreciation deduction, and no change is made to the common basis in such property.[67]

b. Section 734

Another default rule under Subchapter K is that no adjustment occurs to the basis of partnership property upon a partnership's distribution to a partner.[68] If a Section 754 election is in effect, however, the partnership must adjust the basis of partnership property upon making a distribution in order to address discrepancies between inside and outside basis arising as a result of the distribution. Specifically, the Section 734(b) adjustment applies to a partnership with a Section 754 election in effect if (i) the distributee partner recognizes gain or loss on a distribution (a "**734(b)(1)(A) Adjustment**") or (ii) the distributee partner takes a basis in distributed property greater or less than the partnership's adjusted basis in the property immediately before the distribution (a "**734(b)(1)(B) Adjustment**"). The Section 734(b) adjustment increases the partnership's basis by the amount of any gain that the distributee partner recognizes in the case of a 734(b)(1)(A) Adjustment or by an amount equal to the excess of the partnership's adjusted basis in the distributed property over the distributee partner's basis in the property in the case of

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61 *See* I.R.C. § 743(b).

62 *See* Treas. Reg. § 1.743-1(j)(1).

63 The portion of gain in Section 1231 property that is attributable to depreciation recapture generally is treated as a separate asset that is ordinary income property. *See* Treas. Reg. § 1.755-1(a)(1).

64 *See* Treas. Reg. § 1.755-1(b)(2)(i).

65 *See* Treas. Reg. § 1.755-1(b)(2)(i). The basis adjustment is further allocated to each item within the two classes in accordance with the income, gain or loss that would be allocated to the transferee from the sale of the item in the hypothetical cash transaction. *See* Treas. Reg. § 1.755-1(b)(3)(i)(A), (ii)(A).

66 *See* Treas. Reg. § 1.743-1(j)(4)(i)(B)(1).

67 *See id*. As discussed below, special rules apply where the partnership uses the remedial allocation method.

68 *See* I.R.C. § 734(a).

a 734(b)(1)(B) Adjustment.[69] Unlike adjustments under Section 743(b), the adjustment applies to the common basis of the partnership.[70]

Any basis increase under Section 734(b) must be allocated to partnership property in the same class (*i.e.*, capital gain property or ordinary income property) as the distributed property.[71] The increase is further allocated to any properties within the applicable class that have unrealized appreciation in proportion to the amount of such appreciation, with the remainder allocated to property within the class in proportion to fair market value.[72] If a cash distribution to a partner results in gain under Section 731(a)(1) and a corresponding 734(b)(1)(A) Adjustment, such adjustment may only be allocated to capital gain property, including the portion of Section 1231(b) property treated as capital gain property.[73]

The Section 734 regulations provide that an increase in the basis of depreciable property "must be taken into account as if it were newly-purchased recovery property placed in service when the distribution occurs."[74] Any applicable recovery period and method are used to determine the allowable depreciation deduction, and no change is made to the remainder of the property's basis.[75]

c. Remedial Allocations Under Section 704(c)

Section 704(c)(1)(A) requires the allocation for tax purposes of any income, gain, loss or deduction with respect to property contributed to a partnership with built-in gain or loss ("**Section 704(c) property**") "among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution."[76] The regulations require a "reasonable method" for allocating such items and offers the traditional method, the traditional method with curative allocations and the remedial allocation method as three methods that are "generally reasonable."[77]

Under the traditional method, the partnership allocates income, gain, loss or deduction to the Section 704(c) property "to avoid shifting the tax consequences of the built-in gain or loss."[78] However, the "ceiling rule" caps the amount of income, gain, loss or deduction that the partnership may allocate for any taxable year to the amount it actually recognizes.[79]

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69 *See* I.R.C. § 734(b)(1); Treas. Reg. § 1.734-1(b)(1).

70 *See* Treas. Reg. § 1.734-1(d) (requiring only that the partnership attach a statement to the partnership return setting forth the computation of the Section 734(b) adjustment and the allocation thereof).

71 *See* Treas. Reg. § 1.755-1(c)(1)(i).

72 *See* Treas. Reg. § 1.755-1(c)(2)(i).

73 *See* Treas. Reg. § 1.755-1(c)(1)(ii).

74 *See* Treas. Reg. § 1.734-1(e)(1).

75 *See id.*

76 *See* I.R.C. § 704(c)(1)(A). Section 704(c)(1)(A), enacted in 2004, provides additional rules with respect to contributed built-in loss property.

77 *See* Treas. Reg. § 1.704-3(a)(1).

78 *See* Treas. Reg. § 1.704-3(b)(1).

79 *See* Treas. Reg. § 1.704-3(b)(1).

The remedial allocation method offers a way to eliminate the distortions caused by the ceiling rule.[80] Under this allocation method, if the ceiling rule would prevent a tax allocation from matching a book allocation, the partnership creates a remedial item to make up the difference, while simultaneously creating an offsetting remedial item in an identical amount allocated to the contributing partner.[81] Remedial allocations have the same attributes as the tax item limited by the ceiling rule.[82] Remedial allocations address ceiling rule shortfalls by replacing the unavailable tax depreciation with a notional deduction and thus generally convey the equivalent of a full step-up to the noncontributing partners.[83]

The remedial allocation regulations establish a separate framework for calculating depreciation deductions for depreciable property. This framework bifurcates the book value of the depreciable property as though it were two assets.[84] The first deemed asset has a book value equal to the adjusted tax basis of the asset, and the partnership recovers that book basis in the same manner and with the same recovery period as the adjusted tax basis.[85] The second deemed asset (the "**excess book basis asset**") equals the excess of the fair market value of the property over its adjusted tax basis. The partnership depreciates the excess book asset for book purposes using any recovery period and depreciation method available for newly purchased property.[86] The partnership then combines the book depreciation arising from the first asset with the book depreciation arising from the second asset and allocates the book depreciation to the partners under the partnership agreement (subject to Section 704(b)). The partnership allocates the tax depreciation to the noncontributing partner to the extent book depreciation was allocated to that partner and makes remedial allocations to the noncontributing partners to the extent that the book depreciation deductions exceed the tax depreciation deductions available under the ceiling rule.[87] In addition, the partnership must make remedial allocations of income to the contributing partner to offset the remedial allocations of depreciation.

Section 704(c) principles apply equally to property with a book value that differs from its basis arising from a "revaluation."[88] The Section 704(b) regulations permit revaluations immediately before certain events, including a contribution of money or other property by a new partner.[89] In a revaluation, the partnership adjusts the book value of its properties by adjusting them to fair market value and further reflecting the book gain or loss in the partners' capital accounts consistent with the economic agreement that would govern a sale of the properties for

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80 *See id*. The Section 704(c) traditional method with curative allocations addresses the impact of the ceiling rule by reallocating partnership items of income, gain, loss and deduction. *See* Treas. Reg. § 1.704-3(c).

81 *See* Treas. Reg. § 1.704-3(c).

82 *See* Treas. Reg. § 1.704-3(d)(3).

83 *See* Needham, *supra* note 58, at 46.

84 *See* Treas. Reg. § 1.704-3(d)(2).

85 *Id.* Typically, the taxpayer must determine book depreciation at the same rate as tax depreciation. *See* Treas. Reg. § 1.704-1(b)(2)(iv)(g)(3).

86 *See* Treas. Reg. § 1.704-3(d)(2).

87 *See* Treas. Reg. § 1.704-3(d)(7), Ex. 1.

88 *See* Treas. Reg. § 1.704-3(a)(6).

89 *See* Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5)(i). The Section 704(b) regulations require that revaluations made in connection with the exercise of noncompensatory options be made immediately after the exercise. *See* Treas. Reg. § 1.704-1(b)(2)(iv)(s)(1).

book value. The partnership then allocates future taxable income, gain, loss and deduction among the partners under the applicable Section 704(c) method.[90]

2. Adopt Aggregate Approach for Evaluating Basis Adjustments

We acknowledge that whether the basis adjustments contemplated by Section 734(b) (and Section 743(b)) and the notional depreciation deductions under the remedial allocation method satisfy the various components of the No Prior Use Test or the Unrelated Purchase Test depends on the analytical approach employed. For example, in the case of a 734(b)(1)(A) Adjustment resulting from a partnership's redemption for cash of a partner's outstanding interest, immediate expensing might appear to be unavailable because the partnership used the relevant qualified property before the acquisition. Similarly, in the case of a partnership that uses the remedial allocation method following the contribution of qualified property with Section 704(c) gain, immediate expensing might appear to be unavailable because the partnership acquired the qualified property in a carryover-basis exchange pursuant to Section 721. The purpose of the basis adjustments and remedial depreciation deductions, however, is to deliver to the "acquiring" partner the same amount of tax depreciation as such partner would have claimed in the event of an actual purchase of the relevant qualified property from the other partner(s).[91]

Section 197, which generally permits amortization deductions for acquired intangible property, including goodwill and going concern value, acquired from third parties ratably over a 15-year recovery period, is a useful analogy. Because the law generally did not permit taxpayers to amortize goodwill or going concern value before Section 197, Congress included a set of anti-churning rules to ensure that taxpayers did not purchase goodwill from a related party and claim amortization deductions. Under Section 197(f)(9), taxpayers may not amortize goodwill, going concern value or other intangibles not amortizable under prior law ("**Section 197(f)(9) intangibles**"), unless they are transferred after the effective date of the statute in a transaction giving rise to a significant change in ownership or use.[92]

The Section 197 regulations address the treatment of partnership-related basis adjustments under the anti-churning rules.[93] These rules generally deem a partner acquiring a partnership interest to acquire an undivided, proportionate share of all of the partnership's assets, including all of the Section 197(f)(9) intangibles.[94] Again, solely for purposes of the anti-churning rules, the regulations deem transactions involving the partnership to occur at the partner level by and among the applicable partners. In the case of Section 743(b) adjustments, these

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[90] *See* Treas. Reg. § 1.704-3(a)(6).

[91] *See* Needham, *supra* note 58, at 43.

[92] *See* I.R.C. § 197(f)(9)(A). In general, a Section 197(f)(9) intangible is not amortizable if the taxpayer (or a related person) held the intangible before Section 197's enactment, or if the taxpayer has allowed any person that owned or used the intangible before enactment (or a person related to such person) to use the intangible.

[93] *See* Treas. Reg. § 1.197-2(h)(12)(i).

[94] *See id.* ("[E]ach partner is treated as having owned and used the partner's proportionate share of partnership property.").

rules deem a partner that transfers a partnership interest to transfer the partner's share of partnership property, including the Section 197(f)(9) intangible, to the transferee.[95]

Similarly, in the case of Section 734(b) adjustments, the anti-churning rules characterize (solely for this purpose) the continuing partners as acquiring from the distributee partner interests in the Section 197(f)(9) intangibles that remain in the partnership.[96] The anti-churning rules do not apply to the continuing partner's share of the basis adjustment to the intangible, so long as the continuing partner is not the distributee partner or related to the distributee partner.[97] The regulations compute each continuing partner's share of the basis adjustment allocable to a Section 197(f)(9) intangible in proportion to the continuing partners' capital accounts, as determined immediately after the distribution.[98]

The Section 197 regulations also provide rules to determine whether remedial allocations under Section 704(c) are deductible under the anti-churning rules. If a Section 197(f)(9) intangible was not amortizable in the hands of the contributing partner, the partnership generally may not amortize the intangible.[99] Nevertheless, a non-contributing partner may receive remedial allocations of amortization deductions if such partner is not related to the partner that contributed the intangible.[100] Similar rules apply for reverse Section 704(c) allocations arising from a Section 197(f)(9) intangible's revaluation.[101] A partnership may make remedial allocations of amortization with respect to a Section 197(f)(9) intangible if the partners receiving those allocations are not related to the partner receiving the remedial allocations of income.[102]

The Section 197 anti-churning rules address issues similar to those raised by Section 168(k). In determining whether a taxpayer used applicable intangible property before Section 197's effective date, Congress specifically mandated an aggregate theory of partnerships.[103] Treasury Regulations Section 1.197-2(h)(12) (the "**Section 197(f)(9) partnership regulations**") thus treats, for purposes of applying the anti-churning rules, (i) each partner as owning its allocable share of common partnership basis and (ii) any basis adjustment as a transfer of property between the relevant partners.

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95 *See* Applying Section 197 to Partnerships, REG-100163-00, 65 Fed. Reg. 3903, 3903 (Jan. 25, 2000) [hereinafter *Proposed 197 Regulations*].

96 *See id*. at 3904.

97 More specifically, the regulations ask whether the continuing partner is an "eligible partner." *See* Treas. Reg. § 1.197-2(h)(12)(iv)(A). A continuing partner is an eligible partner if it is not the distributee partner or a person related to the distributee partner. Treas. Reg. § 1.197-2(h)(12)(iv)(B)(1). For this purpose, any continuing partner that makes a contribution to the partnership as part of the same series of related transactions that includes the distribution is deemed related to the distributee. Treas. Reg. § 1.197-2(h)(12)(iv)(B)(2).

98 *See* Treas. Reg. § 1.197-2(h)(12)(iv)(D)(1).

99 *See* Treas. Reg. § 1.197-2(h)(12)(vii)(B).

100 *See id.*

101 *See* Rev. Rul. 2004-49, 2004-1 C.B. 939.

102 *See id.*

103 *See* I.R.C. § 197(f)(9)(E) ("With respect to any increase in the basis of partnership property under section 732, 734, or 743, determinations . . . shall be made at the partner level and each partner shall be treated as having owned and used such partner's proportionate share of the partnership assets."); *see also* H. R. REP. NO. 103-213, at 692 (1993) (Conf. Rep.) (similar).

Several considerations would support applying those principles generally, and the principles of the Section 197(f)(9) partnership regulations in particular, to Section 168(k). First, Section 168(k)(2)(E)(ii)(I) and Section 197(f)(9) serve similar purposes. That is, both provisions deny taxpayers tax benefits stemming from the ownership of property based on a concept of prior "use" and employ similar language to achieve that end.[104] In addition, Congress was silent as to the interaction between Section 168(k) and Subchapter K, and the legislative history is silent as well. Accordingly, we believe that an appropriate framework is necessary for a proper evaluation of the underlying issues, and Section 197 supplies that framework.

The government, in our view, has the authority to treat a partnership as an aggregate of its partners in order to carry out the purposes of any provision of the Code, unless the provision in question clearly mandates entity treatment.[105] Aggregate treatment is inherent in the nature of the applicable basis adjustments and in remedial allocation deductions.[106] In addition, the Section 704(c) regulations expressly provide that the excess book basis created under the remedial allocation rules is depreciated under any method available to the partnership for newly purchased property of the same type.[107] Moreover, the regulations under Section 734(b) and 743(b) expressly provide that these basis adjustments constitute newly-purchased property that electing partnerships may depreciate pursuant to Section 168 over the "applicable recovery period."[108]

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[104] *Compare* I.R.C. § 168(k)(2)(E) (property disqualified if "*used* by the taxpayer at any time prior to . . . acquisition" (emphasis added)), *with* I.R.C. § 197(f)(9)(A)(i) (property disqualified if "*held or used* at any time . . . on or before [the] date of enactment by the taxpayer or a related person . . . ." (emphasis added)). The concept of amortization historically has been considered similar to depreciation, and the Code specifically treats amortizable Section 197 intangibles as depreciable assets for Section 167 purposes. *See* I.R.C. § 197(f)(7); *see also, e.g.*, Treasury Regulations No. 94, Relating to the Income Tax under the Revenue Act of 1936, Art. 23(l)-3 (1936) ("Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, licenses, and franchises.").

[105] *See* H.R. Rep. No. 83-2543, at 59 (1954) (Conf. Rep.) ("No inference is intended . . . that a partnership is to be considered as a separate entity for the purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions."). When interpreting the Code, courts have stated that the "proper inquiry" is whether "it is more appropriate to treat the partnership as an aggregate or collection of individuals than as a separate entity." *Holiday Vill. Shopping Ctr. v. United States*, 773 F.2d 276, 279 (Fed. Cir. 1985) (internal quotation marks omitted); *see also Casel v. Comm'r*, 79 T.C. 424, 433 (1982).

[106] *See* Needham, *supra* note 58, at 52.

[107] *See* Treas. Reg. § 1.704-3(d)(2).

[108] *See* Treas. Reg. § 1.734-1(e)(1); Treas. Reg. § 1.743-1(j)(4)(i)(B)(1). In 1984, the government issued proposed regulations under the ACRS anti-churning rules that were never finalized. These regulations did address the treatment of Section 734(b) and Section 743(b) transactions for purposes of ACRS, and would have denied a partnership the use of ACRS depreciation for any adjustment to the basis of property that did not itself qualify for ACRS under the anti-churning rules, *i.e.*, because the property was acquired by the partnership but owned or used prior to the enactment of ACRS by the partnership or a related person. *See* Prop. Reg. § 1.168-4(d)(8). We note that these proposed regulations were issued before the government provided that basis adjustments under Section 734(b) and Section 743(b) were to be treated as newly-purchased property for Section 168 purposes. *See* T.D. 8847, 64 Fed. Reg. 69903 (Dec. 15, 1999) (enacting Treas. Reg. § 1.743-1(j)(4)(i)(B) and Treas. Reg. § 1.734-1(e)(1)). Nor was the remedial

We endorse the determination in the Proposed Regulations to allow immediate expensing with respect to certain Section 743(b) basis adjustments. In addition, we respectfully recommend that the government generally adopt an aggregate approach in evaluating whether a particular transfer of qualified property satisfies the No Prior Use Test and the Unrelated Purchase Test. These determinations, therefore, would be made at the partner level.

a. Remedial Allocation Deductions

Applying an aggregate approach in determining Section 168(k) eligibility in the case of a partnership that uses the remedial allocation method, (i) to the extent of the "forward" Section 704(c) layer attributable to a contribution of qualified property to the partnership, the noncontributing partners would be treated as having purchased the qualified property directly from the contributing partner, and (ii) to the extent of the "reverse" Section 704(c) layer attributable to a permissible revaluation by the partnership, similar principles would apply to treat the deemed noncontributing partners as having purchased the qualified property directly from the deemed contributing partners. In each case, compliance with the No Prior Use Test and Unrelated Purchase Test would be tested at the partner level, and the partnership's status as a "prior user" of the property and potential related party would be disregarded.

We think that the government has ample authority under Section 704(c) to permit immediate expensing in the case of partnerships that use the remedial allocation method. Permitting immediate expensing in this context, in our view, would be fully consistent with the treatment of the excess book basis asset as newly purchased property under the Section 704(c) regulations and would further the congressional intent underlying the amendment to Section 168(k) in the Act, namely, to promote investment in qualified property. We believe that the decision whether to have the partnership elect the remedial allocation method is an appropriate matter for negotiation among the partners. The extension of immediate expensing to remedial allocations generally would not affect the fisc, so long as all the parties are in the same tax bracket. Although the Section 704(c) regulations already contain an anti-abuse rule,[109] if the government thought it were necessary, it could consider an anti-abuse rule in the Section 168(k) regulations to police situations in which there were potential rate differentials among the partners, *e.g.*, a corporation contributes qualified property to a partnership in which an individual is a partner, and the remedial income allocations are taxed at 21% while the remedial allocation deductions reduce income otherwise taxable at 37%.

We note that the initial proposed Section 197 anti-churning regulations did not allow remedial allocations of amortization of Section 197(f)(9) intangibles that were not amortizable in the hands of the contributing partner.[110] In permitting such deductions in the final regulations, the government explained that, "under section 704(c), remedial allocations treat the amortizable portion of contributed property like newly purchased property."[111] The government also noted

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allocation method available yet. It only applies to contributions or revaluations of property after December 20, 1993. *See* Treas. Reg. § 1.704-3(f).

109 *See* Treas. Reg. § 1.704-3(a)(10).

110 *See* Former Prop. Reg. § 1.197-2(h)(5)(ii), 62 Fed. Reg. 2336, 2350 (Jan. 16, 1997).

111 T.D. 8865, 65 Fed. Reg. 3820, 3823 (Jan. 25, 2000).

the similarity between remedial allocations and "basis increases under section 743."[112] In our view, these same considerations strongly support the availability in the final regulations under Section 168(k) of immediate expensing for remedial allocation deductions.

b. Section 734(b) Adjustments

Applying the aggregate approach recommended above, a Section 734(b) basis adjustment attributable to qualified property arising from a partnership distribution to a distributee partner would be treated for Section 168(k) eligibility purposes as if the continuing partners purchased the qualified property directly from the withdrawing partner. Adoption of the aggregate approach alone, however, does not answer whether Section 734(b) adjustments attributable to qualified property should be eligible for immediate expensing.

There are policy arguments in support of permitting a Section 168(k) deduction with respect to a basis adjustment under Section 734(b). A Section 734(b) transaction resembles some of the transactions for which the government has decided to allow a Section 168(k) deduction (*e.g.*, a Section 743(b) transaction) or for which we have suggested a Section 168(k) deduction should be permitted (remedial allocation deductions). In addition, regulations provide that, like a basis adjustment under Section 743(b), a Section 734(b) basis adjustment is treated as newly purchased property, suggesting that both basis adjustments should come to the same result for most U.S. tax issues.[113]

We evaluate 734(b)(1)(A) Adjustments and 734(b)(1)(B) Adjustments separately below. Although we do not recommend at this time that immediate expensing should be available for either adjustment, we think that 734(b)(1)(A) Adjustments present a strong case for eligibility, and we suggest that the government consider this question in connection with its evaluation of the proposed regulations under Section 751(b) and Section 755.

i. Section 734(b)(1)(A) Adjustments

As stated above, a 734(b)(1)(A) Adjustment increases the partnership's basis by the amount of gain recognized by a distributee partner upon a partnership distribution. The triggering event is a taxable transaction in which the distributee partner recognizes gain that is considered gain from the sale or exchange of its partnership interest. For the reasons discussed above, we think it would be appropriate to view this transaction, for purposes of determining compliance with the No Prior Use Test, under aggregate principles as a transfer of the qualified property from the withdrawing partner to the continuing partners. Viewed this way, a 734(b)(1)(A) Adjustment may be analyzed as though the continuing partners purchased, for cash, the withdrawing partner's interest in any remaining qualified property. In addition, the Section 734 regulations already suggest the purchase-like nature of the basis adjustment allocable to depreciable property, providing that such increase is "taken into account as if it were newly-purchased recovery property placed in service when the distribution occurs."[114] In these respects, we think that 734(b)(1)(A) Adjustments can be viewed similarly to Section 743(b)

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[112] *Id.*
[113] *See* Treas. Reg. § 1.734-1(e)(1).
[114] *See id.*

adjustments, which under the Proposed Regulations generally can qualify for immediate expensing.

In the preamble to the Proposed Regulations, the government denied immediate expensing for Section 734(b) adjustments allocable to qualified property on the grounds that the partnership is necessarily a previous user of the property. [115] However, our recommendation of an aggregate approach for evaluating eligibility for immediate expensing, if adopted, would necessarily address this concern and align the evaluation of 734(b)(1)(A) Adjustments and Section 743(b) adjustments, which the Proposed Regulations view through an aggregate approach.

Notwithstanding the strong arguments in support of extending immediate expensing to 734(b)(1)(A) Adjustments, we believe such adjustments raise several technical concerns under the proposed regulations to Section 751(b). Generally, Section 751(b) overrides the usual nonrecognition rules of Section 731 in the case of certain partnership distributions that alter a partner's interest in "unrealized receivables" and substantially appreciated "inventory items" (collectively, "**hot assets**"). For this purpose, qualified property is a hot asset to the extent of any gain that would be treated as ordinary income under Section 1245 if sold at fair market value.[116] Under the existing regulations, if a distribution results in an exchange of all or a portion of the distributee partner's interest in one class of assets for assets in the other class, the distributee partner is deemed to receive a distribution of the relinquished assets (immediately prior to the actual distribution) and then exchange the relinquished assets with the partnership for the acquired assets (the "**asset exchange approach**").[117] Partnerships with depreciated qualified property may be subject to these rules because a portion of any built-in gain is likely potential ordinary income under the Section 1245 depreciation recapture rules.

In November 2014, the government published proposed regulations that would make substantial revisions to the existing regulations under Section 751(b), Section 755 and related provisions (collectively, the "**Proposed 751 Regulations**").[118] In relevant part, the Proposed 751 Regulations provide that, once it is determined that a distribution is a Section 751(b) distribution, the partnership must use a "reasonable approach" consistent with the purpose of Section 751(b) under which, immediately prior to the Section 751(b) distribution, each partner with a Section 751(b) amount recognizes ordinary income (or eliminates a basis adjustment) equal to its respective Section 751(b) amount.[119]

115 *See Proposed Regulations*, *supra* note 2, 83 Fed. Reg. at 39,296.

116 *See* I.R.C. § 751(c).

117 *See* Treas. Reg. § 1.751-1(b)(2).

118 79 Fed. Reg. 65,151 (Nov. 3, 2014), *as amended by* 80 Fed. Reg. 3926 (Jan. 26, 2015). For our report on these proposed regulations, see NEW YORK STATE BAR ASSOCIATION TAX SECTION, REPORT # 1329 ON PROPOSED REGULATIONS UNDER SECTION 751(B) (2015), *reprinted in*, 2015 TNT 175-21 (Sept. 10, 2015) [hereinafter *2015 Report*]. We note that the Proposed 751 Regulations generally provide that a partnership may rely on the proposed rules in determining a partner's interest in hot assets on or after the date of publication of the proposed rules. Specifically, the Proposed 751 Regulations permit reliance only on Proposed Treasury Regulation Section 1.751-1(a)(2) (relating to the clarification of the amount of ordinary income that can be recognized under Section 751(a)), -1(b)(2) (relating to the determination of the Section 751(b) amount), and -1(b)(4) (relating to the anti-abuse rule).

119 *See* Prop. Treas. Reg. § 1.751-1(b)(3)(i).

The Proposed 751 Regulations do not mandate a specific method, but suggest that the "hot asset sale approach" and the "deemed gain approach" generally would be considered reasonable. Very generally, under the hot asset sale approach, a partnership is deemed to distribute Section 751 property to the partner whose interest in the partnership's Section 751 property is reduced, and then the partner is deemed to sell the Section 751 property back to the partnership immediately before the actual distribution.[120] By contrast, the deemed gain approach would require that (i) a partnership recognize gain in its hot assets equal to the aggregate reduction in the partners' share of hot-asset gain, (ii) the gain be allocated to the partner(s) whose share of hot asset gain would otherwise be reduced, and (iii) appropriate basis adjustments be made to the partnership's assets to reflect the recognition of the hot asset gain.[121]

It is not clear the extent to which these basis adjustments would be eligible for immediate expensing or would be treated as failing the No Prior Use Test.[122] Accordingly, while strong arguments can be made in support of extending immediate expensing to 734(b)(1)(A) Adjustments, we think that, on balance, it would be appropriate for the government to consider this issue in connection with its consideration of its course of action on the Proposed 751 Regulations (including the proposed regulations under Section 755).[123]

In this regard, we note that the government previously observed, in connection with the finalization of the Prior 168(k) Regulations, that 734(b)(1)(A) Adjustments "allocable to qualified property under section 755 would have no correlation to the taxpayer's cost of the property."[124] We respectfully disagree and believe that there generally is a correlation between 734(b)(1)(A) Adjustments and the cost of qualified property. Within the class of capital gain property, a 734(b)(1)(A) Adjustment is allocated initially in accordance with relative appreciation in the assets and then in accordance with relative fair market values. Admittedly, the correlation is not perfect. These allocation rules create some distortion from what the allocation of a 734(b)(1)(A) Adjustment would be if the adjustment were based solely on fair market value.[125] First, no part of a 734(b)(1)(A) Adjustment is allocated to ordinary income property. Thus, a 734(b)(1)(A) Adjustment will increase the partnership's basis in capital gain property even if, economically, the adjustment is attributable to appreciation in a partnership's ordinary income property. Second, an allocation of the 734(b)(1)(A) Adjustment may cause the partnership's basis in particular assets to exceed their fair market value.

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120 *See* Notice 2006-14, 2006-1 C.B. 498 (Feb. 2, 2006). For our report on the Notice, see NEW YORK STATE BAR ASSOCIATION TAX SECTION, REPORT # 1122 RESPONDING TO NOTICE 2006-14 RELATING TO THE TREATMENT OF PARTNERSHIP DISTRIBUTIONS UNDER SECTION 751(B) (2006), *reprinted in*, 2006 TNT 230-8 (Nov. 30, 2006) [hereinafter *2006 Report*].

121 *See 2006 Report*. The Proposed 751 Regulations also clarify that a Section 734(b) adjustment allocable to depreciable property is not taken into account in determining the recomputed or adjusted basis in depreciable property for purposes of Section 1245(a)(1). *See* Prop. Reg. § 1.755-1(c)(2)(iii).

122 Our prior reports have noted the potential anti-churning issues raised by the deemed transactions occurring under the hot asset sale approach. *See 2015 Report*, *supra* note 118, at 12 n.16; *2006 Report*, *supra* note 120, at 51.

123 We note our recommendation in the 2015 Report encouraging Congress and Treasury to reevaluate the purposes of, and stakes involved with, Section 751(b) and consider whether the statute should be amended to make Section 751(b) operate far more narrowly as an anti-abuse rule.

124 *See* T.D. 9283, 71 Fed. Reg. 51,727, 51,736 (Aug. 31, 2006).

125 *See* Treas. Reg. § 1.755-1(c)(1)(ii).

Because of these distortions, we recommend that, if the government concludes that 734(b)(1)(A) Adjustments are eligible for immediate expensing, the amount of basis eligible for immediate expensing should be limited to the portion of the adjustment that does not cause the basis of the qualified property to exceed its fair market value at the time the adjustment arises.[126] In addition, as stated above, the portion of gain in Section 1231 property that is attributable to depreciation recapture generally is treated as a separate asset that is ordinary income property.[127] Accordingly, while we are mindful of the resulting complexity, we note that the government may wish to consider whether to impose a further limitation, such that a 734(b)(1)(A) Adjustment would be eligible for immediate expensing only to the extent that the adjustment would have been made to the asset if the adjustment were allocated among all partnership property (and not only capital gain property).

ii. Section 734(b)(1)(B) Adjustments

In addition to the reasons stated above, we believe immediate expensing of 734(b)(1)(B) Adjustments is inappropriate because, unlike the other adjustments discussed in this report, such an adjustment does not arise from the recognition of gain and, therefore, does not resemble a new investment attributable to a true, arm's length purchase. Stated differently, a 734(b)(1)(B) Adjustment is no more than a reallocation of basis from a distributed asset to remaining partnership property, the effect of which is to preserve aggregate unrealized gain or loss with respect to distributed and retained partnership assets. Permitting immediate expensing of these adjustments would thus result in an immediate deduction for the continuing partners, but gain deferral for the partner receiving the distribution.[128] Accordingly, we do not think that the final regulations should permit immediate expensing of 734(b)(1)(B) Adjustments attributable to qualified property.[129]

3. Proposed Modifications Relating to Section 743(b) Adjustments

a. Treasury Regulations Section 1.743-1(j)(4)(i)(B)(2)

Treasury Regulations Section 1.743-1(j)(4)(i)(B)(2) requires that a partnership using the remedial allocation method to recover the portion of any Section 743(b) increase allocable to

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126 Thus, for example, if a partnership owns qualified property with a basis of $30 and a fair market value of $100, and a 734(b)(1)(A) Adjustment of $80 attached to the property, only $70 of the adjustment would be eligible for immediate expensing, and then only to the extent attributable to continuing partners unrelated to the distributee partner. We note that the Section 355(d) regulations contain a similar concept, limiting the extent to which a Section 734(b) adjustment to stock basis is treated as "purchased" for Section 355(d) purposes to the fair market value of the stock at the time of the adjustment. *See* Treas. Reg. § 1.355-6(d)(2)(v)(B).

127 *See* Treas. Reg. § 1.755-1(a)(1).

128 We recognize that Treasury Regulations Section 1.197-2 adopts a more taxpayer-friendly approach, but, for the reasons discussed above, we do not favor importing that treatment in the case of 734(b)(1)(B) Adjustments to Section 168(k).

129 We also agree with the determination in the Proposed Regulations that Section 732 basis adjustments attributable to qualified property should not qualify for immediate expensing. *See Proposed Regulations*, *supra* note 2, 83 Fed. Reg. at 39,296.

Section 704(c) built-in gain over the remaining recovery period for the partnership's excess book basis in the property, "as determined in the final sentence of Treasury Regulations Section 1.704-3(d)(2)."[130] Thus, while Section 743(b) generally treats the adjustment as new property with a new placed-in-service date, the regulations change this treatment to the extent of the remaining Section 704(c) gain inherited by the transferee partner. Instead, the recovery period is the useful life of the related Section 704(c) layer.

Although the purpose of this rule is to align the recovery period governing the adjustment with the remaining recovery period governing the remedial income to the transferee, it has the effect of precluding a Section 168(k) deduction. By contrast, if the partnership had used a different Section 704(c) method (such as the traditional method) with regard to the property, the related Section 743(b) adjustment would have been eligible for immediate expensing given that Treasury Regulations Section 1.743-1(j)(4)(i)(B)(2), by its terms, applies solely in the remedial allocation context. It generally is understood that the government favors the remedial allocation method because it eliminates ceiling rule distortions and that the special rule in Treasury Regulations Section 1.743-1(j)(4)(i)(B)(2) was intended to incentivize partnerships to use that method (and foster "fungibility" of interests in publicly traded partnerships). In addition, this special rule presumably was intended to benefit taxpayers by permitting cost recovery for a Section 743(b) adjustment over the shorter recovery period applicable to the remedial income for the related recovery property, rather than a longer, newly-created recovery period. The interaction of this special rule with Section 168(k), however, essentially reverses the effect of the special rule, which now discourages use of the remedial method and requires cost recovery with respect to Section 743(b) adjustments over a longer period of time. By effectively limiting the availability of a Section 168(k) deduction for acquirors of partnership interests that have made a cognizable capital investment in qualified property, this special rule, as applied in situations where immediate expensing is otherwise available, also arguably runs counter to Congress's intent in expanding the immediate expensing rules in the Act.

Based on the foregoing, a majority of the Executive Committee recommends that the government modify Treasury Regulations Section 1.743-1(j)(4)(i)(B)(2). Specifically, the government should permit a partnership to elect immediate expensing with respect to the portion of the Section 743(b) adjustment that is attributable to Section 704(c) built-in gain, even if the partnership is using the remedial allocation method with regard to that Section 704(c) gain.

On the other hand, for the reasons discussed below, a minority of the Executive Committee would recommend that the government make no change to Treasury Regulations Section 1.743-1(j)(4)(i)(B)(2). As currently written, the provision has the effect of aligning the period over which a purchasing partner may recover its Section 743(b) adjustment attributable to the Section 704(c) built-in gain with the period over which the corresponding remedial allocations of income are made. Immediate expensing of the Section 743(b) adjustment attributable to the Section 704(c) built-in gain would disadvantage the government from a timing

[130] In general, Subchapter K does not require symmetry between the amortization by a purchaser of a partnership interest of its Section 743(b) basis adjustment and any related recognition of income or gain with respect to Section 704(c) property. *See generally* Gregory J. Marich & William S. McKee, *Sections 704(c) and 743(b): The Shortcomings of the Existing Regulations and the Problem of Publicly Traded Partnerships*, 41 TAX L. REV. 627 (1986).

perspective: deductions would be accelerated, while the corresponding remedial allocations of income would not.

b. Successive Transfers of Partnership Interests

Under Proposed Regulations Section 1.168(k)-2(b)(3)(iv), for purposes of applying the No Prior Use Test and Unrelated Purchase Test, the transfer of a partnership interest is treated as the transfer, by the transferor to the transferee, of a depreciable interest in the transferor's proportionate share of the underlying partnership property. If the partnership has a Section 754 election in place (or there is a substantial built in loss), any increase in basis of depreciable property under Section 743(b) may be eligible for immediate expensing, so long as the No Prior Use Test and Unrelated Purchase Test are met as between the transferor partner and the transferee partner. However, this rule's application is unclear where the transferee ("**T1**") disposes of the partnership interest in a Section 168(i)(7) transaction to a transferee ("**T2**") in the same taxable year in which T1 acquires the partnership interest. Ordinarily, under Proposed Regulations Section 1.168(k)-2(f)(1)(iii), the adjustment would be entitled to immediate expensing, notwithstanding the disposition, with the only consequence that T1 would share the deduction with T2 based on the number of months during the taxable year that T1 and T2, respectively, held the property. However, Proposed Regulations Section 1.168(k)-2(f)(1)(iii) applies, by its terms, solely to dispositions of qualified property. It does not apply to transfers of any other assets, including partnership interests, even if those interests correspond to Section 743(b) basis adjustments in qualified property.[131]

The uncertainty stems, in part, from the state of the law regarding Section 743(b) adjustments and transfers of partnership interests. Under Treasury Regulations Section 1.743-1(f), where there has been more than one transfer of a partnership interest, a transferee's basis adjustment is determined without regard to any prior transferee's basis adjustment. Under regulations proposed in 2014, however, if a partnership interest is transferred in a "substituted basis transaction" within the meaning of Treasury Regulations Section 1.755-1(b)(5), the transferee succeeds to any Section 743(b) basis adjustment of the transferor.[132] Under the approach of these proposed regulations, while T2 may succeed to T1's basis adjustment, T2's acquisition of the adjustment would not appear to satisfy the Unrelated Purchase Test. Instead, the acquisition appears to violate Section 179(d)(2)(C) (because the adjustment is inherited from T1) and possibly Section 179(d)(2)(A) (to the extent T1 and T2 are more than 50 percent related).[133]

We believe that the treatment of partnership interests should be aligned with the treatment of proportionate shares of qualified property. To this end, we recommend that the final

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131 The rule in Proposed Regulations Section 1.168(k)-2(b)(3)(iv) that the transfer of a partnership interest is treated as the transfer of the underlying partnership property only applies for a limited purpose (determining compliance with the No Prior Use Test) and does not appear to recast the partnership interest, in whole or in part, as qualified property for purposes of Proposed Regulations Section 1.168(k)-2(f)(1)(iii).

132 *See* Prop. Reg. 1.743-1(f), 79 Fed. Reg. 3042 (Jan. 16, 2014).

133 We note that "self-help" may be available to the extent that T1 can close its taxable year before the transfer of the partnership interest to T2. *See* I.R.C. § 706(c)(2).

regulations provide that, for purposes of the rule currently in Proposed Regulations Section 1.168(k)-2(f)(1)(iii), a partnership interest is treated as a depreciable interest in the partner's proportionate share of the underlying partnership property.

4. Section 168(k)(7) Elections for Partnership Basis Adjustments

The Proposed Regulations flexibly interpret the Section 168(k)(7) Election rules with respect to partnership adjustments. Specifically, as we read the Proposed Regulations, they would permit the following: (i) if a partnership has made a Section 168(k)(7) Election with respect to a class of qualified property that the partnership owns, the partnership can immediately expense Section 743(b) adjustments allocable to property of the same class, (ii) a partnership may make a Section 168(k)(7) Election with respect to Section 743(b) adjustments allocable to qualified property of a certain class, even if the partnership does not make a Section 168(k)(7) Election for all of its qualified property in such class, (iii) a partner can immediately expense Section 743(b) adjustments allocable to qualified property held by the partnership, even if such adjustments are allocable to qualified property with respect to which the partner itself has made a Section 168(k)(7) Election, and (iv) a partnership can make inconsistent Section 168(k)(7) Elections with respect to different Section 743(b) adjustments.[134]

While we appreciate the above flexibility, we nonetheless recommend that the government require consistency in the final regulations. For instance, one approach, which would be simplest to administer, would provide that any election out of immediate expensing by a partnership with respect to its qualified property would apply equally to the partnership's common basis as well as any Section 743(b) basis adjustments. In addition, the partnership could not separately elect out of immediate expensing with respect to any Section 743(b) basis adjustments available to its partners.

Alternatively, the government might require that any Section 168(k)(7) Election with respect to partnership basis adjustments would have to be consistent with the relevant partner's treatment of qualified property in the same class. Under this alternative, a partnership could not elect out of immediate expensing for Section 743(b) adjustments with respect to a particular class of qualified property unless the applicable partner also elected out of immediate expensing for qualified property in the same class. This alternative arguably would harmonize with the general approach of the Proposed Regulations to analyze Section 743(b) adjustments at the partner (rather than the partnership) level.[135] However, in contrast to the first approach, the partnership's Section 168(k)(7) Elections with respect to partnership basis adjustments would not have to be consistent with the partnership's own treatment of qualified property. In addition, under this alternative, the partnership could make inconsistent Section 168(k)(7) Elections with respect to Section 743(b) adjustments among different partners.

Finally, if the government adopts our recommendation to permit immediate expensing with respect to remedial allocation deductions, we recommend that any Section 168(k)(7) Election with respect to such remedial allocations be treated consistently with the other Section 168(k)(7) Elections for partnership basis adjustments. For instance, if the government were to

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[134] *See* Prop. Reg. § 1.168(k)-2(e)(1); Prop. Reg. § 1.743-1(j)(4)(i)(B)(1).

[135] *See Proposed Regulations*, *supra* note 2, 83 Fed. Reg. at 39296.

adopt our first suggested approach for imposing consistency with respect to Section 168(k)(7) Elections, then an applicable partnership would make any Section 168(k)(7) Elections with respect to remedial allocation deductions at the partnership level.

5. Transferor Allocation Rule

a. Introduction

Proposed Regulations Section 1.168(k)-2(f)(1)(i) preserves the rule under the current regulations that qualified property placed in service and disposed of during the same taxable year generally is not eligible for immediate expensing.[136] Both the current regulations and the Proposed Regulations contain an exception to this general rule that allows Section 168(k) deductions for qualified property despite a later disposition of the qualified property in the same taxable year if the acquiror effects the later disposition through a Section 168(i)(7) transaction (generally, a transfer in which basis carries over to the transferee).[137] As is the case in the current regulations, the transferor and transferee must share the deduction, with the deduction allocated between the transferor and transferee based on the number of months each holds the qualified property within the taxable year.[138] However, the Proposed Regulations would carve out an exception to Section 168(i)(7) for certain partnership contributions. Specifically, under the penultimate sentence of Proposed Regulations Section 1.168(k)-2(f)(1)(iii) (the "**Transferor Allocation Rule**"), if the qualified property is transferred in a Section 721(a) contribution to a partnership that has as a partner a person (other than the transferor) who previously used the qualified property in the same taxable year that it is placed in service by the transferor, the Section 168(k) deduction is allocated entirely to the transferor.

The Transferor Allocation Rule appears to have been crafted with transactions like Situation 1 of Revenue Ruling 99-5[139] (a "**Situation 1 Transaction**") in mind, although, as described below, this rule would cut considerably more broadly.[140] Consider the facts of Situation 1 with the following modifications. LLC owns qualified property with a basis of zero and a fair market value of $100. A owns all of the outstanding interests in LLC, which is disregarded as separate from A for U.S. tax purposes, and sells a 60-percent interest in LLC to an unrelated purchaser, B, for $60. The transaction is characterized for U.S. tax purposes as B's acquisition of a 60-percent interest in the qualified property, followed immediately by the contribution by A and B of their respective interests in the qualified property to a partnership in exchange for partnership interests in a Section 721(a) transaction. As a result of this characterization, A recognizes $60 of gain under Section 1001(a) on the sale of the 60-percent interest in the qualified property, and B takes a Section 1012(a) cost basis of $60 in its share of the qualified property. B's acquisition thus qualifies as a "purchase" under Section 179, and, if B is treated as placing the qualified property in service prior to B's deemed contribution to the

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136 *See* Treas. Reg. § 1.168(k)-1(f)(1)(i).

137 *See* Treas. Reg. § 1.168(k)-1(f)(1)(iii); Prop. Reg. § 1.168(k)-2(f)(1)(iii).

138 The allocation is made in accordance with the rules in Treasury Regulations Section 1.168(d)-1(b)(7)(ii).

139 1999-1 C.B. 434.

140 *See Proposed Regulations*, *supra* note 2, 83 Fed. Reg. at 39,299 (describing a Situation 1 Transaction "as an example of . . . a fact pattern" to which the Transferor Allocation Rule would apply).

partnership, B is entitled to a Section 168(k) deduction of $60. B's deemed contribution under Section 721(a) of its interest in the qualified property to the newly formed partnership does not disqualify B from a Section 168(k) deduction under Proposed Regulations Section 1.168(k)-2(f)(1)(i) because a Section 721(a) contribution is a Section 168(i)(7) transaction. Without the Transferor Allocation Rule, B and the partnership must share in the resulting deduction, with the effect that A could be allocated $24 of the deduction (*i.e.*, 40 percent of $60) by virtue of its interest in the partnership. The Transferor Allocation Rule, however, allocates the entire deduction to B, precluding A from receiving any Section 168(k) benefit.

The proper treatment of Situation 1 Transactions and other partnership contribution transactions is difficult, and the government's approach embodied in the Transferor Allocation Rule offers both advantages and disadvantages. On balance, we believe that the Transferor Allocation Rule would be unnecessary for addressing Situation 1 Transactions and other partnership contribution transactions, and the complications the rule creates could be avoided, if the government adopts our recommendations regarding immediate expensing of remedial allocations. Alternatively, if the government does not permit immediate expensing of remedial allocations, we believe that certain changes to the Transferor Allocation Rule would be appropriate. We discuss below the advantages and disadvantages of the Transferor Allocation Rule before turning to the details of our recommendations.

i. <u>Proposed Regulations' Approach</u>

Initially, we acknowledge that the Transferor Allocation Rule has merit. It offers a straightforward, easily administrable rule for Situation 1 Transactions, which are common in everyday practice. The Transferor Allocation Rule also aligns the treatment of Situation 1 Transactions with the Proposed Regulations' treatment of Section 743(b) adjustments. Just as the Proposed Regulations consider the purchaser of a partnership interest as acquiring a proportionate share of the partnership's qualified property, so do the Proposed Regulations consider the purchaser in a Situation 1 Transaction as purchasing a proportionate share of the underlying qualified property. The Proposed Regulations reward both purchasers with all of the bonus depreciation.

However, the Transferor Allocation Rule has several flaws. First, it is unclear why the newly formed partnership in a Situation 1 Transaction should *never* be allocated bonus depreciation deductions. As the preamble to the Proposed Regulations makes clear, the Transferor Allocation Rule keeps bonus depreciation deductions away from the newly formed partnership out of a concern that the partnership could allocate the deductions to the seller.[141] The statute, however, generally allows a partnership to take bonus depreciation deductions on qualified property purchased from other than a majority partner. Section 179(d)(2)(A), as incorporated by Section 168(k)(2)(E)(ii)(I), excludes qualified property only if acquired from a person whose relationship to the acquiror would result in the disallowance of losses under Section 267 or Section 707(b). For a partnership acquiring qualified property from a partner, this means that the only acquisitions that are disqualifying under Section 179(d)(2)(A) are those from partners owning, directly or indirectly, more than 50 percent of the capital interests or the profits

[141] *See Proposed Regulations*, *supra* note 2, 83 Fed. Reg. at 39,299.

interests in the partnership. A partnership, therefore, could satisfy Section 179(d)(2)(A) and, assuming all other applicable requirements are met, immediately expense the cost of qualified property that it acquires from a 50-percent-or-less partner. The Transferor Allocation Rule, nonetheless, presupposes that a partnership should not immediately expense the cost of qualified property held by *any* partner. Indeed, the preamble to the Proposed Regulations appears to say as much.[142] We believe that presupposition is incorrect.

Second, the Transferor Allocation Rule creates discrepancies in the treatment of immediate expensing across different kinds of partnership formation transactions. For example, the Transferor Allocation Rule produces a result for Situation 1 Transactions that is much different from the result under the statute for the set of facts sometimes referred to as the "Missing Situation 3" of Revenue Ruling 99-5 ("**Situation 3 Transactions**"). Like in the Situation 1 Transaction described above, assume that A owns all of the outstanding interests in LLC, except that B contributes $60 cash to LLC in exchange for a 60-percent ownership interest, and LLC distributes $60 to A. Under Treasury Regulations Section 1.707-3(b)(1), the cash distribution is treated as a partial sale by A to the newly formed partnership, and A would recognize $60 of gain. However, B would be allocated only $36 (*i.e.*, 60% of $60) of the partnership's Section 168(k) deduction. It is unclear why different treatment of Situation 1 Transactions and Situation 3 Transactions is appropriate.[143]

The Transferor Allocation Rule's treatment of Situation 1 Transactions also contrasts with the treatment of transactions like Situation 2 of Revenue Ruling 99-5 ("**Situation 2 Transactions**"). Assume that B contributes $60 cash to the LLC in exchange for a 60-percent interest in LLC, which uses the contributed cash in its business. For U.S. tax purposes, A is treated as contributing the qualified property to the newly formed partnership in exchange for a 40-percent interest, while B is treated as contributing $60 in exchange for the 60-percent interest. Under the Proposed Regulations, because B is not considered to acquire any qualified property, B is not eligible for immediate expensing. The newly formed partnership is also ineligible for immediate expensing, because its basis in the qualified property is determined under Section 723 by reference to the basis of the qualified property in A's hands, which the Unrelated Purchase Test precludes. The reason, though, for treating Situation 1 Transactions differently is unclear: in both cases, B parted with $60, but only in Situation 1 is B eligible to claim immediate expensing.

Third, as noted earlier, the Transferor Allocation Rule sweeps more broadly than Situation 1 Transactions. Indeed, this special rule, by its terms, applies whenever qualified property is contributed in a Section 721(a) transaction to a partnership that has as a partner a

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[142] *See id.* ("The Treasury Department and the IRS believe that allocating any portion of the deduction to a partner who previously had a depreciable interest in the property would be inconsistent with section 168(k)(2)(E)(ii)(I).").

[143] By way of comparison, we note that the Section 197 anti-churning rules align the treatment of Situation 1 Transactions and Situation 3 Transactions. *See* Treas. Reg. § 1.197-2(k), Exs. 17, 18. In the Situation 3 Transaction, this is because of the relationship between the contributing partner and the partnership (tested at a more-than-20-percent threshold). *See* Treas. Reg. § 1.197-2(h)(6). In the Situation 1 Transaction, this is because of a special rule in the Section 197 anti-churning regulations that tests whether the transferee in a nonrecognition transaction is related to a prior disqualifying user, even if the transferor is unrelated. *See* Treas. Reg. § 1.197-2(h)(10).

person (other than the transferor) who previously had a depreciable interest in the qualified property, provided that the contribution occurs in the same taxable year in which the qualified property is placed in service.[144] Thus, for example, assume that B purchases from A qualified property in a transaction otherwise eligible for immediate expensing, B immediately contributes the qualified property to a partnership for a 45-percent interest, A contributes cash for a 5-percent interest, and an unrelated party C contributes cash to the partnership for a 50-percent interest. In such case, the Transferor Allocation Rule would allocate all of the bonus depreciations deductions to B. Since A is a partner in the partnership, the partnership would be entitled to none of the deductions, and, thus, C would obtain no Section 168(k) benefit from its investment in the partnership. The rationale for applying the Transferor Allocation Rule in this context is unclear, especially because C, a third party that never held a depreciable interest in the qualified property, joins the partnership in a transaction tantamount to a purchase transaction, *i.e.*, the type of activity Congress sought to encourage in the Act.

Finally, the Transferor Allocation Rule, as with any bright-line rule, appears susceptible to manipulation. For example, assume that a taxpayer acquires and places in service qualified property in a transaction that is otherwise eligible for immediate expensing, and, in the same taxable year, the taxpayer contributes the qualified property to a partnership in a Section 721(a) transaction. Ordinarily, under Proposed Regulations Section 1.168(k)-2(f)(1)(iii), the taxpayer would surrender a portion of its bonus depreciation deductions to the partnership. However, the taxpayer might seek to enlist the seller of the qualified property to join the partnership, perhaps by assigning the seller only a 1-percent interest, in which case the Transferor Allocation Rule would apply to prevent any allocation of bonus depreciation deductions to the partnership. The Transferor Allocation Rule asks solely whether the seller is a partner in the partnership to which the qualified property is contributed. In this way, the Transferor Allocation Rule is easy to plan into, as all the parties need to do is issue a small partnership interest to the seller. If the Transferor Allocation Rule can easily be planned into, then the general rule of Proposed Regulations Section 1.168(k)-2(f)(1)(iii) can just as easily be avoided.

ii. Remedial Allocation Approach

Immediate expensing of remedial allocations, which we generally endorse above, would largely obviate the need for the Transferor Allocation Rule and generally avoid the problems identified above. Consider the Situation 1 Transaction described above, but without the Transferor Allocation Rule and assuming that remedial allocations can be immediately expensed. Under the fiction of Revenue Ruling 99-5, B is deemed to acquire a 60-percent interest in the qualified property for $60 and, so long as B is treated as placing the qualified property in service prior to B’s deemed contributed to the partnership, B receives a Section 168(k) deduction of $60. However, under Proposed Regulations Section 1.168(k)-2(f)(1)(i) and without the Transferor Allocation Rule, all $60 of the Section 168(k) deduction would be claimed by the newly formed partnership. Because B is a partner in the newly formed partnership, B does not lose the deduction entirely, but rather must share the deduction with A under the terms of the partnership agreement, $24 (*i.e.*, 40 percent) to A and $36 (*i.e.*, 60 percent) to B. Furthermore, if the newly formed partnership elects the remedial allocation method, A’s contributed property would be

[144] *See* Prop. Reg. § 1.168(k)-2(f)(1)(iii).

Section 704(c) Property (with a basis of zero and fair market value of $40) and B would be entitled to a remedial deduction of an additional $24 (*i.e.*, 40 percent of $60). For its part, A would receive a remedial allocation of income of $24. B has a total deduction of $60, and A receives no net benefit — precisely the same answer for the same transaction under the Transferor Allocation Rule.

In addition, allowing immediate expensing of remedial allocations generally would align the treatment of Situation 1 Transactions and Situation 2 Transactions under the Proposed Regulations. Under the facts of the Situation 2 Transaction described above, B would be entitled to a remedial allocation of $60 arising from the contribution of qualified property with built-in gain of $100. B ends up with the same benefit as it would in economically similar circumstances. Moreover, immediate expensing of remedial allocations would align both Situation 1 Transactions and Situation 2 Transactions with the purchase by B of a partnership interest where B would be entitled to expense its Section 743(b) adjustment.

Immediate expensing of remedial allocations also would bring Situation 1 Transactions and Situation 3 Transactions into closer alignment. In the Situation 3 Transaction described above, B would be entitled to a remedial allocation of $24 (*i.e.*, 60 percent of $40) arising from the portion of A's transfer of the qualified property to the partnership treated as a contribution under Treasury Regulations Section 1.707-3(b)(1), in addition to the $36 deduction resulting from the deemed purchase.[145]

Admittedly, reliance on immediate expensing of remedial allocations to address Situation 1 Transactions may create oddities of its own. Assume that LLC, which is again disregarded as separate from A, owns qualified property with a basis and a fair market value of $100, and A sells a 50-percent ownership interest in LLC to B for $50. For U.S. tax purposes, the transaction is treated as a purchase by B for $50 of a 50-percent interest in the qualified property, followed by the contribution by A and B of their respective interests in the qualified property to a newly formed partnership. Under Proposed Regulations Section 1.168(k)-2(f)(1)(iii), the $50 deduction that B receives from the purchase must be allocated entirely to the partnership, which in turn allocates it $25 to A and $25 to B. Because the portion of the qualified property that A contributes to the partnership has no built-in gain, it is not Section 704(c) Property, and no remedial allocations are available. A receives a benefit even though A previously held the property, and B receives less of a benefit (on a present value basis) than it would receive under the Transferor Allocation Rule.

Moreover, immediate expensing of remedial allocations will not precisely replicate the Transferor Allocation Rule in all cases, especially outside of Situation 1 Transactions. Assume

[145] We note that the Direct Transfer Recast Rule requires that the relationship between the original holder and the final transferee be tested after a series of related transactions, though, as discussed in Part III.B.3, below, it is unclear whether the Direct Transfer Recast Rule is meant to apply to Situation 1 Transactions. The Direct Transfer Recast Rule appears to contemplate that the ultimate transferee would ordinarily claim immediate expensing and, moreover, would deny the intermediate transferee any such deduction. *See* Prop. Reg. § 1.168(k)-2(b)(3)(vi), Ex. 18. However, the Proposed Regulations preclude the ultimate transferee in a Situation 1 Transaction (*i.e.*, the partnership) from claiming a Section 168(k) deduction, and instead the intermediate transferee receives the entire amount of the deduction. Accordingly, regardless of whether our recommendations regarding remedial allocations are adopted, the government may wish to clarify the possible application of the Direct Transfer Recast Rule in Situation 1 Transactions.

that, instead of owning qualified property through LLC, A directly owns qualified property, with a basis and a fair market value of $100, B buys the qualified property from A and contributes it to a partnership in which A is a 50-percent owner, and the partnership holds zero-basis goodwill contributed by A as the partnership's only other asset. As a result, the partnership will have a bonus depreciation deduction of up to $100, allocated up to $50 to A and up to $50 to B, and A's offsetting remedial income allocation from the amortization of the goodwill will likely be spread out over 15 years. This result, however, appears consistent with the statute because the partnership is not related to A or B.

While our recommended approach may not yield a perfect economic answer in every conceivable circumstance, we believe that, on balance, it is preferable to the Transferor Allocation Rule.

iii. Modifications to Proposed Regulations' Approach

If the final regulations do not permit immediate expensing of remedial allocations, we recommend that the Transferor Allocation Rule be retained, but note that the government may wish to revisit certain aspects of the rule.

First, the Transferor Allocation Rule does not contemplate transactions in which a person related to the prior user of the qualified property is a partner in the partnership. Assume that S1, a subsidiary of A, owns qualified property, and B purchases the qualified property from S1. In the same taxable year, B contributes the property to a partnership in which A is a partner. It appears that the Transferor Allocation Rule is not triggered in these circumstances, because S1 is not a partner in the partnership. The government may wish to consider expanding the Transferor Allocation Rule to cover situations like this by including a related party rule.

Second, the government may wish to consider limiting the Transferor Allocation Rule to situations in which the partnership is related to the prior user of the qualified property. While the preamble to the Proposed Regulations expresses concern that a prior user may receive any benefit, the statute itself denies immediate expensing only when the partnership and prior user are related. Narrowing the application of the Transferor Allocation Rule in this way would be consistent with the statute and with congressional intent.

Finally, to the extent that the government wishes to align the treatment of Section 743(b) adjustments and Situation 1 Transactions, it may consider whether a special rule is necessary for Section 168(k)(7) Elections with respect to Situation 1 Transactions. Under the Proposed Regulations and subject to the government's evaluation of our recommendation for consistency in Part III.A.4 above, the relevant partnership makes any Section 168(k)(7) Elections with respect to Section 743(b) adjustments, and this election does not appear to affect a partner's ability to claim immediate expensing with respect to qualified property of the same class that the partner owns directly. In the case of qualified property purchased pursuant to a Situation 1 Transaction, however, the partnership would not be the party to make a Section 168(k)(7) Election because the resulting deduction is at the partner level. This, in turn, means that whether or not a Situation 1 Transaction results in a Section 168(k) deduction depends on the relevant partner's applicable Section 168(k)(7) Elections for the taxable year. The Proposed Regulations do not provide purchasers in Situation 1 Transactions with the same flexibility in terms of Section 168(k)(7) Elections as partnerships currently enjoy with respect to such elections in the Proposed Regulations.

b. Clarification of Placement in Service

As discussed above, Proposed Regulations Section 1.168(k)-2(f)(1)(iii) applies when a transferor transfers qualified property in a Section 168(i)(7) transaction in the same taxable year that the transferor places the qualified property in service. The preamble to the Proposed Regulations implies that this rule is intended to capture Situation 1 Transactions,[146] but, as a technical matter, it is unclear whether the buyer in a paradigmatic Situation 1 Transaction would qualify. That is, by its terms, this rule requires that the transferor place the qualified property in service prior to the relevant nonrecognition transaction. In a traditional Situation 1 Transaction, however, the contributing partner would be deemed to hold the contributed property for only an instant. Property generally is considered to be placed in service when it is placed in a condition or state of readiness and availability for a specifically assigned function, whether in a trade or business, in the production of income, in a tax-exempt activity or in a personal activity.[147] Because the buyer in a Situation 1 Transaction is only deemed to hold the contributed property for a moment, the buyer arguably would not meet this standard.[148]

At the same time, we note that there may be scenarios in which the purchaser in a Situation 1 Transaction arguably ought to be treated as placing the acquired assets in service, or otherwise arguably ought to be eligible for immediate expensing. For instance, assume that LLC operates a business and currently employs an asset in that business, and then B acquires an interest in LLC. Under the deemed transactions outlined in Revenue Ruling 99-5, the asset in question was actually in service (as that phrase is commonly understood) in the business at all relevant times: prior to B's purchase, during the brief period in which B was deemed to hold its interest in the asset directly and then after B's contribution to LLC as well.

Based on the foregoing, the government may wish to issue guidance clarifying that an asset acquired through a Situation 1 Transaction meets the "placed in service" requirement in the depreciation rules.

B. Other Issues

1. Safe Harbor for Prior Use

As described above, the Proposed Regulations request comments regarding whether a safe harbor should be created with respect to Section 168(k)(2)(E)(ii)(I) and Proposed Regulations Section 1.168(k)-2(b)(3)(iii)(B)(1), disregarding certain prior "uses" that occur outside a specified lookback period.[149] We appreciate the government's recognition that an unlimited lookback period may impose a significant burden on taxpayers, and we endorse the adoption of an appropriate safe harbor, which we think would be a prudent exercise of the government's regulatory authority in this area.

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[146] *See Proposed Regulations*, *supra* note 2, 83 Fed. Reg. at 39,299.

[147] *See* Treas. Reg. §§ 1.46-3(d)(1), 1.167(a)-11(e)(1)(i).

[148] *Cf. Acro Mfg. Co. v. Comm'r*, 334 F.2d 40, 43-44 (6th Cir. 1964) ("[T]he ownership of these assets for such a minimal, transitory period of only a few hours at the most was insufficient to establish use of the assets in the taxpayer's business or to place the taxpayer in the [applicable business] . . . .").

[149] *See Proposed Regulations*, *supra* note 2, 83 Fed. Reg. at 39,295.

a. Plan-Based Exemption

As an initial matter, while the preamble to the Proposed Regulations requests comments on a safe harbor with a lookback period consisting of a set number of years, we respectfully recommend that the final regulations instead incorporate a plan-based exemption for the No Prior Use Test. This exemption would treat an asset as previously used only if the prior use or disposition of the asset occurred pursuant to a plan that included the taxpayer's reacquisition of the asset.[150] Whether a plan, in fact, exists would be determined on the basis of all the facts and circumstances.

Because we view the No Prior Use Test as identifying a broad class of potentially abusive transactions for which additional scrutiny is appropriate, we think that the rule's efficacy would be increased by focusing on taxpayer intentions. Presumably, most abusive reacquisitions of qualified property will occur pursuant to a plan that includes the original use or disposition of such property. We believe that a plan-based exemption would disallow a Section a 168(k) deduction, and focus limited government resources, where the risk of abuse is highest and allow a Section 168(k) deduction where the risk of abuse is least. By contrast, a safe harbor that exempts reacquisitions based solely on the amount of time between a prior use or disposition and a reacquisition will permit some abusive transactions that fall within the safe harbor, while disallowing Section 168(k) deductions for other non-abusive transactions. As an example, a taxpayer might acquire qualified property and receive a Section 168(k) deduction, sell the property in the next taxable year (with the new owner receiving a Section 168(k) deduction) and lease the property back from its new owner, and then reacquire the property again once any applicable lookback period expired, receiving another Section 168(k) deduction. While each Section 168(k) deduction in this example arises out of an accompanying capital investment, it appears that the taxpayer in the example never intended to cease using the property in question, and the plan-based exemption we propose should, assuming the facts demonstrate as much, exclude the taxpayer's reacquisition as part of a plan with the taxpayer's earlier use and disposition of the property.

We also note that our recommended plan-based exemption may limit recordkeeping burdens. Taxpayers that do not repurchase assets pursuant to a plan with an earlier use or disposition could, in theory, undertake no additional recordkeeping with respect to the No Prior

[150] As noted below, if a plan-based exemption applied to situations in the Proposed Regulations in which one person is required to determine whether a second person previously used an asset (such as a consolidated group's need, under the Stock/Asset Acquisition Rule, to determine if corporations entering the group previously used assets that are being acquired as part of the same series of related transactions), the transaction should be exempt unless the second person's prior use or disposition of the asset occurred pursuant to a plan that included the transaction(s) prompting the prior use inquiry (e.g., in the case of the Stock/Asset Acquisition Rule, the series of related transactions that include an acquisition of qualified property and the admission to the relevant consolidated group of a corporation that previously used such qualified property).

Use Test, while additional recordkeeping burdens appear probable under any time-based safe harbor.[151]

On the other hand, we appreciate that a plan-based test could be difficult to police, and that taxpayer intentions can be difficult to discern or prove, both for the government and for taxpayers. Similar standards, however, operate in other provisions of the tax law, including in Section 355(e) and, to some degree, the Section 197 regulations[152] and the consolidated return rules. [153] We expect that a functioning plan-based exemption could be established with respect to the No Prior Use Test as well.

In addition, the tax law in some cases buttresses plan-based tests with time-based rules and presumptions.[154] We considered whether it would be viable or appropriate for a plan-based exemption from the No Prior Use Test to incorporate a rebuttable presumption that a plan existed until a certain number of years after the relevant prior use, with the opposite presumption applying thereafter. However, we note that any such time-based presumption would likely produce arbitrary results depending on when the relevant transactions occur, presuming some transactions occurring pursuant to an abusive plan to be within the safe harbor and presuming others not occurring pursuant to an abusive plan to fail to qualify for a Section 168(k) deduction. After considering the options listed above, on balance, we favor a pure plan-based exemption from the No Prior Use Test and do not recommend that the government adopt any time-based presumption or other time-based rules if it incorporates a plan-based exemption to the No Prior Use Test in the final regulations.

b. Other Alternative Potential Exemptions

i. Exemption for Prior Use Absent Knowledge

The government could also consider treating a person as previously using an asset for purposes of the No Prior Use Test only if the person possesses actual or constructive knowledge of the prior use. The broad exemption provided by such a rule might be appropriate given that it will be difficult for taxpayers to track the prior use and ownership of less valuable assets, especially when acquired in the used property market. In addition, such an exemption would be in line with other provisions of the tax law that apply a presumption regarding ownership in the

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151 We appreciate that some taxpayers might still undertake additional recordkeeping on account of the No Prior Use Test even if a plan-based exemption existed in order to be able to demonstrate through contemporaneous documentation that a subsequent reacquisitions did not, in fact, occur as part of a plan.

152 C*f.* Treas. Reg. § 1.197-2(h)(5)(ii) (using "series of related transactions" standard).

153 *Cf., e.g.*, Treas. Reg. § 1.1502-13(j)(4) (grouping intercompany transactions that are "part of the same plan or arrangement" for purposes of adjusting tax results to achieve single company treatment).

154 *See, e.g.*, I.R.C. § 355(e)(2)(B) (presuming for purposes of Section 355(e) that an acquisition of a 50-percent or greater interest in the distributing or controlled corporation that occurs within 2 years of the relevant distribution occurs pursuant to a plan with the distribution); *cf.* I.R.C. § 338(d)(3) (purchases within 12-month acquisition aggregated in determining if qualified stock purchase occurs); Treas. Reg. §§ 1.1502-35(d)(4)(ii)(A) (similar rule), 1.385-3(b)(3)(iii)(A) (covered debt instrument treated as funding any covered distribution and or acquisition occurring within 36 months of instrument's issuance).

absence of actual knowledge to the contrary.[155] Because taxpayers will have greater ability to track the prior use and ownership of certain types of items, this rule could provide that a taxpayer has constructive knowledge of the prior use of an asset with a fair market value exceeding a particular threshold, or of the prior use of certain kinds of assets with researchable chains of title, such as aircraft or other vehicles.

ii. Recovery Period-Based Safe Harbor

Another possible alternative would be a lookback period measured by reference to the recovery period for an applicable item of property, such as the lesser of the property's recovery period or a set number of years.[156] Such a rule would presumably address most potential abusive transactions as it would not permit immediate expensing for reacquired property until the property had lost at least a significant portion of its value.[157] While such a rule seems harsh, we note that an asset's actual useful life likely exceeds its recovery period under Section 168 in many cases (given accelerated depreciation), meaning that assets subject to this rule would likely have at least some useful economic life remaining at the time they became subject to reacquisition in transactions for which immediate expensing was available. In addition, imposing a limit on the number of years in the lookback period could lead, of course, to disparate treatment of different types of assets. For instance, with a lookback period consisting of the lesser of 10 years and the asset's recovery period, a 5-year asset with an actual useful life of 6 years could be repurchased in a transaction eligible for immediate expensing during a 1-year period (or for approximately 17% of the asset's useful life), while a 20-year asset with an actual useful life of 24 years could be repurchased in a transaction eligible for immediate expensing during a 14-year period (or for approximately 58% of the asset's useful life). Finally, the great variability of lookback periods would presumably limit the administrability benefits at which any proposed safe harbor presumably would be aimed.

c. Options for Temporal Safe Harbor / Lookback Period of Set Number of Years

If the government does not incorporate a plan-based exemption to the No Prior Use Test in the final regulations, and instead incorporates a safe harbor with a lookback period consisting

155 *See, e.g.*, Temp. Reg. § 1.382-2T(k)(1)(i) (presumption that certain 5% shareholders may be identified through Schedule 13D and 13G filings in absence of actual knowledge to contrary under Section 382); Treas. Reg. § 1.367(a)-3(c)(5)(iii) (similar rule in definition of five-percent target shareholder for purposes of Section 367(a) rules on transfers of stock and securities by U.S. person to foreign corporation); Treas. Reg. § 1.355-7(h)(8) (similar rule in definition of five-percent shareholder for purposes of Section 355(e) rules). Similar presumptions that operate in the absence of knowledge to the contrary also exist with respect to non-ownership rules in the Code. *See, e.g.*, Treas. Reg. § 1.1441-1 (permitting withholding agents to make various assumptions regarding payee or beneficial owner tax status absent actual knowledge or reason to know of actual tax status).

156 *See* Capitol Tax Partners, LLP, Comment Letter on Proposed Section 168(k) Regulations, *reprinted in* 2018 TNT 193-19 (Oct. 4, 2018).

157 Because of the lower value, the reacquiring taxpayer would pay a reduced amount for the property, and the amount of the Section 168(k) deduction would likewise be reduced, along with the risk that taxpayers might plan into such a transaction for abusive reasons.

of a set number of years, the government will have numerous options for selecting the appropriate number of years. There is precedent in the tax law for lookback periods (or similar provisions) that apply a 12-month period,[158] a 2-year period,[159] a 3-year period,[160] a 5-year period,[161] or a 10-year period,[162] among other timeframes.[163]

We do not take a position as to the appropriate lookback period if Treasury and the Service decide to establish this type of safe harbor to the No Prior Use Test, but we do offer

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158 *See, e.g.*, I.R.C. §§ 338(d)(3) (12-month aggregation period for a "qualified stock purchase"), 382(h)(8) (aggregation of "a series of related transactions during any 12-month period"); Treas. Reg. §§ 1.336-1(b)(6)(i) (12-month aggregation period for a "qualified stock disposition"), 1.368-2(c) (aggregation of stock acquisitions occurring over "a relatively short period of time such as 12 months" for Section 368(a)(1)(B) purposes), 1.1503-2(g)(2)(iii)(A)(4), (5), (7) (references to acquisitions in "a series of transactions" within "a twelve-month period" in dual consolidated loss regulations).

159 *See, e.g.*, I.R.C. §§ 355(e)(2)(B) (2-year period before or after a distribution during which actions are presumed to occur pursuant to a plan for purposes of Section 355(e)), 7874(c)(3) (foreign corporation's acquisition of substantially all properties of domestic corporation or partnership within 2 years before or after satisfying ownership requirements for surrogate foreign corporation status treated as part of plan for purposes of Section 7874), 336(d)(2)(B)(ii) (acquisition of property within 2 years prior to liquidation treated as part of plan to recognize loss for purposes of Section 336(d)(2)(B)(i)(II)); *see also* Treas. Reg. § 301.6532-1(a) (2-year period to file suit for recovery of tax after mailing of notice of disallowance of claim).

160 *See, e.g.*, I.R.C. §§ 382(i)(1) (3-year testing period for Section 382 ownership change), 332(b)(3) (complete liquidation can occur through distributions over 3-year period); Treas. Reg. §§ 1.7874-8(g)(4)(i) (3-year lookback period for prior domestic entity acquisitions under the Section 7874 serial inverter rule), 1.385-3(b)(3)(iii)(A) (3-year lookback period and 3-year look-forward period for covered acquisitions and distributions under the "per se" funding rule in the debt-equity regulations), 1.305-3(b)(4) (distribution or series of distributions of stock more than 3 years before or after receipt of cash or property by some shareholders not pursuant to the same plan presumed not to be a disproportionate distribution for purposes of Section 305); *see also* I.R.C. § 6511(a) (3-year period from time of return filing for filing of refund claim).

161 *See, e.g.*, I.R.C. §§ 1374(d)(7) (5-year recognition period for built-in C corporation gain of S corporations), 355(a)(3)(B) (stock acquired in taxable transaction within 5 years of distribution treated as boot under Section 355), 355(b)(2)(B) (trade or business relied upon for tax-free distribution under Section 355 must be actively conducted for 5 years before distribution), 382(h)(7)(A) (5-year recognition period after ownership change under Section 382); *see also* I.R.C. §§ 1362(g) (5-year waiting period to elect S corporation status after taxable year of termination of election), 1504(a)(3) (5-year waiting period to reconsolidate corporation), 871(d)(2) (5-year waiting period to elect to treat income from U.S. real property as effectively connected after revoking such election).

162 *See, e.g.*, I.R.C. §§ 302(c)(2) (10-year testing period for termination of interest in redeeming corporation), 864(c)(7) (income and gain attributable to disposition of property that was used in U.S. trade or business within prior 10-year period treated as arising from disposition occurring while property was still used in U.S. trade or business), 514(b)(3) (land acquired for use exempt use within 10 years may avoid classification as debt-financed property); Temp. Reg. § 1.337(d)-7T(f)(1)(i) (10-year lookback period for purposes of temporary REIT spinoff regulations); *see also* I.R.C. § 877(a)(1) (expatriation tax applicable to persons that lost U.S. citizenship in 10-year period preceding close of current taxable year).

163 Other timeframes certainly occur in the tax law, though more rarely than those listed above. *See, e.g.*, I.R.C. § 965(h) (election permitting taxpayers to elect to pay transition tax amount over 8-year period); Treas. Reg. § 1.702-3T (permitting partners to include income from multiple partnership taxable years over 4 taxable years where the inclusion of income from multiple taxable years occurred due to changes to the rules for partnership taxable years in the Tax Reform Act of 1986).

some observations that the government may wish to consider. As a general matter, we note that a lengthy lookback period could deny access to a safe harbor for many shorter-lived types of assets, because their useful lives generally will expire before any taxpayer has a chance to reacquire them in a qualifying transaction. A longer lookback period also may create significant recordkeeping burdens for taxpayers, as it will be difficult to track the comings and goings of individual assets, some of which may never be identified by a serial number in business records.[164] The relatively broad reach of the No Prior Use Test, coupled with the lack of any specific abuse identified in the legislative history, might militate in favor of a shorter lookback period.

On the other hand, we recognize that an extremely short lookback period could sap the No Prior Use Test of any independent vitality, especially given that multiple acquisitions of an item of qualified property within a single taxable year generally would already disallow immediate expensing under existing rules.[165] The No Prior Use Test is a statutory rule, adopted by Congress as an integral component of its expansion of the immediate expensing rules in the Act. Accordingly, choosing a safe harbor with a lookback period consisting of a set number of years will require the government to appropriately balance the taxpayer burdens and other factors weighing in favor of a shorter lookback period with the need to retain an effective No Prior Use Test that implements congressional intent.

d. Recommendation that Safe Harbor Extend to Analogous Provisions

Additionally, we note that the preamble to the Proposed Regulations mentions the possibility of a safe harbor and lookback period only with respect to the No Prior Use Test. We recommend, however, that any safe harbor or other exemption incorporated in the final regulations apply not only for purposes of assessing compliance with the No Prior Use Test, but also to certain analogous provisions of the Proposed Regulations that similarly require taxpayers to locate prior uses of acquired property.[166] For instance, if the final regulations adopt the plan-based safe harbor recommended in Part III.B.1.a above, this safe harbor also would apply in the determination (i) by one member of a consolidated group as to whether any other current or former member of such group has previously used acquired assets for purposes of the Group Prior Use Test,[167] (ii) by a member of a consolidated group, for purposes of the Stock/Asset Acquisition Rule, whether any corporation that becomes part of the same consolidated group in a series of related transactions has previously used assets acquired as part of the same series of related transactions,[168] and (iii) by a partnership, for purposes of Proposed Regulations Section 1.168(k)-2(f)(1)(iii), whether any partner in the partnership previously used assets contributed to the partnership by a contributing partner that has received a Section 168(k) deduction for such

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164 *See* I.R.C. § 168(k)(2) (defining “qualified property”).

165 *See* Treas. Reg. § 1.168(k)-1(f)(1)(i); Prop. Reg. § 1.168(k)-2(f)(1)(i).

166 Alternatively, if the government adopted a presumption against prior use for low-value assets or adopted a lookback period for assets based on recovery periods, either of those safe harbors simply would change the length of time a taxpayer must verify another person’s prior use of assets or change the types of assets for which prior use must be verified.

167 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(3)(i).

168 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(3)(ii).

assets. Similarly, if the government selected a solely temporal safe harbor in the final regulations, then we believe that it should apply in making these determinations as well.[169]

This additional change, in our view, would promote the administrability and consistency of the final regulations by avoiding the burdens and confusion that would attend multiple conflicting lookback analyses in a single regulatory package. In addition, we believe that such a change is appropriate because these analogous provisions generally would be even more difficult than the No Prior Use Test for taxpayers to comply with if required to look back over an unlimited period of time, because each provision requires the taxpayer to gather information about the prior uses of property by other persons who may not be incentivized to share such information, may be entirely unwilling to do so or in some cases may even be legally or contractually barred from doing so.

2. Definitional Issues

a. "Depreciable Interest"

As described above, the Proposed Regulations implement the No Prior Use Test for acquisitions of used property by treating a taxpayer as having previously used an asset if the taxpayer or a predecessor previously held a "depreciable interest" in the asset, whether or not the taxpayer or a predecessor previously claimed depreciation deductions for the asset.[170] We do not take a position on the suitability of measuring "use" in terms of holding a depreciable interest, but note the possibility that the Proposed Regulations may consider a taxpayer not to have "used" an asset for purposes of the No Prior Use Test notwithstanding actual use (as that term is commonly understood). For instance, where a taxpayer leases a business asset and then employs the asset in its business, the taxpayer clearly "uses" the asset under the dictionary definition of the term. However, because the lessee taxpayer generally could not depreciate its interest in the leased asset,[171] the Proposed Regulations indicate that the taxpayer did not hold a depreciable interest in the asset and, upon acquiring a fee interest in the asset in an otherwise-qualifying acquisition, the taxpayer could qualify for immediate expensing with respect to the amount paid.[172] We note that this deviation from the plain meaning of "use" is obviously favorable to taxpayers.

i. <u>Clarity of Definition</u>

The Proposed Regulations do not define the phrase "depreciable interest," and the phrase is not used in either the statute or the Prior 168(k) Regulations. The phrase is used in several

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169 *See* Prop. Reg. § 1.168(k)-2(f)(1)(iii).

170 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(1).

171 The taxpayer, of course, could depreciate its interest in any leasehold improvements made upon the leased asset, and therefore likely holds a depreciable interest in such leasehold improvements. *See* Prop. Reg. § 1.168(k)-2(b)(3)(vi), Ex. 8. The Proposed Regulations provide that, in such a case, if the taxpayer later acquires the leased property (including the leasehold improvements), immediate expensing is available solely with respect to the portion of the property's basis not attributable to the leasehold improvements. *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(1).

172 *See* Prop. Reg. § 1.168(k)-2(b)(3)(vi), Ex. 6.

examples in the Proposed Regulations that indicate a depreciable interest exists where a taxpayer holds an asset and is eligible for depreciation deductions with respect to that asset, but does not exist where a taxpayer holds an asset and is not so eligible.[173] This phrase appears to arise from Section 167 and case law and other authority interpreting the requirements to take a depreciation deduction (not all of which use the phrase "depreciable interest"). These authorities generally have likened a depreciable interest to a fee interest in, or "tax ownership" of, an asset.[174]

In the absence of a definition, it is unclear whether the phrase "depreciable interest" in the Proposed Regulations is intended to have the same meaning as that phrase has in the Section 167 authorities. Alternatively, the Proposed Regulations may intend that a "depreciable interest" exist only where a taxpayer has tax ownership of an asset *and* has placed the asset in service in its business, or only where a taxpayer has tax ownership, has placed the relevant asset in service in its business *and* could qualify for a depreciation deduction but foregoes the deduction.[175] Numerous other more specific questions could also arise.[176]

In many cases, taxpayers' general understanding of the meaning of the phrase "depreciable interest" may suffice. On the other hand, we note that, under the Proposed Regulations as drafted, "depreciable interest" is the key phrase in Section 168(k)'s expansion to acquisitions of used property, and its meaning, therefore, will be key for many taxpayers. It presumably would be relatively straightforward to add language to the final regulations directing taxpayers to Section 167 for the meaning of "depreciable interest" or otherwise defining the phrase in accordance with its apparent meaning.

For these reasons, we recommend that the government clarify the definition of "depreciable interest" in the final regulations.

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[173] *See, e.g.*, Prop. Reg. § 1.168(k)-2(b)(3)(vi), Ex. 6-8.

[174] *See, e.g.*, LAFA 2004-23-03F (June 4, 2004) (citing authorities on meaning of "depreciable interest"). Several authorities appear to have defined a depreciable interest as consisting solely of an ownership interest in an asset, separate from any requirement to place the asset in service. *See, e.g.,* Rev. Proc. 2007-48, § 3(4), 2007-2 C.B. 110 (Revenue Procedure for treating rotable spare parts as depreciable assets applies only when the taxpayer "has a depreciable interest in the rotable spare parts and [also] has placed in service the rotable spare parts after 1986"); Rev. Rul. 79-255, 1979-2 C.B. 17 ("in order to obtain the investment credit with respect to a qualified film, a taxpayer must have an ownership interest in at least a part of the film. That is, the taxpayer must have a depreciable interest in at least a part of the film.").

[175] With respect to the placement in service requirement, as stated in Part III.A.5.b above, existing law generally considers property to be placed in service when it is placed in a condition or state of readiness and availability for a specifically assigned function, whether in a trade or business, in the production of income, in a tax-exempt activity or in a personal activity. *See* Treas. Reg. §§ 1.46-3(d)(1), 1.167(a)-11(e)(1)(i).

[176] For example, what if a taxpayer is able to take a deduction with respect to an asset's cost, but the deduction is not clearly "depreciation"? Is an interest in a live theatrical production, the cost of which is eligible for expensing under Section 181 or Section 168(k), a depreciable interest? Arguably, any interest for which immediate expensing is available must be a depreciable interest, as defined in the Proposed Regulations, or else taxpayers could "churn" property back and forth without the restrictions of Section 168(k)(2)(E)(ii)(I).

ii. Situations Where Statute or Prior 168(k) Regulations Disregard Prior Use

As described above, portions of Section 168(k) and the Prior 168(k) Regulations continue to allow immediate expensing for acquired property the original use of which commences with the taxpayer. Under these authorities, however, certain instances of transitory ownership of an asset prior to its acquisition by the relevant taxpayer may be disregarded in determining whether the taxpayer makes an original use of the asset. Specifically, among certain other exceptions,[177] the statute or the Prior 168(k) Regulations disregard for purposes of the original use requirement: (i) a person's use of an asset for 3 months or less if the person then sells the property to the taxpayer and the taxpayer leases the property back to the original user (the "**Sale-Leaseback Exception**"),[178] (ii) a syndicator-lessor's use of an asset for a 3-month period (or longer under certain circumstances[179]) so long as the syndicator-lessor sells the asset within that period and the lessee that is the end user of the asset remains the same (the "**Syndication Exception**"),[180] and (iii) certain temporary uses of an asset by a seller whose business includes the sale of fractional interests in such assets, so long as the fractional interests in the asset remain held primarily for sale to customers during the course of the temporary use (the "**Fractional Interest Exception**" and together with the Sale-Leaseback Exception and the Syndication Exception, the "**Transitory Use Exceptions**").[181]

Does the original transitory user in each of these situations hold a depreciable interest in the asset in question for purposes of the No Prior Use Test? Each original transitory user appears to hold a fee interest and to be the "tax owner" of the asset for a brief period of time. The Proposed Regulations also appear to provide that a lessor such as that in the Syndication Exception is the one that holds the depreciable interest in a leased asset, not the lessee.[182] Some of the Transitory Use Exceptions, moreover, clearly contemplate that the original transitory user places the relevant assets in service in its business, making "depreciable interest" treatment even more likely.[183] Even if many of these transitory users do not so employ the relevant assets, such

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[177] For instance, the Prior 168(k) Regulations also disregard prior ownership that is followed by both a sale-leaseback and a syndication. *See* Treas. Reg. §§ 1.168(k)-1(b)(3)(iii)(C), (b)(5)(ii)(C).

[178] *See* Treas. Reg. § 1.168(k)-1(b)(3)(iii)(A), (b)(5)(ii)(A). The Act removed the exception for sale-leaseback transactions, which is now present only in the Prior 168(k) Regulations, from Section 168(k) itself. *See Act*, *supra* note 4, at § 13201(c)(2); I.R.C. § 168(k)(2)(E)(ii) (prior to amendment by the Act).

[179] Specifically, where multiple items of property are subject to a single lease, to preserve original use status for the later purchaser, the syndicator-lessor must sell each item within 3 months after the date the final unit is placed in service (which may be up to 12 months after the first unit is placed in service). *See* I.R.C. § 168(k)(2)(E)(iii)(II); Treas. Reg. §§ 1.168(k)-1(b)(3)(iii)(B), (b)(5)(ii)(B); *see also* Prop. Reg. §§ 1.168(k)-2(b)(3)(v), (b)(4)(iv).

[180] *See* I.R.C. § 168(k)(2)(E)(iii); Treas. Reg. §§ 1.168(k)-1(b)(3)(iii)(B), (b)(5)(ii)(B); *see also* Prop. Reg. §§ 1.168(k)-2(b)(3)(v), (b)(4)(iv).

[181] *See* Treas. Reg. §§ 1.168(k)-1(b)(3)(iv); *see also* Prop. Reg. § 1.168(k)-2(b)(3)(ii)(C).

[182] *See, e.g.*, Prop. Reg. § 1.168(k)-2(b)(3)(vi), Ex. 6.

[183] *See, e.g.*, I.R.C. § 168(k)(2)(E)(iii)(II) (referring to asset subject to the Syndication Exception as "placed in service" by originally transitory user).

a fact may be of no avail if, as described in Part I.A.1.a.i above, a holder does not need to place an asset in service in its business in order to be treated as holding a "depreciable interest."[184]

The potential treatment of these original transitory uses as prior holders of depreciable interests disqualified by the No Prior Use Test raises a consistency issue. Assuming that an original transitory user held a depreciable interest, absent an exception, such a user cannot claim immediate expensing in the event of an otherwise-qualifying subsequent acquisition in the used property market.[185] However, if these original transitory uses of the relevant qualified property were so insubstantial as to be disregarded under the original use acquisition rules, why should they be both regarded and disqualifying under the No Prior Use Test?

An additional effect of treating these instances of transitory ownership as prior uses for purposes of the No Prior Use Test is to create more prior users who must be tracked under other provisions of the Proposed Regulations. Each original transitory user could also be a person whose membership in, or entry into, a consolidated group could prevent the group from claiming immediate expensing for acquired qualified property.[186] In addition, assuming that the final regulations retain the Transferor Allocation Rule, if an original transitory user of qualified property holds an interest in a partnership, any other partner that contributes the same qualified property to the partnership after purchasing the property in the same taxable year will need to determine whether the original transitory user previously used the property for a brief period of time and, upon making the determination, wholly claim the qualified property's Section 168(k) deduction and ensure that the partnership does not claim any portion of the deduction.[187] It is not clear that these results are appropriate or that the administrative burden taxpayers will need to undertake to avoid them is necessary.

Moreover, the apparent intent of the No Prior Use Test is to prevent situations that might be perceived as abusive, such as permitting a taxpayer to claim immediate expensing multiple times for the same asset. However, the No Prior Use Test, by its terms, will apply even if an original transitory user has never claimed immediate expensing for the asset. In such a case, absent some other indication of abuse, a prior transitory use that may already be disregarded for purposes of the original use requirement seems a fair candidate for an exception to the No Prior Use Test as well. Accordingly, we recommend that the government consider adding an exception in the final regulations to the definition of prior use as holding a depreciable interest (as currently located in Proposed Regulations Section 1.168(k)-2(b)(3)(iii)(B)(1)) so as to

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[184] We note that the scope of the definition of "depreciable interest" may limit this dilemma. For instance, if a "depreciable interest" existed only where a taxpayer held tax ownership of an asset, placed the asset in service in its business and was permitted to depreciate the asset, many original transitory users presumably would not be treated as holding depreciable interests in the assets in question, either because they did not place the relevant assets in service, or because placing an asset in service and disposing of it in the same taxable year generally precludes the taxpayer from taking a depreciation deduction with respect to such asset. *See* Treas. Reg. § 1.168(d)-1(b)(3)(ii) ("No depreciation deduction is allowed for property placed in service and disposed of during the same taxable year."). Presumably, such a taxpayer might still be treated as holding a depreciable interest if the placement in service and disposition occurred in separate taxable years, which is possible under the terms of the Transitory Use Exceptions.

[185] *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(A)(1).

[186] *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(3)(ii).

[187] *See* Prop. Reg. § 1.168(k)-2(f)(1)(iii).

disregard uses eligible for one of the Transitory Use Exceptions, provided that the original transitory user did not claim immediate expensing with respect to that original transitory use. Such an exception would mirror the Transitory Use Exceptions and essentially disregard the original transitory use – the original transitory use would not itself generate a Section 168(k) deduction, but also would not prevent any subsequent acquirors of the relevant qualified property from claiming the deduction assuming they are otherwise eligible to do so.

b. "Predecessor"

In several sections, the Proposed Regulations provide that a particular rule applies to a taxpayer and its "predecessor."[188] Most notably, for the cost of used property to be eligible for immediate expensing under the Proposed Regulations,[189] the property must not have been "used by the taxpayer or a predecessor at any time prior to" its acquisition by the taxpayer.[190] The Proposed Regulations do not define the term "predecessor," nor does the statute or the Prior 168(k) Regulations.[191]

There are several other authorities in the tax law that define the meaning of "predecessor" or "successor" at greater or lesser length. Presumably, in the absence of a specific definition, taxpayers should refer to such analogous authority, which frequently defines a predecessor by reference to a transfer described in Section 381. As we have noted in other reports on other areas of the tax law, it may also be appropriate to treat other similar transactions not described in Section 381, such as Section 351 exchanges, as causing a transferor to be treated as a predecessor.[192] Accordingly, the government may wish to address these issues in the final

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188 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(A)(1), (b)(3)(iii)(B)(1), (b)(3)(iii)(B)(2), (b)(3)(iv)(D)(1)(i), (b)(3)(v), (b)(3)(vi), (b)(4)(iv), (b)(5)(iii)(A), (b)(5)(iii)(B), (b)(5)(vii).

189 We note that Proposed Regulations Section 1.168(k)-2(b)(3)(iii)(A)(1) would prevent a Section 168(k) deduction where a predecessor of the taxpayer has previously used an asset although the equivalent statutory provision, Section 168(k)(2)(E)(ii)(I), does not contain any reference to a "predecessor."

190 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(A)(1).

191 The Prior 168(k) Regulations also use the term "predecessor" without definition. *See* Treas. Reg. § 1.168(k)-1(b)(4)(ii)(A), (B).

192 *See* Guidance Under Section 355(e) Regarding Predecessors, Successors, and Limitation on Gain Recognition; Guidance Under Section 355(f), 81 Fed. Reg. 91,738, 91,746 (Treasury and the Service continue to study whether transferee in Section 351 transaction should be treated as a successor for purposes of Section 355(e)) (Dec. 19, 2016); NEW YORK STATE BAR ASSOCIATION TAX SECTION, REPORT # 1370 ON TEMPORARY AND PROPOSED REGULATIONS DEALING WITH "PREDECESSORS" AND "SUCCESSORS" UNDER SECTION 355(E) (2017), *reprinted in*, 2017 TNT 105-27 (June 2, 2017). Questions may also arise as to how a "predecessor of a predecessor" should be treated. *See* Guidance Regarding Predecessors and Successors Under Section 355(e); Limitation on Gain Recognition Under Section 355(e), REG-145535-02, 69 Fed. Reg. 67,873, 67,874 (Nov. 22, 2004) ("The IRS and Treasury Department . . . are concerned that treating [transferors to predecessors of Distributing] as predecessors of Distributing would add substantial complexity."); NEW YORK STATE BAR ASSOCIATION TAX SECTION, REPORT ON FINAL, TEMPORARY AND PROPOSED REGULATIONS UNDER SECTION 337(D) RELATING TO CERTAIN TRANSFERS OF PROPERTY TO REGULATED INVESTMENT COMPANIES AND REAL ESTATE INVESTMENT TRUST 25 n.60 (2017), *reprinted in*, 2017 TNT 195-27 (Oct. 10, 2017); NEW YORK STATE BAR ASSOCIATION TAX SECTION, REPORT # 1089 ON PROPOSED REGULATIONS DEALING WITH "PREDECESSORS" AND "SUCCESSORS" IN SECTION 355(E) (2005), *reprinted in*, 2005 TNT 123-13 (July 4, 2005).

regulations in the form of a definition of the term "predecessor," or by providing confirmation in the preamble to the final regulations that the term is intended to be defined by reference to Section 381 or other related transactions, or to otherwise have its usual meaning.

c. "Series of Related Transactions"

The Proposed Regulations also contain a few rules (including most that apply to consolidated groups) that use the phrase "series of related transactions" without defining it.[193] The phrase is not used in the Prior 168(k) Regulations, and is used twice in Section 168(i)(3)(A), as well as certain related regulations, without definition.[194] The preamble to the Proposed Regulations introduces the phrase through an example, and the Proposed Regulations include a more detailed version of this example as Example 22, reproduced in part below:[195]

> (i) H Corporation, which is not a member of a consolidated group, has a depreciable interest in Equipment #4. Parent owns all the stock of I Corporation, and Parent and I Corporation are members of the Parent consolidated group. No member of the Parent consolidated group ever had a depreciable interest in Equipment #4. Neither Parent nor I Corporation is related to H Corporation within the meaning of section 179(d)(2)(A) or (B) and § 1.179-4(c). During 2018, H Corporation sells Equipment #4 to a person not related to H Corporation, Parent, or I Corporation within the meaning of section 179(d)(2)(A) or (B) and § 1.179-4(c). In a series of related transactions, during 2019, Parent acquires all of the stock of H Corporation, and I Corporation purchases Equipment #4 from an unrelated person.

The remainder of the example provides that the Stock/Asset Acquisition Rule applies to I Corporation's purchase of Equipment #4, and immediate expensing is unavailable.

It is not clear from the facts of the example why Parent's acquisition of H Corporation stock and I Corporation's acquisition of Equipment #4 are part of the same series of related transactions. Example 22 does not explain the relationship between these two transactions, aside from indicating that they occur during the same calendar year. However, the example does not clearly state that temporal proximity alone is sufficient to create a series of related transactions. Example 22 describes only the 2019 transactions as occurring as part of a series of related transactions, and appears to suggest that the 2018 and 2019 transactions are not related for this purpose, notwithstanding that they occur only approximately one year apart. Under the Stock/Asset Acquisition Rule, the 2018 transaction apparently requires no relation to the 2019 acquisitions to achieve the result described in Example 22, further suggesting that the 2018 and 2019 transactions in Example 22 are not part of the same series of related transactions.

Based upon a review of the example and the rules in the Proposed Regulations that it demonstrates, it does not seem that transactions separated by one year, or otherwise close in

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193 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(3)(ii), -2(b)(3)(iii)(B)(3)(iii), -2(b)(3)(iii)(C).

194 *See* Treas. Reg. § 1.168(i)-2(c); Temp. Reg. § 1.168(j)-1T, A-17(iv). This phrase (or a variant thereof) is also used in certain other sections of the tax law, particularly Treasury Regulations Section 1.197-2, which uses the phrase numerous times without definition, and Treasury Regulations Section 1.355-7, which explains the concept of a "plan (or a series of related transactions)" at length.

195 *See* Prop. Reg. § 1.168(k)-2(b)(3)(vi), Ex. 22.

time, must necessarily be treated as part of the same series of related transactions. We appreciate that cautious taxpayers may be inclined to view any temporally close transactions as part of a series of related transactions, notwithstanding any suggestion to the contrary in Example 22.[196] In the alternative, the phrase might be read to mean that multiple transactions are "related" when they occur as part of a plan decided upon beforehand. Alternatively, the phrase could be interpreted as applying any (or all) of the three main variations of the step transaction doctrine.[197] Many of these interpretations may overlap in practice. On balance, we believe that it is appropriate to interpret a "series of related transactions" as applying to transactions that are part of the same taxpayer plan.

In addition, the rules that would adopt a "series of related transactions" standard are consequential and heighten the importance for taxpayers to apply the standard correctly. Taxpayers undertaking various business transactions over time, that wish to preserve immediate expensing, presumably will want to know what steps they can take to ensure that unrelated transactions are not unintentionally characterized as part of a "series of related transactions."

For all these reasons, the government may wish to consider clarifying the use of the phrase in Example 22 and/or providing guidance on the phrase's general meaning. We do not ultimately conclude, however, that the adoption of a definition of "series of related transactions" is essential for the final regulations.

3. Prop. Reg. § 1.168(k)-2(b)(3)(iii)(C)

The Direct Transfer Recast Rule set forth in Proposed Regulations Section 1.168(k)-2(b)(3)(iii)(C) recharacterizes a series of related transactions involving multiple transfers of property as a single direct transfer of the property from the original holder to the final transferee, and provides that the relationship between the original holder and the final transferee should be

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196 *See, e.g.*, DAVID L. CAMERON, THOMAS KITTLE-CAMP & PHILLIP F. POSTLEWAITE, FEDERAL INCOME TAXATION OF INTELLECTUAL PROPERTIES & INTANGIBLE ASSETS § 1.04 (referring to the "temporal or other characteristics" that could cause transactions to be part of a "series of related transactions" for Section 197 purposes).

197 *See, e.g.*, AMERICAN BAR ASSOCIATION SECTION OF TAXATION, COMMENTS ON GUIDANCE NEEDED UNDER 1997 AMENDMENTS TO SECTION 355 AND 358 n.13 (1998), *reprinted in*, 98 TNT 93-22 (May 14, 1998) (generally arguing that "plan" and "series of related transactions" should be defined by reference to the step transaction doctrine for purposes of Section 355(e)). The three alternative forms of the step transaction applied by courts generally are identified as (i) a binding commitment test, which integrates multiple transactions if they occur pursuant to a legally binding agreement, *see, e.g.*, *Comm'r v. Gordon*, 391 U.S. 83, 96 (1968), (ii) a mutual interdependence test, which integrates multiple transactions "so interdependent that the legal relations created by one transaction would be fruitless without the completion of the series," *Am. Bantam Car Co. v. Comm'r*, 11 T.C. 397, 405 (1947), *aff'd*, 177 F.2d 513 (3d Cir. 1949); *see also Penrod v. Comm'r*, 88 T.C. 1415, 1428 (1987), and (iii) an end result test, which integrates multiple transactions when all of the transactions appear to have been intended to achieve the same end result, *see, e.g.*, *King Enters., Inc. v. United States*, 418 F.2d 511, 516 (Ct. Cl. 1969); *True v. United States*, 190 F.3d 1165, 1175 (10th Cir. 1999). For an overview of the issues relating to the application of the step transaction doctrine by the courts, see NEW YORK STATE BAR ASSOCIATION TAX SECTION, REPORT ON THE ROLE OF THE STEP TRANSACTION DOCTRINE IN SECTION 355 STOCK DISTRIBUTIONS: CONTROL REQUIREMENT AND NORTH-SOUTH TRANSACTIONS 4-8 (2013), *reprinted in*, 2013 TNT 215-21 (Nov. 5, 2013).

tested after the last such related transaction, solely for purposes of the used property acquisition requirements in Section 168(k)(2)(E)(ii). An example in the preamble to the Proposed Regulations indicates that this rule would prevent immediate expensing in the case of a qualified property sale from a father to an unrelated third party, followed by the third party's sale of the property to the father's daughter.[198] As discussed below, it is not always clear how to apply the Direct Transfer Recast Rule.

First, the Direct Transfer Recast Rule provides sparse details regarding the transaction that is deemed to occur. For instance, where A transfers property to B in exchange for cash and B transfers the property to C in a nonrecognition transaction in exchange for stock or other property (or for no consideration), it is not entirely clear whether C is deemed to pay cash or to transfer in a nonrecognition transaction, and whether C is receiving a carryover or cost basis in the acquired property. The Proposed Regulations only mention a potential relatedness issue under Section 179(d)(2)(A) between A and C under Proposed Regulations Section 1.168(k)-2(b)(3)(iii)(C).[199] If the Direct Transfer Recast Rule is intended solely to test relatedness under Section 179(d)(2)(A), and cannot disqualify a transaction for any other reason, the final regulations should clearly state as much.[200]

Alternatively, if a transaction deemed to occur under the Direct Transfer Recast Rule must be tested under all of the rules of Section 168(k)(2)(E)(ii), final regulations should provide further clarification regarding how to apply the rule. The form and basis results of, and consideration for, this deemed transaction will be relevant in determining (i) whether C is receiving property the basis of which is determined by reference to the basis of property previously held by C,[201] or (ii) whether C is receiving property the basis of which is determined by reference to the basis of the transferor,[202] each of which would prevent immediate expensing. In general, it seems appropriate to treat the deemed direct transfer between A and C as qualifying under Section 179(d)(2)(C) and 179(d)(3) if any of the indirect transfers disregarded by the Direct Transfer Recast Rule so qualify. In addition, the final regulations should clarify whether B's prior use of the transferred property prevents immediate expensing, notwithstanding that the transfer of property is deemed to occur between A and C without B's involvement. We would assume that B's prior use is not relevant in such a case.

Even where relatedness is the sole issue, it may not be clear how to apply the Direct Transfer Recast Rule in scenarios involving Section 179(d)(2)(B). The Direct Transfer Recast Rule simply states that "the relation between the original transferor and the ultimate transferee is tested immediately after the last transaction in the series," but it is not clear if this approach of

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198 *See Proposed Regulations*, *supra* note 2, 83 Fed. Reg. at 39,295. Presumably, to clearly rely on this rule, the daughter's subsequent acquisition might need to occur in a subsequent year than the unrelated third party's acquisition since an acquisition in the same year might not qualify for immediate expensing under Proposed Regulations Section 1.168(k)-2(f)(1)(i).

199 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(C), (b)(3)(vi), Ex. 18.

200 This interpretation seems less defensible since the Direct Transfer Recast Rule itself states that the deemed transaction rule applies for purposes of "section 168(k)(2)(E)(ii) and paragraph (b)(3)(iii)(A) of this section," which include Section 179(d)(2)(C) and (d)(3) and Section 168(k)(2)(E)(ii)(I).

201 Such a transfer would fail to qualify (in whole or in part) under Section 168(k)(2)(E)(ii)(II) and Section 179(d)(3).

202 Such a transfer would fail to qualify under Section 168(k)(2)(E)(ii)(II) and Section 179(d)(2)(C).

taking a snapshot of the parties' relationship works with a rule like Section 179(d)(2)(B), which labels persons as related based on the existence of a relationship over a sustained period of time.

In the case of two corporations that become members of the same controlled group pursuant to a series of related transactions that also involves a sale of qualified property between the two, Section 179(d)(2)(B) would require testing whether the two corporations are "component members" of the same controlled group for purposes of Section 1563, a determination that generally is based on membership in the group for one-half of the relevant taxable year.[203] If the corporations both become members of the controlled group pursuant to a series of related transactions ending in the first half of the taxable year,[204] the corporations should be component members for purposes of Section 179(d)(2)(B). By contrast, if a series of related transactions ends in the second half of the taxable year, does the Direct Transfer Recast Rule treat the two corporations as non-members prior to the end of the series of related transactions, in which case the purchaser of the qualified property may be eligible for immediate expensing (setting aside for this discussion the effect of Section 179(d)(2)(A))?[205] Presumably, the Direct Transfer Recast Rule should not operate in this manner.

Finally, we note that the Direct Transfer Recast Rule may overlap with the rule in Proposed Regulations Section 1.168(k)-2(f)(1)(iii). Under the latter rule, a taxable acquisition of qualified property, followed by a contribution of the property to a partnership in a transaction described in Section 721 in the same taxable year, results in the acquiror and the partnership sharing a Section 168(k) deduction, which is allocated between them based on the number of months held. Assuming that the initial acquisition and the transfer to the partnership are part of the same series of related transactions, which seems quite possible as the transfer must occur in the same taxable year, does the Direct Transfer Recast Rule override this rule and treat the transfer as occurring directly between the partnership and the original seller?[206] Because the rule for Section 168(i)(7) transactions in Proposed Regulations Section 1.168(k)-2(f)(1)(iii) is narrower and more specific (and because a similar rule has been present in the Prior 168(k) Regulations for many years), it may be appropriate that the Direct Transfer Recast Rule not apply to a transaction described in Proposed Regulations Section 1.168(k)-2(f)(1)(iii). In any case, we would recommend that the government clarify the application of the Direct Transfer Recast Rule, including in the areas described above.

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203 *See* Treas. Reg. § 1563-1(b)(3)(iii).

204 The same issues would arise if one corporation were a component member of an existing controlled group and the second corporation became a member of the same controlled group pursuant to a series of related transactions also involving a sale of qualified property between the two.

205 We appreciate that, because of the significant overlap between Section 179(d)(2)(A) and Section 179(d)(2)(B), the former may still apply in many of these cases and cause the transaction to fail Section 168(k)(2)(E)(ii)(II).

206 Presumably, this recharacterization would occur only if the original taxable acquisition was an acquisition of used property seeking to qualify under Section 168(k)(2)(E)(ii) and not qualifying under the original use acquisition requirements. We would not interpret the Direct Transfer Recast Rule as requiring an acquisition of qualified property that satisfies the original use acquisition requirements to be recharacterized and then, in recharacterized form, to also satisfy the used property acquisition requirements. The Proposed Regulations appear to support this conclusion by stating that the Direct Transfer Recast Rule applies "[s]olely for purposes of section 168(k)(2)(E)(ii) and paragraph (b)(3)(iii)(A) of [the Proposed Regulations]". *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(C).

4. Consolidated Group Issues

We consider the Group Prior Use Test, described in Part II.C, above, an appropriate implementation of the No Prior Use Test in the consolidated group context. However, as described below, we suggest that the government consider certain clarifying guidance to prevent possible misinterpretations of this rule and otherwise assist taxpayers.

a. Acquisitions Involving Two Consolidated Groups

Importantly, the Group Prior Use Test disallows immediate expensing only when a corporation that is a member of a consolidated group acquires qualified property in an otherwise-eligible purchase, and applies only to the consolidated group of which the acquiring corporation is a member. This qualification is particularly relevant in certain acquisitions involving two consolidated groups.

Assume that Buyer is a domestic corporation that is a member of a consolidated group (the "**Acquiring Group**"). Holder is a domestic corporation unrelated to Buyer that holds qualified property and that is a member of an unrelated consolidated group (the "**Target Group**"). Target is another domestic corporation that is also a member of the Target Group. Holder is not a direct or indirect subsidiary of Target, and Target has never directly held the qualified property currently held by Holder. As part of a series of related transactions, Buyer acquires qualified property from Holder for cash in a taxable purchase, and Target also becomes a member of the Acquiring Group (*e.g.*, in a taxable stock purchase).

The Group Prior Use Test should not apply to the example. Because Target has never directly held the qualified assets held by Holder and acquired by Buyer, our example does not represent a series of related transactions described in Proposed Regulations Section 1.168(k)-2(b)(3)(iii)(B)(3)(ii) in which a member of a consolidated group acquires assets and a corporation that previously held those assets becomes a member of the same consolidated group. Although Target was a member of the Target Group at a time when another member of the Target Group, Holder, held the assets, the Proposed Regulations do not impute Holder's prior use of the assets to Target under these circumstances. Rather, Holder's prior use would be imputed to Target under the Group Prior Use Test only if Target itself had acquired the assets while a member of the Target Group. This result is appropriate because the same result would obtain in a single corporation context. If Target were a division or disregarded subsidiary of a single corporation, and another division or disregarded subsidiary held qualified property, the Acquiring Group's acquisition of Target and the qualified property would be treated as two asset acquisitions and would not implicate the Stock/Asset Acquisition Rule, absent other facts.

However, we think it is conceivable that a taxpayer might erroneously assume that the Stock/Asset Acquisition Rule applied in a transaction like the one presented in the above example. The Group Prior Use Test treats a consolidated group member as previously using qualified property held by other members only when the first member acquires the property in question while a member of the group, and, as a result, the Group Prior Use Test (along with the Stock/Asset Acquisition Rule) does not prevent immediate expensing in our example. If the Group Prior Use Test instead treated every member of a consolidated group as previously holding a depreciable interest in all assets previously held at any time by any member of the group, arguably immediate expensing would be unavailable in our example because Target would be treated as having previously used the assets on account of its prior membership in the Target Group.[207] To clarify that this latter interpretation is incorrect and conflicts with the preamble's general recognition that consolidated corporations are separate taxpayers, we suggest that the government include an example in the final regulations similar to the one above and explain that immediate expensing is available on these facts.

b. Example 21 & Similar Transactions

In Example 21 in the Proposed Regulations, Parent owns all of the stock of F corporation and G corporation, which are both members of a consolidated group. In a series of related transactions, G corporation sells qualified property to F corporation, and Parent sells F corporation's stock to X corporation, an unrelated third party that is also the parent of a consolidated group. The Proposed Regulations indicate that F is not treated as previously holding a depreciable interest in the qualified property under the Group Prior Use Test because F's membership in the consolidated group is tested at the end of the series of related transactions when F is no longer a member. Accordingly, Example 21 states that, assuming all other relevant requirements are satisfied, immediate expensing is available with respect to the qualified property acquired by F. We generally approve of this result and note that the IRS has previously issued several private letter rulings addressing similar but more complex transactions, many of which involve a "busted" Section 351 exchange (*e.g.*, through the sale of non-voting preferred stock of the transferee corporation to a party that does not contribute property to the transferee) within a consolidated group, followed by the transferee's departure from the group through one or more spin-off transactions (a "**spin-off disposition**").[208]

However, aspects of the U.S. tax treatment of a transaction like that described in Example 21 remain unclear. In particular, which group should receive the Section 168(k) deduction for the qualified property held by F? Alternatively, in the context of a spin-off disposition where the purchasing entity becomes a subsidiary of a controlled corporation that departs the group in a spin-off, should the distributing corporation's consolidated group receive the Section 168(k) deduction, or the controlled corporation's consolidated group? The legislative history of Section 168(k), including the legislative history of the changes thereto in the Act, indicates that Congress intends Section 168(k) to stimulate the economy by incentivizing capital investment.[209] Using Example 21 as the base case, the capital investor there is the X consolidated group, which paid cash to acquire qualified property from the Parent consolidated group. The X consolidated group makes a capital investment both under the tax fiction imposed by the Proposed Regulations, which treats F as leaving (or not being a member of) the Parent consolidated group prior to purchasing qualified property, and in economic reality, because any purchase of qualified property for cash by F while a part of the Parent consolidated group results in the X consolidated group acquiring qualified property when the X consolidated group acquires F (and having the

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207 Specifically, in such case, Target would be treated as previously holding a depreciable interest in the assets held by Holder and acquired by Buyer, and the transaction would be subject to the Stock/Asset Acquisition Rule.

208 *See, e.g.*, Priv. Ltr. Rul. 201203004 (Jan. 20, 2012).

209 *See* H.R. REP. NO. 107-251, at 20 (2001) (Section 168(k) "will accelerate purchases of equipment, promote capital investment, modernization, and growth, and will help to spur an economic recovery.").

same amount of cash on a group basis as it would have had after an actual purchase).[210] Therefore, on balance, we believe that the consolidated group in which the purchasing entity and the qualified property reside after the completion of the transaction generally should be entitled to the Section 168(k) deduction.

At the same time, we appreciate that a spin-off disposition raises more policy issues than the more simple type of transaction described in Example 21, and it may not be as clear in a spin-off disposition which consolidated group, the distributing corporation's or the controlled corporation's, should receive the Section 168(k) deduction. However, we note that, if the controlled corporation's consolidated group purchased assets from the distributing corporation's consolidated group after the spin-off, the controlled group presumably would receive the full Section 168(k) deduction. Where the same purchase instead takes place a short time before, but as part of the same plan with, the spin-off, it would seem appropriate that the parties receive the same tax results.

Returning to Example 21 in the Proposed Regulations, there appear to be several potential technical obstacles to the X consolidated group's ability to claim a Section 168(k) deduction. Initially, we note that the Proposed Regulations generally eliminate one potential obstacle: F's and G's relatedness, which would otherwise pose an issue under the Unrelated Purchase Test. Under the Proposed Regulations, F and G generally are treated as unrelated persons for purposes of such test.[211] Second, the sale of qualified property clearly occurs first in the series of related transactions in Example 21, prior to F's departure from the group.[212] Therefore, the sale appears to be an intercompany transaction subject to the consolidated return rules. When an intercompany sale of depreciable property occurs within a consolidated group, the group parent generally includes the tax items arising from the sale, including gain or loss and any related deductions, in its consolidated return for that taxable year.[213] The deduction could be included in F's return in some circumstances, for instance if the next day rule altered the date on which the sale was treated as occurring.[214] However, in Example 21, if significant time passes between G's sale to F and F's departure from the Parent consolidated group, it seems likely that the sale would be treated as an intercompany transaction.

The consolidated return rules generally adjust the recognition of tax items in intercompany transactions in order to approximate the result that would attain if the transaction

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[210] In addition, we note that, depending on the form of the acquisition of F, the X consolidated group may be eligible to make an election under Section 338 or Section 336(e) to treat the acquisition as a deemed asset sale.

[211] Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(3)(iii), (b)(3)(iii)(C).

[212] While the example indicates that the qualified property sale comes first, it does not specify the time period between the sale of qualified property and the sale of F's stock. Depending on the breadth of the "series of related transactions" standard, it presumably is possible that a significant amount of time could elapse between the two sales without changing the tax results described in the example.

[213] *See* Treas. Reg. § 1.1502-76(b)(1).

[214] *See* Treas. Reg. § 1.1502-76(b)(1)(ii)(B). Alternatively, a newly-formed buyer corporation that receives assets in a taxable transaction (avoiding successor status) and is immediately transferred to an acquiring consolidated group could also be treated as having never been part of the selling consolidated group. *See* Priv. Ltr. Rul. 201644018 (Oct. 28, 2016).

had occurred between divisions of a single corporation.[215] Accordingly, in the case of an intercompany sale of depreciable property, the selling member generally would recognize gain as the purchasing member took depreciation deductions, producing no net tax result (the same as would occur if one division of a single corporation purchased the property from another division).[216] If the purchasing member recognized a depreciation deduction greater than the selling member's total gain on the sale, the matching rule might treat the excess depreciation deduction as a noncapital, nondeductible amount.[217] If the consolidated return rules applied in this manner to the transaction described in Example 21, the Parent consolidated group might be permitted to take a Section 168(k) deduction only in the amount of G corporation's gain on the sale of qualified property, while the X consolidated group might receive no Section 168(k) deduction.

Additionally, whether an intercompany transaction or not, G's sale to F could be subject to Section 168(i)(7), which generally provides that, in a transfer of depreciable property between two members of the same consolidated group, the transferee "steps into the shoes" of the transferor and continues to use the transferor's existing depreciation method with respect to so much of the transferee's basis in the asset as does not exceed the transferor's basis. If Section 168(i)(7) applied and G had a basis and existing depreciation method with respect to the qualified property, the purchaser, F, generally would continue to depreciate an equal amount of basis in the qualified property under G's depreciation method (and could presumably treat any additional basis in the qualified property as newly purchased and subject to Section 168(k), though this is not clear).[218] Section 168(i)(7) might not apply in certain cases, such as if the qualified property were transferred in a transaction for which a Section 338 or Section 336(e) election were made.[219] However, in Example 21, F and G are members of the same consolidated

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[215] *See* Treas. Reg. § 1.1502-13(c).

[216] *See* Treas. Reg. § 1.1502-13(c)(7)(ii), Ex. 4. Transactions between 3 parties are also subject to the matching rule. *See* Former Reg. § 1.1502-13(c)(7)(ii), Ex. 13 (prior to removal by later regulations for unrelated reasons); *see also* T.D. 9261, 71 Fed. Reg. 26687 (2006).

[217] *See* Treas. Reg. § 1.1502-13(c).

[218] A transfer between members of a consolidated group would also be subject to the Group Prior Use Test, but because one of the group members leaves the group as part of the same series of related transactions that includes the transfer, the departing member's membership in the consolidated group would be tested after the last of the series of related transactions (*i.e.*, after F's departure). *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(3)(iii). Accordingly, F should not be treated as a member of the Parent consolidated group for purposes of the consolidated group rules in the Proposed Regulations, including the Group Prior Use Test.

[219] Some commentators have assumed that the rule in the Section 338 regulations providing that the "old target" and "new target" are treated as unrelated corporations for most U.S. tax purposes prevents Section 168(i)(7) from applying to such a transaction. *See, e.g.*, JAMES T. CHUDY & HARSHA REDDY, 788-3RD T.M., STOCK PURCHASES TREATED AS ASSET ACQUISITIONS – SECTION 338 § IX.A.2.a ("In addition, new target should not be considered related to old target for purposes of the 'churning' or carryover depreciation election rules of §168(f)(5) and §168(i)(7)."). The government may wish to consider guidance confirming this point. *See also* Treas. Reg. § 1.197-2(h)(8) (clarifying that new target in a Section 338 deemed acquisition is not treated as holding or using old target's assets for purposes of Section 197). As a general matter, it is not clear why a Section 338 election should produce a different result in a transaction like Example 21 than a direct asset sale. In our view, the government should instead consider whether Section 168(i)(7) should not apply where the purchasing entity leaves the consolidated group.

group at the time of the sale transaction and, therefore, likely would be subject to Section 168(i)(7).[220]

These potential results under the consolidated return regulations and Section 168(i)(7) appear to conflict with Congress's intent as enacted in the statute, both as to the amount of the allowable deduction (*i.e.*, denying any deduction in excess of the seller's gain) and as to which party is permitted to take a deduction (*i.e.*, the selling consolidated group, which has made no new capital investment). Accordingly, we recommend that the government issue regulations or other guidance specifying (i) which party (the X consolidated group or Parent consolidated group in Example 21, or the distributing corporation consolidated group or controlled corporation consolidated group, in the case of the more complex spin-off disposition) can properly claim a Section 168(k) deduction and (ii) the amount of the deduction and the tax treatment thereof under the consolidated return rules and Section 168(i)(7).

5. Section 336(e) Elections

We agree with the Proposed Regulations' decision to expressly amend Treasury Regulations Section 1.179-4(c)(2) to provide that assets deemed transferred in connection with either a Section 338 election or a Section 336(e) election should be treated as acquired through a qualifying "purchase," which also permits the assets to satisfy the used property acquisition requirements and potentially qualify for immediate expensing.[221] However, we note that the regulations under Section 336(e), which deem an asset transfer to occur notwithstanding a transfer of stock, contain two deemed asset transfer models. The first model, described in Treasury Regulations Section 1.336-2(b)(1), is similar to that of Section 338(h)(10).

The second model, sometimes referred to as the "sale-to-self" model, applies to a distribution of stock of a controlled corporation that qualifies under Section 355(a) but becomes subject to Section 355(d) or Section 355(e) and, therefore, is treated as a taxable distribution to the distributing corporation. This model treats the "old target" (usually, the controlled corporation) as selling its assets to an unrelated party and then purchasing the assets back.[222] Except for certain specified purposes, the sale-to-self model does not treat the target corporation as a newly formed entity.[223]

The lack of a deemed "new target" in the sale-to-self model may pose an issue for a Section 355(d) or Section 355(e) distribution's qualification as a "purchase" under Section 179.

220 While the Proposed Regulations (and other regulations, such as those issued under Section 338, and certain private letter rulings) do test relatedness and/or membership in a consolidated group after the last of a series of related transactions, no such rule clearly applies for Section 168(i)(7) purposes to treat a pure asset sale between F and G while both are still members of the same consolidated group as a transfer between unrelated persons.

221 The preamble to the Proposed Regulations also indicates that this treatment applied under prior law. *See Proposed Regulations*, *supra* note 2, 83 Fed. Reg. at 39,294.

222 *See* Treas. Reg. § 1.336-2(b)(2)(i)(A), (ii)(A).

223 *See* Treas. Reg. § 1.336-2(b)(2)(ii)(C). Absent a rule treating the deemed acquisition in a Treasury Regulations Section 1.336-2(b)(2) scenario as a qualifying purchase, the deemed acquisition may not satisfy the requirements of Section 179(d)(2)(A) and (B); under the Direct Transfer Recast Rule, a controlled corporation could be treating as selling to itself.

Specifically, the Section 179 regulations grant "purchase" status only to acquisitions of assets "deemed to have been acquired by a new target corporation" as a result of a Section 338 election, and the Proposed Regulations generally would maintain this language.[224] This language, however, may suggest that assets transferred in the sale-to-self model are not transferred in a "purchase" for Section 179 purposes and, therefore, do not qualify for immediate expensing.

In addition, the No Prior Use Test may pose an issue under the sale-to-self model. Assuming that the fiction provided for in the Section 336(e) regulations for a Section 355(d) or (e) distribution is respected, and the Direct Transfer Recast Rule does not apply, the old target (usually, the controlled corporation) sells its assets to an unrelated third party and then reacquires the assets from an unrelated third party. Thus, the controlled corporation arguably has previously used the assets in question, potentially causing an issue under the No Prior Use Test.

In general, whether assets transferred under the sale-to-self model should be eligible for immediate expensing is debatable. There arguably is no additional capital investment to justify a Section 168(k) or Section 179[225] deduction in the case of a taxable distribution under Section 355(d) or Section 355(e), though the same could also be said of a stock purchase under Section 338, which expressly qualifies for a Section 168(k) deduction. On the other hand, the sale-to-self model does not appear to have been designed to impose additional restrictions on the deemed asset transfers involved. Rather, the goal of treating the controlled corporation as the same entity was a taxpayer-friendly one, namely, to cause the controlled corporation to preserve its tax attributes (such as E&P) and the consequences of a Section 355(e) distribution as much as possible.[226] Treating a deemed asset transfer under the sale-to-self model as a "purchase" under Section 179 does not interfere with this goal and is consistent with the general approach of Section 336(e) to deem a taxable asset transfer to have occurred. In addition, we note that, in order to avoid negative tax consequences that would otherwise apply in the sale-to-self model under the Section 197 anti-churning rules and the wash sale rules, the existing Section 336(e) regulations already provide several exceptions that treat the sale-to-self deemed asset transfers as occurring between unrelated parties.[227]

We do not ultimately take a position as to whether a deemed asset transfer under the sale-to-self model should be treated as a "purchase" under Section 179 and, therefore, potentially eligible for a Section 168(k) deduction, but note that the government may wish to clarify this

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[224] *See* Treas. Reg. § 1.179-4(c)(2).

[225] Like Section 168(k), Congress's motivation in enacting Section 179 appears to have been to spur investment. *See* H.R. REP. NO. 85-2198, at 5 (1958) (Section 179 "will in the opinion of your committee make it possible for small business to use depreciation reserves for expansion. In addition, this will make less critical the determination of the useful lives of assets in the hands of the taxpayer and the estimation of salvage value. This also should encourage additional investment in small business since it provides for a faster recovery of capital before the taxing of earnings.").

[226] *See* Regulations Enabling Elections for Certain Transactions Under Section 336(e), REG-143544-04, 73 Fed. Reg. 49965, 49968 (Aug. 25, 2008) ("The IRS and Treasury Department believe that, except as necessary to carry out the purposes of section 336(e), the section 355 consequences generally should continue to apply in such a transaction. For example, if the controlled corporation were treated as a new corporation, with no earnings and profits, the controlled corporation may be able to distribute its assets to its shareholders without recognizing any dividend consequences under section 301(c)(1). Therefore, to preserve the consequences of section 355 distributions, the proposed regulations provide special rules").

[227] *See* Treas. Reg. § 1.336-2(b)(2)(ii)(C).

issue. To the extent the government believed it appropriate to permit a Section 355(d) or (e) distribution for which a Section 336(e) election was made to qualify for immediate expensing, the easiest way to address both the Section 179 "purchase" issue and the No Prior Use Test would be to provide, either through a regulatory amendment to Treasury Regulations Section 1.336-2(b)(2)(ii)(C) or other applicable guidance, that, for Section 179(d) and Section 168(k) purposes, the old target in its capacity as an acquiror of assets should be treated as a separate and distinct taxpayer unrelated to the old target in its capacity as a seller of assets.

6. Interaction of Section 181 & Section 168(k)

The Act added qualified film or television productions and qualified live theatrical productions to the definition of qualified property under Section 168(k)(2)(A)(i), permitting taxpayers to take Section 168(k) deductions for such an item if acquired and placed in service after September 27, 2017. Section 181, as amended by the Bipartisan Budget Act of 2018,[228] also permits a taxpayer to expense the cost of such a production, subject to a specific dollar limitation on the amount of the deduction and so long as the production is commenced on or prior to December 31, 2017.[229]

It is not clear how these two expensing provisions interact with respect to a production acquired and placed in service after September 27, 2017 and commenced on or prior to December 31, 2017. Section 168(k) does not address this issue: at the time of the Act's enactment, there was no risk of interaction because Section 181 applied solely with respect to productions commenced on or prior to December 31, 2016. One possible model to adopt would be Section 179, which, like Section 181, is subject to a specific dollar limitation. The Prior Section 168(k) Regulations specifically provide that the Section 168(k) deduction applies to the portion of an asset's basis remaining after any Section 179 deduction.[230] The government may wish to consider issuing similar guidance with respect to the interaction of Section 181 and Section 168(k).

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[228] *See* Pub. L. No. 115-123, § 40308, 132 Stat. 64, 83 (2018).

[229] Because of the differing language of the Section 168(k) "placed in service" and "acquisition date" requirements and the Section 181(g) "commencement" requirement, a production might be treated as "commenced" on a different date than it was "placed in service" or "acquired."

[230] *See* Treas. Reg. § 1.168(k)-1(d)(1)(i), (a)(2)(iii).

Federal Regulations

¶153,773. Preamble to Prop Regs. 08/08/2018. Fed. Reg. Vol. 83, No. 153 p. 39292.

[REG- 104397- 18]

Additional First Year Depreciation Deduction §§ 1.48-12, 1.167(a)-14, 1.168(b)-1, 1.168(d)-1, 1.168(i)-4, 1.168(i)-6, 1.168(k)-0, 1.168(k)-2, 1.169-3, 1.179-4, 1.179-6, 1.312-15, 1.704-1, 1.704-3, 1.743-1

SUMMARY:

This document contains proposed regulations that provide guidance regarding the additional first year depreciation deduction under section 168(k) of the Internal Revenue Code (Code). These proposed regulations reflect changes made by the Tax Cuts and Jobs Act. These proposed regulations affect taxpayers who deduct depreciation for qualified property acquired and placed in service after September 27, 2017.

DATES:

Written or electronic comments and requests for a public hearing must be received by October 9, 2018.

ADDRESSES:

Send submissions to: CC:PA:LPD:PR (REG- 104397- 18), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG- 104397- 18), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC 20224, or sent electronically via the Federal eRulemaking Portal at http:// www.regulations.gov (IRS REG- 104397- 18).

FOR FURTHER INFORMATION CONTACT:

Concerning the proposed regulations, Elizabeth R. Binder, (202) 317-7005; concerning submissions of comments or requests for a public hearing, Regina L. Johnson, (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to 26 CFR part 1 under section 168(k). Section 168(k) was added to the Code by section 101 of the Job Creation and Worker Assistance Act of 2002, Public Law 107-147 (116 Stat. 21). Section 168(k) allows an additional first year depreciation deduction in the placed-in-service year of qualified property. Subsequent amendments to section 168(k) increased the percentage of the additional first year depreciation deduction from 30 percent to 50 percent (to 100 percent for property acquired and placed in service after September 8, 2010, and generally before January 1, 2012), extended the placed-in-service date generally through December 31, 2019, and made other changes. See section 201 of the Jobs and Growth Tax Relief Reconciliation Act of 2003, Public Law 108-27 (117 Stat. 752), sections 403 and 408 of the Working Families Tax Relief Act of 2004, Public Law 108-311 (118 Stat. 1166), sections 336 and 337 of the American Jobs Creation Act of 2004, Public Law 108-357 (118 Stat. 1418), sections 403 and 405 of the Gulf Opportunity Zone Act of 2005, Public Law 109-135 (119 Stat. 2577), section 103 of the Economic Stimulus Act of 2008, Public Law 110-185 (122 Stat. 613), section 3081 of the Housing Assistance Tax Act of 2008, Public Law 110-289 (122 Stat. 2654), section 1201 of the American Recovery and Reinvestment Tax Act of 2009, Public Law 111-5 (123 Stat. 115), section 2022 of the Small Business Jobs Act of 2010, Public Law 111-240 (124 Stat. 2504), section 401 of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Public Law 111-312 (124 Stat. 3296), section 331 of the American Taxpayer Relief Act of 2012, Public Law 112-240 (126 Stat. 2313), sections 125, 202, 210, 212, and 214 of the Tax Increase Prevention Act of 2014, Public Law 113-295 (128 Stat. 4010), and section 143 of the Protecting Americans from Tax Hikes Act of 2015, enacted as Division Q of the Consolidated Appropriations Act, 2016, Public Law 114-113 (129 Stat. 2242).

On December 22, 2017, section 168(k) and related provisions were amended by sections 12001(b)(13), 13201, and 13204 of the Tax Cuts and Jobs Act, Public Law 115-97 (131 Stat. 2054) (the "Act") to provide further changes to the additional first year depreciation deduction. Unless otherwise indicated, all references to section 168(k) hereinafter are references to section 168(k) as amended.

Section 167(a) allows as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in a trade or business or of property held for the production of income. The depreciation deduction allowable for tangible depreciable property placed in service after

1986 generally is determined under the Modified Accelerated Cost Recovery System provided by section 168 (MACRS property). The depreciation deduction allowable for computer software that is placed in service after August 10, 1993, and is not an amortizable section 197 intangible, is determined under section 167(f)(1).

Section 168(k), prior to amendment by the Act, allowed an additional first year depreciation deduction for the placed-in-service year equal to 50 percent of the adjusted basis of qualified property. Qualified property was defined in part as property the original use of which begins with the taxpayer.

Section 13201 of the Act made several amendments to the allowance for additional first year depreciation deduction in section 168(k). For example, the additional first year depreciation deduction percentage is increased from 50 to 100 percent; the property eligible for the additional first year depreciation deduction is expanded to include certain used depreciable property and certain film, television, or live theatrical productions; the placed-in-service date is extended from before January 1, 2020, to before January 1, 2027 (from before January 1, 2021, to before January 1, 2028, for longer production period property or certain aircraft property described in section 168(k)(2)(B) or (C)); and the date on which a specified plant is planted or grafted by the taxpayer is extended from before January 1, 2020, to before January 1, 2027.

Section 168(k) allows a 100-percent additional first year depreciation deduction for qualified property acquired and placed in service after September 27, 2017, and placed in service before January 1, 2023 (before January 1, 2024, for longer production period property or certain aircraft property described in section 168(k)(2)(B) or (C)). If a taxpayer elects to apply section 168(k)(5), the 100-percent additional first year depreciation deduction also is allowed for a specified plant planted or grafted after September 27, 2017, and before January 1, 2023. The 100-percent additional first year depreciation deduction is decreased by 20 percent annually for qualified property placed in service, or a specified plant planted or grafted, after December 31, 2022 (after December 31, 2023, for longer production period property or certain aircraft property described in section 168(k)(2)(B) or (C)).

Section 168(k)(2)(A), as amended by the Act, defines "qualified property" as meaning, in general, property (1) to which section 168 applies that has a recovery period of 20 years or less, which is computer software as defined in section 167(f)(1)(B) for which a deduction is allowable under section 167(a) without regard to section 168(k), which is water utility property, which is a qualified film or television production as defined in section 181(d) for which a deduction would have been allowable without regard to section 181(a)(2) or (g) or section 168(k), or which is a qualified live theatrical production as defined in section 181(e) for which a deduction would have been allowable without regard to section 181(a)(2) or (g) or section 168(k); (2) the original use of which begins with the taxpayer or the acquisition of which by the taxpayer meets the requirements of section 168(k)(2)(E)(ii); and (3) which is placed in service by the taxpayer before January 1, 2027. Section 168(k)(2)(E)(ii) requires that the acquired property was not used by the taxpayer at any time prior to such acquisition and the acquisition of such property meets the requirements of section 179(d)(2)(A), (B), and (C) and section 179(d)(3).

However, section 168(k)(2)(D) provides that qualified property does not include any property to which the alternative depreciation system under section 168(g) applies, determined without regard to section 168(g)(7) (relating to election to have the alternative depreciation system apply), and after application of section 280F(b) (relating to listed property with limited business use).

Section 13201(h) of the Act provides the effective dates of the amendments to section 168(k) made by section 13201 of the Act. Except as provided in section 13201(h)(2) of the Act, section 13201(h)(1) of the Act provides that these amendments apply to property acquired and placed in service after September 27, 2017. However, property is not treated as acquired after the date on which a written binding contract is entered into for such acquisition. Section 13201(h)(2) provides that the amendments apply to specified plants planted or grafted after September 27, 2017.

Additionally, section 12001(b)(13) of the Act repealed section 168(k)(4) (relating to the election to accelerate alternative minimum tax credits in lieu of the additional first year depreciation deduction) for taxable years beginning after December 31, 2017. Further, section 13204(a)(4)(B)(ii) repealed section 168(k)(3) (relating to qualified improvement property) for property placed in service after December 31, 2017.

Explanation of Provisions

The proposed regulations describe and clarify the statutory requirements that must be met for depreciable property to qualify for the additional first year depreciation deduction provided by section 168(k). Further, the proposed regulations instruct taxpayers how to determine the additional first year depreciation deduction and the amount of depreciation otherwise allowable for this property. Because the Act made substantial amendments to section 168(k), the proposed regulations update existing regulations in §1.168(k)-1 by providing a new section at §1.168(k)-2 for property acquired and placed in service after September 27, 2017, and make conforming amendments to the existing regulations.

1. Eligibility Requirements for Additional First Year Depreciation Deduction

The proposed regulations follow section 168(k)(2), as amended by the Act, and section 13201(h) of the Act to provide that depreciable property must meet four requirements to be qualified property. These requirements are (1) the depreciable property must be of a specified type; (2) the original use of the depreciable property must commence with the taxpayer or used depreciable property must meet the acquisition requirements of section 168(k)(2)(E)(ii); (3) the depreciable property must be placed in service by the taxpayer within a specified time period or must be planted or grafted by the taxpayer before a specified date; and (4) the depreciable property must be acquired by the taxpayer after September 27, 2017.

2. Property of a Specified Type

A. Property Eligible for the Additional First Year Depreciation Deduction

The proposed regulations follow the definition of qualified property in section 168(k)(2)(A)(i) and (k)(5) and provide that qualified property must be one of the following: (1) MACRS property that has a recovery period of 20 years or less; (2) computer software as defined in, and depreciated under, section 167(f)(1); (3) water utility property as defined in section 168(e)(5) and depreciated under section 168; (4) a qualified film or television production as defined in section 181(d) and for which a deduction would have been allowable under section 181 without regard to section 181(a)(2) and (g) or section 168(k); (5) a qualified live theatrical production as defined in section 181(e) and for which a deduction would have been allowable under section 181 without regard to section 181(a)(2) and (g) or section 168(k); or (6) a specified plant as defined in section 168(k)(5)(B) and for which the taxpayer has made an election to apply section 168(k)(5). Qualified improvement property acquired after September 27, 2017, and placed in service after September 27, 2017, and before January 1, 2018, also is qualified property.

For property placed in service after December 31, 2017, section 13204 of the Act amended section 168(e) to eliminate the 15-year MACRS property classification for qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property, and amended section 168(k) to eliminate qualified improvement property as a specific category of qualified property. Because of the effective date of section 13204 of the Act (property placed in service after December 31, 2017), the proposed regulations provide that MACRS property with a recovery period of 20 years or less includes the following MACRS property that is acquired by the taxpayer after September 27, 2017, and placed in service by the taxpayer after September 27, 2017, and before January 1, 2018: (1) Qualified leasehold improvement property; (2) qualified restaurant property that is qualified improvement property; and (3) qualified retail improvement property. For the same reason, the proposed regulations provide that qualified property includes qualified improvement property that is acquired by the taxpayer after September 27, 2017, and placed in service by the taxpayer after September 27, 2017, and before January 1, 2018. Further, to account for the statutory amendments to the definition of qualified improvement property made by the Act, the proposed regulations define qualified improvement property for purposes of section 168(k)(3) (before amendment by section 13204 of the Act) and section 168(e)(6) (as amended by section 13204 of the Act).

For purposes of determining the eligibility of MACRS property as qualified property, the proposed regulations retain the rule in §1.168(k)-1(b)(2)(i)(A) that the recovery period applicable for the MACRS property under section 168(c) of the general depreciation system (GDS) is used, regardless of any election made by the taxpayer to depreciate the class of property under the alternative depreciation system of section 168(g) (ADS).

B. Property Not Eligible for the Additional First Year Depreciation Deduction

The proposed regulations provide that qualified property does not include (1) property excluded from the application of section 168 as a result of section 168(f); (2) property that is required to be depreciated under the ADS (as described below); (3) any class of property for which the taxpayer elects not to deduct the additional first year depreciation under section 168(k)(7); (4) a specified plant placed in service by the taxpayer in the taxable year and for which the taxpayer made an election to apply section 168(k)(5) for a prior year under section 168(k)(5)(D); (5) any class of property for which the taxpayer elects to apply section 168(k)(4) (this exclusion applies to property placed in service in any taxable year beginning before January 1, 2018, because section 12001(b)(13) of the Act repealed section 168(k)(4) for taxable years beginning after December 31, 2017); or (6) property described in section 168(k)(9)(A) or (B). Section 168(k)(9) provides that qualified property does not include (A) any property that is primarily used in a trade or business described in section 163(j)(7)(A)(iv), or (B) any property used in a trade or business that has had floor plan financing indebtedness (as defined in section 163(j)(9)) if the floor plan financing interest related to such indebtedness was taken into account under section 163(j)(1)(C). Section 163(j) applies to taxable years beginning after December 31, 2017. Accordingly, the exclusion of property described in section 168(k)(9) from the additional first year depreciation deduction applies to property placed in service in any taxable year beginning after December 31, 2017.

Property is required to be depreciated under the ADS if the property is described under section 168(g)(1)(A), (B), (C), (D), (F), or (G) or if other provisions of the Code require depreciation for the property to be determined under the ADS. Accordingly, MACRS property that is nonresidential real property, residential rental property, and qualified improvement property held by an electing real property trade or business (as defined in section 163(j)(7)(B)), and property with a recovery period of 10 years or more that is held by an electing farming business (as defined in section 163(j)(7)(C)), are not eligible for the additional first year depreciation deduction for taxable years beginning after December 31, 2017. Pursuant to section 168(k)(2)(D), MACRS property for which the taxpayer makes an election under section 168(g)(7) to depreciate the property under the ADS is eligible for the additional first year depreciation deduction (assuming all other requirements are met).

C. Elections

The proposed regulations provide rules for making the election out of the additional first year depreciation deduction pursuant to section 168(k)(7) and for making the election to apply section 168(k)(5) to a specified plant. Additionally, the proposed regulations provide rules for making the election under section 168(k)(10) to deduct 50 percent, instead of 100 percent, additional first year depreciation for qualified property acquired after September 27, 2017, by the taxpayer and placed in service or planted or grafted, as applicable, by the taxpayer during its taxable year that includes September 28, 2017. Because section 168(k)(10) does not state that the election may be made "with respect to any class of property" as stated in section 168(k)(7) for making the election out of the additional first year depreciation deduction, the proposed regulations provide that the election under section 168(k)(10) applies to all qualified property.

3. New and Used Property

A. New Property

The proposed regulations generally retain the original use rules in §1.168(k)-1(b)(3). Pursuant to section 168(k)(2)(A)(ii), the proposed regulations do not provide any date by which the original use of the property must commence with the taxpayer. Because section 13201 of the Act removed the rules regarding saleleaseback transactions, the proposed regulations also do not retain the original use rules in §1.168(k)-1(b)(3)(iii)(A) and (C) regarding such transactions, including a sale-leaseback transaction followed by a syndication transaction. The rule in the proposed regulations for syndication transactions involving new or used property is explained later in the preamble.

B. Used Property

Pursuant to section 168(k)(2)(A)(ii) and (k)(2)(E)(ii), the proposed regulations provide that the acquisition of used property is eligible for the additional first year depreciation deduction if such acquisition meets the following requirements: (1) The property was not used by the taxpayer or a predecessor at any time prior to the acquisition; (2) the acquisition of the property meets the related party and carryover basis requirements of section 179(d)(2)(A), (B), and (C) and §1.179-4(c)(1)(ii), (iii), and (iv), or (c)(2); and (3) the acquisition of the property meets the cost requirements of section 179(d)(3) and §1.179-4(d).

i. Section 336(e) Election

A section 338 election and a section 336(e) election share many of the same characteristics. Therefore, the proposed regulations modify §1.179-4(c)(2), which addresses the treatment of a section 338 election, to include property deemed to have been acquired by a new target corporation as a result of a section 336(e) election. Section 1.336-1(a)(1) provides that to the extent not inconsistent with section 336(e) or the regulations under section 336(e), the principles of section 338 and the regulations under section 338 apply for purposes of the regulations under section 336. To the extent that property is deemed to have been acquired by a "new target corporation," the Treasury Department and the IRS read §1.179-4(c)(2), without modification, as applying to the deemed acquisition of property by a new target corporation as a result of a section 336(e) election, just as it applies as the result of a section 338 election. However, to remove any doubt, the proposed regulations modify §1.179-4(c)(2) to provide that property deemed to have been acquired by a new target corporation as a result of a section 338 or a section 336(e) election will be considered acquired by purchase for purposes of section 179.

ii. Property Not Previously Used By The Taxpayer

The proposed regulations provide that the property is treated as used by the taxpayer or a predecessor at any time before its acquisition of the property only if the taxpayer or the predecessor had a depreciable interest in the property at any time before the acquisition, whether or not the taxpayer or the predecessor claimed depreciation deductions for the property. If a lessee has a depreciable interest in the improvements made to leased property and subsequently the lessee acquires the leased property of which the improvements are a part, the proposed regulations provide that the unadjusted depreciable basis, as defined in §1.168(b)-1(a)(3), of the acquired property that is eligible for the additional first year depreciation deduction, assuming all other requirements are met, does not include the unadjusted depreciable basis attributable to the improvements.

Further, if a taxpayer initially acquires a depreciable interest in a portion of the property and subsequently acquires an additional depreciable interest in the same property, the proposed regulations also provide that such additional depreciable interest is not treated as being previously used by the taxpayer. However, if a taxpayer holds a depreciable interest in a portion of the property, sells that portion or a part of that portion, and subsequently acquires a depreciable interest in another portion of the same property, the proposed regulations provide that the taxpayer will be treated as previously having a depreciable interest in the property up to the amount of the portion for which the taxpayer held a depreciable interest in the property before the sale.

The Treasury Department and the IRS request comments on whether a safe harbor should be provided on how many taxable years a taxpayer or a predecessor should look back to determine if the taxpayer or the predecessor previously had a depreciable interest in the property. Such comments should provide the number of taxable years recommended for the look-back period and the reasoning for such number.

iii. Rules Applying to Consolidated Groups

Members of a consolidated group generally are treated as separate taxpayers. See Woolford Realty Co. v. Rose, 286 U.S. 319, 328 (1932) ("[a] corporation does not cease to be [a taxpayer] by affiliating with another"). However, the Treasury Department and the IRS believe that the additional first year depreciation deduction should not be permitted to members of a consolidated group when property is disposed of by one member of a consolidated group outside the group and subsequently acquired by another member of the same group because permitting such a deduction would not clearly reflect the group's income tax liability. See section 1502 (permitting consolidated group regulations different from the rules of chapter 1 of subtitle A of the Code otherwise applicable to separate corporations to clearly reflect the income tax liability of a consolidated group or each member of the group). To implement this position, these proposed regulations treat a member of a consolidated group as previously having a depreciable interest in all property in which the consolidated group is treated as previously having a depreciable interest. For purposes of this rule, a consolidated group will be treated as having a depreciable interest in property if any current or previous member of the group had a depreciable interest in the property while a member of the group.

The Treasury Department and the IRS also believe that the additional first year depreciation deduction should not be allowed when, as part of a series of related transactions, one or more members of a consolidated group acquire both the stock of a corporation that previously had a depreciable interest in the property and the property itself. Assume a corporation (the selling corporation) has a depreciable interest in property and sells it to an unrelated party. Subsequently, as part of a series of related transactions, a member of a consolidated group, unrelated to the selling corporation, acquires the property and either that member or a different member of the group acquires the stock of the selling corporation. In substance, the series of transactions is the same as if the selling corporation reacquired the property and then transferred it to another member of the group, in which case the additional first year depreciation deduction would not be allowed. Accordingly, these proposed regulations deny the deduction in such circumstances.

Additionally, if the acquisition of property is part of a series of related transactions that also includes one or more transactions in which the transferee of the property ceases to be a member of a consolidated group, then whether the taxpayer is a member of a consolidated group is tested immediately after the last transaction in the series.

iv. Series of Related Transactions

In determining whether property meets the requirements of section 168(k)(2)(E)(ii), the Treasury Department and the IRS believe that the ordering of steps, or the use of an unrelated intermediary, in a series of related transactions should not control. For example, if a father buys and places equipment in service for use in the father's trade or business and subsequently the father sells the equipment to his daughter for use in her trade or business, the father and daughter are related parties under section 179(d)(2)(A) and §1.179-4(c)(1)(ii) and therefore, the daughter's acquisition of the equipment is not eligible for the additional first year depreciation deduction. However, if in a series of related transactions, the father sells the equipment to an unrelated party and then the unrelated party sells the equipment to the father's daughter, the daughter's acquisition of the equipment from the unrelated party, absent the rule in the proposed regulations, is eligible for the additional first year depreciation deduction (assuming all other requirements are met). Thus, the proposed regulations provide that in the case of a series of related transactions, the transfer of the property will be treated as directly transferred from the original transferor to the ultimate transferee, and the relation between the original transferor and the ultimate transferee is tested immediately after the last transaction in the series.

C. Application to Partnerships

On September 8, 2003, the Treasury Department and the IRS published temporary regulations (T.D. 9091, 2003-2 C.B. 939) in the Federal Register (68 FR 52986) relating to the additional first year depreciation deduction provisions of sections 168(k) and 1400L(b) (before amendment by sections 403 and 408 of the Working Families Tax Relief Act of 2004). Those regulations provided that any increase in the basis of qualified property due to a section 754 election generally is not eligible for the additional first year depreciation deduction. The preamble to those regulations explained that any increase in basis due to a section 754 election does not satisfy the original use requirement. The final regulations (T.D. 9283, 2006-2 C.B. 633, 642-43) published in the Federal Register on August 31, 2006 (71 FR 51738) retained the rule for increases in basis due to section 754 elections at §1.168(k)-1(f)(9). Because the Act amended section 168(k) to allow the additional first year depreciation deduction for certain used property in addition to new property, the Treasury Department and the IRS have reconsidered whether basis adjustments under sections 734(b) and 743(b) now qualify for the additional first year depreciation deduction. The Treasury Department and the IRS also have considered whether certain section 704(c) adjustments as well as the basis of distributed property determined under section 732 should qualify for the additional first year depreciation deduction.

i. Section 704(c) Remedial Allocations

Section 1.704-3(d)(2) provides, in part, that under the remedial allocation method, the portion of a partnership's book basis in contributed property that exceeds its adjusted tax basis is recovered using any recovery period and depreciation (or other cost recovery) method available to the partnership for newly purchased property (of the same type as the contributed property) that is placed in service at the time of contribution. The proposed regulations provide that remedial allocations under section 704(c) do not qualify for the additional first year depreciation deduction under section 168(k).

Notwithstanding the language of §1.704-3(d)(2) that any method available to the partnership for newly purchased property may be used to recover the portion of the partnership's book basis in contributed property that exceeds its adjusted tax basis, remedial allocations do not meet the requirements of section 168(k)(2)(E)(ii). Because the underlying property is contributed to the partnership in a section 721 transaction, the partnership's basis in the property is determined by reference to the contributing partner's basis in the property, which violates sections 179(d)(2)(C) and 168(k)(2)(E)(ii)(II). In addition, the partnership has already had a depreciable interest in the contributed property at the time the remedial allocation is made, which is in violation of section 168(k)(2)(E)(ii)(I) as well as the original use requirement.

The same rule applies in the case of revaluations of partnership property (reverse section 704(c) allocations).

ii. Zero Basis Property

Section 1.704-1(b)(2)(iv)(g)(3) provides that, if partnership property has a zero adjusted tax basis, any reasonable method may be used to determine the book depreciation, depletion, or amortization of the property. The proposed regulations provide that the additional first year depreciation deduction under section 168(k) will not be allowed on property contributed to the partnership with a zero adjusted tax basis because, with the additional first year depreciation deduction, the partners have the potential to shift built-in gain among partners.

iii. Basis Determined Under Section 732

Section 732(a)(1) provides that the basis of property (other than money) distributed by a partnership to a partner other than in liquidation of the partner's interest is its adjusted basis to the partnership immediately before the distribution. Section 732(a)(2) provides that the basis determined under section 732(a)(1) shall not exceed the adjusted basis of the partner's interest in the partnership reduced by any money distributed in the same transaction. Section 732(b) provides that the basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest is equal to the adjusted basis of the partner's interest in the partnership reduced by any money distributed in the same transaction.

Property distributed by a partnership to a partner fails to satisfy the original use requirement because the partnership used the property prior to the distribution. Distributed property also fails to satisfy the acquisition requirements of section 168(k)(2)(E)(ii)(II). Any portion of basis determined by section 732(a)(1) fails to satisfy section 179(d)(2)(C) because it is determined by reference to the partnership's basis in the distributed property. Similarly, any portion of basis determined by section 732(a)(2) or (b) fails to satisfy section 179(d)(3) because it is determined by reference to the distributee partner's basis in its partnership interest (reduced by any money distributed in the same transaction).

iv. Section 734(b) Adjustments

Section 734(b)(1) provides that, in the case of a distribution of property to a partner with respect to which a section 754 election is in effect (or when there is a substantial basis reduction under section 734(d)), the partnership will increase the adjusted basis of partnership property by the sum of (A) the amount of any gain recognized to the distributee partner under section 731(a)(1), and (B) in the case of distributed property to which section 732(a)(2) or (b) applies, the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution (as adjusted by section 732(d)) over the basis of the distributed property to the distributee, as determined under section 732.

Because a section 734(b) basis adjustment is made to the basis of partnership property (i.e., non-partner specific basis) and the partnership used the property prior to the partnership distribution giving rise to the basis adjustment, a section 734(b) basis adjustment fails the original use clause in section 168(k)(2)(A)(ii) and also fails the used property requirement in section 168(k)(2)(E)(ii)(I). The proposed regulations therefore provide that section 734(b) basis adjustments are not eligible for the additional first year depreciation deduction.

v. Section 743(b) Adjustments

Section 743(b)(1) provides that, in the case of a transfer of a partnership interest, either by sale or exchange or as a result of the death of a partner, a partnership that has a section 754 election in effect (or if there is a substantial built-in loss immediately after such partnership interest transfer under section 743(d)), will increase the adjusted basis of partnership property by the excess of the transferee's basis in the transferred partnership interest over the transferee's share of the adjusted basis of partnership's property. This increase is an adjustment to the basis of partnership property with respect to the transferee partner only and, therefore, is a partner specific basis adjustment to partnership property. The section 743(b) basis adjustment is allocated among partnership properties under section 755. As stated above, prior to the Act, a section 743(b) basis adjustment would always fail the original use requirement in section 168(k)(2)(A)(ii) because partnership property to which a section 743(b) basis adjustment relates would have been previously used by the partnership and its partners prior to the transfer that gave rise to the section 743(b) adjustment. After the Act, while a section 743(b) basis adjustment still fails the original use clause in section 168(k)(2)(A)(ii), a transaction giving rise to a section 743(b) basis adjustment may satisfy the used property clause in section 168(k)(2)(A)(ii) because of the used property acquisition requirements of section 168(k)(2)(E)(ii), depending on the facts and circumstances.

Because a section 743(b) basis adjustment is a partner specific basis adjustment to partnership property, the proposed regulations take an aggregate view and provide that, in determining whether a section 743(b) basis adjustment meets the used property acquisition requirements of section 168(k)(2)(E)(ii), each partner is treated as having owned and used the partner's proportionate share of partnership property. In the case of a transfer of a partnership interest, section 168(k)(2)(E)(ii)(I) will be satisfied if the partner acquiring the interest, or a predecessor of such partner, has not used the portion of the partnership property to which the section 743(b) basis adjustment relates at any time prior to the acquisition (that is, the transferee has not used the transferor's portion of partnership property prior to the acquisition), notwithstanding the fact that the partnership itself has previously used the property. Similarly, for purposes of applying section 179(d)(2)(A), (B), and (C), the partner acquiring a partnership interest is treated as acquiring a portion of partnership property, and the partner who is transferring a partnership interest is treated as the person from whom the property is acquired.

For example, the relationship between the transferor partner and the transferee partner must not be a prohibited relationship under section 179(d)(2)(A). Also, the transferor partner and transferee partner may not be part of the same controlled group under section 179(d)(2)(B). Finally, the transferee partner's basis in the transferred partnership interest may not be determined in whole or in part by reference to the transferor's adjusted basis, or under section 1014.

The same result will apply regardless of whether the transferee partner is a new partner or an existing partner purchasing an additional partnership interest from another partner. Assuming that the transferor partner's specific interest in partnership property that is acquired by the transferee partner has not previously been used by the transferee partner or a predecessor, the corresponding section 743(b) basis adjustment will be eligible for the additional first year depreciation deduction in the hands of the transferee partner, provided all other requirements of section 168(k) are satisfied (and assuming

§1.743-1(j)(4)(i)(B)(2) does not apply). This treatment is appropriate notwithstanding the fact that the transferee partner may have an existing interest in the underlying partnership property, because the transferee's existing interest in the underlying partnership property is distinct from the interest being transferred.

Finally, the proposed regulations provide that a section 743(b) basis adjustment in a class of property (not including the property class for section 743(b) basis adjustments) may be recovered using the additional first year depreciation deduction under section 168(k) without regard to whether the partnership elects out of the additional first year depreciation deduction under section 168(k)(7) for all other qualified property in the same class of property and placed in service in the same taxable year. Similarly, a partnership may make the election out of the additional first year depreciation deduction under section 168(k)(7) for a section 743(b) basis adjustment in a class of property (not including the property class for section 743(b) basis adjustments), and this election will not bind the partnership to such election for all other qualified property of the partnership in the same class of property and placed in service in the same taxable year.

D. Syndication Transaction

The syndication transaction rule in the proposed regulations is based on the rules in section 168(k)(2)(E)(iii) for syndication transactions. For new or used property, the proposed regulations provide that if (1) a lessor has a depreciable interest in the property and the lessor and any predecessor did not previously have a depreciable interest in the property, (2) the property is sold by the lessor or any subsequent purchaser within three months after the date the property was originally placed in service by the lessor (or, in the case of multiple units of property subject to the same lease, within three months after the date the final unit is placed in service, so long as the period between the time the first unit is placed in service and the time the last unit is placed in service does not exceed 12 months), and (3) the user (lessee) of the property after the last sale during the three-month period remains the same as when the property was originally placed in service by the lessor, then the purchaser of the property in the last sale during the three-month period is considered the taxpayer that acquired the property and the taxpayer that originally placed the property in service, but not earlier than the date of the last sale. Thus, if a transaction is within the rules described above, the purchaser of the property in the last sale during the three-month period is eligible to claim the additional first year depreciation for the property (assuming all requirements are met), and the earlier purchasers of the property are not.

4. Placed-in-Service Date

The proposed regulations generally retain the placed-in-service date rules in §1.168(k)-1(b)(5). Pursuant to the effective date in section 13201(h) of the Act and section 168(k)(2)(A)(iii) and (k)(2)(B)(i)(II), the proposed regulations provide that qualified property must be placed in service by the taxpayer after September 27, 2017, and before January 1, 2027, or, in the case of property described in section

168(k)(2)(B) or (C), before January 1, 2028. Because section 13201 of the Act removed the rules regarding sale-leaseback transactions, the proposed regulations do not retain the placed-in-service date rules in §1.168(k)-1(b)(5)(ii)(A) and (C) regarding such transactions, including a sale-leaseback transaction followed by a syndication transaction.

Further, the proposed regulations provide rules for specified plants. Pursuant to section 168(k)(5)(A), if the taxpayer has made an election to apply section 168(k)(5) for a specified plant, the proposed regulations provide that the specified plant must be planted before January 1, 2027, or grafted before January 1, 2027, to a plant that has already been planted, by the taxpayer in the ordinary course of the taxpayer's farming business, as defined in section 263A(e)(4).

Pursuant to section 168(k)(2)(H), the proposed regulations also provide that a qualified film or television production is treated as placed in service at the time of initial release or broadcast as defined under §1.181-1(a)(7), and a qualified live theatrical production is treated as placed in service at the time of the initial live staged performance. The proposed regulations also provide that the initial live staged performance of a qualified live theatrical production is the first commercial exhibition of a production to an audience. An initial live staged performance does not include limited exhibition, prior to commercial exhibition to general audiences, if the limited exhibition is primarily for purposes of publicity, determining the need for further production activity, or raising funds for the completion of production. For example, the initial live staged performance does not include a preview of the production if the preview is primarily to determine the need for further production activity.

5. Date of Acquisition

The proposed regulations provide rules applicable to the acquisition requirements of the effective date under section 13201(h) of the Act. The proposed regulations provide that these rules apply to all property, including self-constructed property or property described in section 168(k)(2)(B) or (C).

A. Written Binding Contract

Pursuant to section 13201(h)(1)(A) of the Act, the proposed regulations provide that the property must be acquired by the taxpayer after September 27, 2017, or, acquired by the taxpayer pursuant to a written binding contract entered into by the taxpayer after September 27, 2017. Because of the clear language of section 13201(h)(1) of the Act regarding written binding contracts, the proposed regulations also provide that property that is manufactured, constructed, or produced for the taxpayer by another person under a written binding contract that is entered into prior to the manufacture, construction, or production of the property for use by the taxpayer in its trade or business or for its production of income is acquired pursuant to a written binding contract. Further, if the written binding contract states the date on which the contract was entered into and a closing date, delivery date, or other similar date, the date on which the contract was entered into is the date the taxpayer acquired the property. The proposed regulations retain the rules in §1.168(k)-1(b)(4)(ii) defining a binding contract. Additionally, the proposed regulations provide that a letter of intent for an acquisition is not a binding contract.

B. Self-Constructed Property

If a taxpayer manufactures, constructs, or produces property for its own use, the Treasury Department and the IRS recognize that the written binding contract rule in section 13201(h)(1) of the Act does not apply. In such case, the proposed regulations provide that the acquisition rules in section 13201(h)(1) of the Act are treated as met if the taxpayer begins manufacturing, constructing, or producing the property after September 27, 2017. The proposed regulations provide rules similar to those in §1.168(k)-1(b)(4)(iii)(B) for defining when manufacturing, construction, or production begins, including the safe harbor, and in §1.168(k)-1(b)(4)(iii)(C) for a contract to acquire, or for the manufacture, construction, or production of, a component of the larger self-constructed property. As stated in the preceding paragraph, these selfconstructed rules in the proposed regulations do not apply to property that is manufactured, constructed, or produced for the taxpayer by another person under a written binding contract that is entered into prior to the manufacture, construction, or production of the property.

C. Qualified Film, Television, or Live Theatrical Productions

The proposed regulations also provide rules for qualified film, television, or live theatrical productions. For purposes of section 13201(h)(1)(A) of the Act, the proposed regulations provide that a qualified film or television production is treated as acquired on the date principal photography commences, and a qualified live theatrical production is treated as acquired on the date when all of the necessary elements for producing the live theatrical production are secured. These elements may include a script, financing, actors, set, scenic and costume designs, advertising agents, music, and lighting.

D. Specified Plants

Pursuant to section 13201(h)(2) of the Act, if the taxpayer makes an election to apply section 168(k)(5) for a specified plant, the proposed regulations provide that the specified plant must be planted after September 27, 2017, or grafted after September 27, 2017, to a plant that has already been planted, by the taxpayer in the ordinary course of the taxpayer's farming business, as defined in section 263A(e)(4).

6. Longer Production Period Property or Certain Aircraft Property

The proposed regulations provide rules for determining when longer production period property or certain aircraft property described in section 168(k)(2)(B) or (C) meets the acquisition requirements of section 168(k)(2)(B)(i)(III) or (k)(2)(C)(i), as applicable. Pursuant to section 168(k)(2)(B)(i)(III) and (k)(2)(C)(i), the proposed regulations provide that property described in section 168(k)(2)(B) or (C) must be acquired by the taxpayer before January 1, 2027, or acquired by the taxpayer pursuant to a written binding contract that is entered into before January 1, 2027. These acquisition requirements are in addition to those in section 13201(h)(1) of the Act, which require acquisition to occur after September 27, 2017.

The proposed regulations provide that the written binding contract rules for longer production period property and certain aircraft property are the same rules that apply for purposes of determining whether the acquisition requirements of section 13201(h)(1) of the Act are met.

With respect to self-constructed property described in section 168(k)(2)(B) or (C), the proposed regulations follow the acquisition rule in section 168(k)(2)(E)(i) for selfconstructed property and provide that the acquisition requirements of section 168(k)(2)(B)(i)(III) or (k)(2)(C)(i), as applicable, are met if a taxpayer manufactures, constructs, or produces the property for its own use and such manufacturing, construction, or productions begins before January 1, 2027. Further, only for purposes of section 168(k)(2)(B)(i)(III) and (k)(2)(C)(i), the proposed regulations provide that property that is manufactured, constructed, or produced for the taxpayer by another person under a written binding contract that is entered into prior to the manufacture, construction, or production of the property for use by the taxpayer in its trade or business or for its production of income is considered to be manufactured, constructed, or produced by the taxpayer. The proposed regulations also provide rules similar to those in §1.168(k)-1(b)(4)(iii)(B) for defining when manufacturing, construction, or production begins, including the same safe harbor, and in §1.168(k)-1(b)(4)(iii)(C) for a contract to acquire, or for the manufacture, construction, or production of, a component of the larger self-constructed property.

7. Computation of Additional First Year Depreciation Deduction and Otherwise Allowable Depreciation

Pursuant to section 168(k)(1)(A), the proposed regulations provide that the allowable additional first year depreciation deduction for qualified property is equal to the applicable percentage (as defined in section 168(k)(6)) of the unadjusted depreciable basis (as defined in §1.168(b)-1(a)(3)) of the property. For qualified property described in section 168(k)(2)(B), the unadjusted depreciable basis (as defined in §1.168(b)-1(a)(3)) of the property is limited to the property's basis attributable to manufacture, construction, or production of the property before January 1, 2027, as provided in section 168(k)(2)(B)(ii).

Pursuant to section 168(k)(2)(G), the proposed regulations also provide that the additional first year depreciation deduction is allowed for both regular tax and alternative minimum tax (AMT) purposes. However, for AMT purposes, the amount of the additional first year depreciation deduction is based on the unadjusted depreciable basis of the property for AMT purposes. The amount of the additional first year depreciation deduction is not affected by a taxable year of less than 12 months for either regular or AMT purposes.

The proposed regulations provide rules similar to those in §1.168(k)-1(d)(2) for determining the amount of depreciation otherwise allowable for qualified property. That is, before determining the amount of depreciation otherwise allowable for qualified property, the proposed regulations require the taxpayer to first reduce the unadjusted depreciable basis (as defined in §1.168(b)-1(a)(3)) of the property by the amount of the additional first year depreciation deduction allowed or allowable, whichever is greater (the remaining adjusted depreciable basis), as provided in section 168(k)(1)(B). Then, the remaining adjusted depreciable basis is depreciated using the applicable depreciation provisions of the Code for the property (for example, section 168 for MACRS property, section 167(f)(1) for computer software, and section 167 for film, television, or theatrical productions). This amount of depreciation is allowed for both regular tax and AMT purposes, and is affected by a taxable year of less than 12 months. However, for AMT purposes, the amount of depreciation allowed is determined by calculating the remaining adjusted depreciable basis of the property for AMT purposes and using the same depreciation method, recovery period, and convention that applies to the property for regular tax purposes. If a taxpayer uses the optional depreciation tables in Rev. Proc. 87-57 (1987-2 C.B. 687) to compute depreciation for qualified property that is MACRS property, the proposed regulations also provide that the remaining adjusted depreciable basis of the property is the basis to which the annual depreciation rates in those tables apply.

8. Special Rules

The proposed regulations also provide rules similar to those in §1.168(k)-1(f) for certain situations. However, the special rules in §1.168(k)-1(f)(9) regarding the increase in basis due to a section 754 election are addressed in the proposed regulations regarding the used property acquisition requirements. Further, the special rules in §1.168(k)-1(f)(1)(iii) regarding property placed in service and transferred in a section 168(i)(7) transaction in the same taxable year, and in §1.168(k)-1(f)(5) regarding like-kind exchanges or involuntary conversions, are updated to reflect the used property acquisition requirements in section 168(k)(2)(E)(ii). The special rules in the proposed regulations also are updated to reflect the applicable dates under section 168(k), and the changes by the Act to technical terminations of partnerships and the rehabilitation credit.

The proposed regulations provide rules for the following situations: (1) Qualified property placed in service or planted or grafted, as applicable, and disposed of in the same taxable year; (2) redetermination of basis of qualified property; (3) recapture of additional first year depreciation for purposes of section 1245 and section 1250; (4) a certified pollution control facility that is qualified property; (5) like-kind exchanges and involuntary conversions of qualified property; (6) a change in use of qualified property; (7) the computation of earnings and profits; (8) the increase in the limitation of the amount of depreciation for passenger automobiles; (9) the rehabilitation credit under section 47; and (10) computation of depreciation for purposes of section 514(a)(3).

The proposed regulations provide a special rule for qualified property that is placed in service in a taxable year and then contributed to a partnership under section 721(a) in the same taxable year when one of the other partners previously had a depreciable interest in the property. Situation 1 of Rev. Rul. 99-5 (1999-1 C.B. 434) is an example of such a fact pattern. Under §1.168(k)-1(f)(1)(iii) and its cross-reference to §1.168(d)-1(b)(7)(ii), the additional first year depreciation deduction associated with the contributed property would be allocated between the contributing partner and the partnership based on the proportionate time the contributing partner and the partnership held the property throughout the taxable year. The partnership could then allocate a portion of the deduction to the partner with a previous depreciable interest in the property. The Treasury Department and the IRS believe that allocating any portion of the deduction to a partner who previously had a depreciable interest in the property would be inconsistent with section 168(k)(2)(E)(ii)(I). Therefore, the proposed regulations provide that, in this situation, the additional first year depreciation deduction with respect to the contributed property is not allocated under the general rules of §1.168(d)-1(b)(7)(ii). Instead, the additional first year depreciation deduction is allocated entirely to the contributing partner prior to the section 721(a) transaction and not to the partnership.

With respect to like-kind exchanges and involuntary conversions, §1.168(k)-1(f)(5) provides that the exchanged basis and excess basis, if any, of the replacement property is eligible for the additional first year depreciation deduction if the replacement property is qualified property. The proposed regulations retain this rule if the replacement property also meets the original use requirement. Pursuant to section 168(k)(2)(E)(ii)(II) and its crossreference to section 179(d)(3), the proposed regulations also provide that only the excess basis, if any, of the replacement property is eligible for the additional first year depreciation deduction if the replacement property is qualified property and also meets the used property acquisition requirements. These rules also apply when a taxpayer makes the election under §1.168(i)-6(i)(1) to treat, for depreciation purposes only, the total of the exchanged basis and excess basis, if any, in the replacement MACRS property as property placed in service by the taxpayer at the time of replacement and the adjusted depreciable basis of the relinquished MACRS property as disposed of by the taxpayer at the time of disposition. The proposed regulations also retain the other rules in §1.168(k)-1(f)(5) for like-kind exchanges and involuntary conversions, but update the definitions to be consistent with the definitions in §1.168(i)-6, which addresses how to compute depreciation of property involved in like-kind exchanges or involuntary conversions.

Proposed Applicability Date

These regulations are proposed to apply to qualified property placed in service or planted or grafted, as applicable, by the taxpayer during or after the taxpayer's taxable year that includes the date of publication of a Treasury decision adopting these rules as final regulations in the Federal Register. Pending the issuance of the final regulations, a taxpayer may choose to apply these proposed regulations to qualified property acquired and placed in service or planted or grafted, as applicable, after September 27, 2017, by the taxpayer during taxable years ending on or after September 28, 2017.

Special Analyses

The Administrator of the Office of Information and Regulatory Affairs (OIRA), Office of Management and Budget, has waived review of this proposed rule in accordance with section 6(a)(3)(A) of Executive Order 12866. OIRA will subsequently make a significance determination of the final rule, pursuant to section 3(f) of Executive Order (E.O.) 12866 and the April 11, 2018, Memorandum of Agreement between the Department of Treasury and the Office of Management and Budget (OMB).

The proposed regulations do not impose a collection of information on small entities and provide clarifying rules for taxpayers to enjoy the tax benefit of 100-percent additional first year depreciation as provided by the amendments to section 168 by the Act. Therefore, a regulatory flexibility analysis is not required under the Regulatory Flexibility Act (5 U.S.C. chapter 6). Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the ADDRESSES heading. The Treasury Department and the IRS request comments on all aspects of the proposed rules. All comments will be available at http://www.regulations.gov or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the Federal Register.

Drafting Information

The principal authors of these proposed regulations are Kathleen Reed and Elizabeth R. Binder of the Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the Treasury Department and the IRS participated in their development.

Statement of Availability

The IRS Revenue Procedures and Revenue Rulings cited in this document are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at http://www.irs.gov.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

1. INCOME TAXES

PAR. 1 The authority citation for part 1 is amended by adding an entry for §1.168(k)-2 in numerical order to read in part as follows:

26 U.S.C. 7805

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Section 1.168(k)-2 also issued under 26 U.S.C. 1502.

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Kirsten Wielobob,

Deputy Commissioner for Services and Enforcement.

[FR Doc. 2018-16716 Filed 8-3-18; 4:15 pm]

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NEW YORK STATE BAR ASSOCIATION
One Elk Street, Albany, New York 12207 PH 518.463.3200 www.nysba.org

TAX SECTION

2018-2019 Executive Committee

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1101 New York Ave, N.W.
Washington, DC 20005
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212/403-1300
ANDREW H. BRAITERMAN
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Report No. 1406
November 26, 2018

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable William M. Paul
Principal Deputy Chief Counsel and
Deputy Chief Counsel (Technical)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: *Report No. 1406 – Report on Proposed GILTI Regulations*

Dear Messrs. Kautter, Rettig, and Paul:

I am pleased to submit Report No. 1406, commenting on the proposed regulations (the "**Proposed Regulations**") issued by the Internal Revenue Service and the Department of the Treasury (collectively, the "**Treasury**") under Sections 951, 951A, 1502 and 6038 to implement the so-called "GILTI" provisions of the Code that were added by the legislation informally known as the Tax Cuts and Jobs Act of 2017 (the "**Act**").

We commend the Treasury for its efforts in providing substantial and timely guidance on the GILTI rules. These rules constitute some of the most far-reaching changes made in many years to the U.S. international tax system. The Proposed Regulations clearly represent the

FORMER CHAIRS OF SECTION:

Peter L. Faber, Alfred D. Youngwood, Gordon D. Henderson, David Sachs, J. Roger Mentz, Willard B. Taylor, Richard J. Hiegel, Herbert L. Camp, William L. Burke, Arthur A. Feder, James M. Peaslee, Peter C. Canellos, Michael L. Schler, Carolyn Joy Lee, Richard L. Reinhold, Steven C. Todrys, Harold R. Handler, Robert H. Scarborough, Robert A. Jacobs, Samuel J. Dimon, Andrew N. Berg, Lewis R. Steinberg, David P. Hariton, Kimberly S. Blanchard, Patrick C. Gallagher, David S. Miller, Erika W. Nijenhuis, Peter H. Blessing, Jodi J. Schwartz, Andrew W. Needham, Diana L. Wollman, David H. Schnabel, David R. Sicular, Stephen B. Land, Michael S. Farber

results of an enormous effort on the part of the Treasury, and they provide very helpful guidance to taxpayers on certain aspects of the GILTI rules.

This Report supplements our prior report submitted on May 4, 2018, which discussed certain significant issues arising from the Act's addition of the GILTI provisions to the Code. The prior report is attached for your reference. In this Report, we make recommendations on issues presented by the Proposed Regulations, and also restate certain recommendations from the Prior Report that were not adopted in the Proposed Regulations. Many of our comments relate to the various basis adjustment rules in the Proposed Regulations. We are concerned about the enormous complexity created by those rules.

We appreciate your consideration of our recommendations. If you have any questions or comments regarding this Report, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Karen G. Sowell

Karen G. Sowell
Chair

Enclosure

Cc:

Lafayette "Chip" G. Harter III
Deputy Assistant Secretary (International Tax Affairs)
Department of the Treasury

Douglas L. Poms
International Tax Counsel
Department of the Treasury

Brian Jenn
Deputy International Tax Counsel
Department of the Treasury

Brenda Zent
Special Advisor to the International Tax Counsel
Department of the Treasury

Marjorie A. Rollinson
Associate Chief Counsel (International)
Internal Revenue Service

Daniel M. McCall
Deputy Associate Chief Counsel (International)
Internal Revenue Service

Raymond J. Stahl
Senior Counsel, Office of Associate Chief Counsel (International)
Internal Revenue Service

John J. Merrick
Special Counsel, Office of Associate Chief Counsel (International)
Internal Revenue Service

Jeffrey G. Mitchell
Branch Chief, Office of Associate Chief Counsel (International)
Internal Revenue Service

Kristine A. Crabtree
Senior Technical Reviewer, Office of Associate Chief Counsel (International)
Internal Revenue Service

Report No. 1406

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON PROPOSED GILTI REGULATIONS

November 26, 2018

Table of Contents

I. Introduction

This Report[1] comments on proposed regulations (the "**Proposed Regulations**")[2] issued by the Internal Revenue Service (the "**IRS**") and the Department of the Treasury (collectively with the IRS, the "**Treasury**") to implement the so-called "GILTI" provisions of the Code. These provisions were added by the legislation informally known as the Tax Cuts and Jobs Act of 2017 (the "**Act**").[3] The Proposed Regulations were issued under Sections 951, 951A, 1502 and 6038.[4]

This Report supplements our prior report (the "**Prior Report**")[5] submitted on May 4, 2018, which discussed certain significant issues arising from the Act's addition of the GILTI provisions to the Code. We have attached the Prior Report as an Appendix hereto for ease of reference. In this Report, we make recommendations on issues presented by the Proposed Regulations, and also restate certain recommendations from the Prior Report that were not adopted in the Proposed Regulations. However, given the limited period of time available to comment on the Proposed Regulations, this Report is necessarily limited to issues that we have identified so far and that we believe to be most important. It is not intended as a complete list of issues raised by the Proposed Regulations.

In general, the discussion in this Report follows the order in which issues are presented by the Proposed Regulations. However, we discuss in a separate section of this Report certain provisions of the Proposed Regulations that relate to tax basis. While those provisions appear in different portions of the Proposed Regulations, they are intended to create a unified set of rules and are best evaluated based on the overall results that they reach.

We commend the Treasury for its efforts in providing substantial and timely guidance on the GILTI rules. These rules constitute some of the most far-reaching

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[1] The principal authors of this report are Michael Schler and Andrew Davis. Helpful comments were received from Kim Blanchard, Micah Bloomfield, Andrew Braiterman, Jonathan Brenner, Marty Collins, Peter Connors, Charles Cope, Marc Countryman, Tim Devetski, Andrew Dubroff, Pamela Lawrence Endreny, Phillip Gall, Larry Garrett, Micah Gibson, Kevin Glenn, Edward Gonzalez, Andrew Herman, Brian Krause, Andrew Needham, Elena Romanova, David Schnabel, Eric Sloan, Karen Gilbreath Sowell, Chaim Stern, Ted Stotzer, Linda Swartz, Shun Tosaka, Dana Trier, Gordon Warnke and Bob Wilkerson. This report reflects solely the views of the Tax Section of the New York State Bar Association (***"NYSBA"***) and not those of the NYSBA Executive Committee or the House of Delegates.

[2] REG-104390-18, Federal Register Vol. 83, No. 196, October 10, 2018 (the "**Federal Register GILTI**") at 51072-51111.

[3] The Act is formally known as "*An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018*", P.L. 115-97.

[4] Unless otherwise stated, all "Code" and "Section" references are to the Internal Revenue Code of 1986, as amended.

[5] NYSBA Tax Section Report No. 1394, *Report on the GILTI Provisions of the Code* (May 4, 2018).

changes made in many years to the U.S. international tax system. The Proposed Regulations clearly represent the results of an enormous effort on the part of the Treasury, and they provide very helpful guidance to taxpayers on certain aspects of the GILTI rules.

We understand that subsequent proposed regulations will address the calculation of the foreign tax credit ("**FTC**") allowed to a U.S. shareholder ("**U.S. shareholder**")[6] of a controlled foreign corporation ("**CFC**")[7] under the GILTI rules. We do not address those issues in this Report, but will do so in a subsequent report after those proposed regulations are issued.

II. Summary of Principal Recommendations and Comments[8]

<u>Part III: Non-Basis Issues</u>

A. Proposed Regulation Section 1.951-1: Amounts Included in Gross Income of U.S. Shareholders

1. This Proposed Regulation generally relates to the allocation of Subpart F income and tested income among classes of stock of a CFC, based on a Hypothetical Distribution of such income. The broad language of the Anti-Avoidance Rule in this regulation should be narrowed so that it only covers the reallocation of the reported amount of Subpart F income or tested income among the U.S. shareholders actually owning Section 958(a) stock in the CFC. In addition, examples should be provided and certain types of transactions should generally be permissible under the Rule. If, contrary to our recommendation, a narrow interpretation of the Rule is rejected, the Rule should be moved elsewhere in the regulation and its scope should be clarified. Part III.A.2(a).

2. The Anti-Avoidance Rule should not allow the IRS to change the current effects of transactions that occurred before the general effective date of the final regulation, or possibly, in the case of Subpart F, that occurred before the date the Proposed Regulations were published. Moreover, if contrary to our recommendation a broad interpretation of the Rule is adopted, this interpretation should not apply under either Subpart F or GILTI to transactions that occurred before the date of publication of the Proposed Regulations (or arguably the date that final regulations are issued). Part III.A.2(a).

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[6] A U.S. shareholder of a foreign corporation is a U.S. person that actually or constructively owns 10% or more of the vote or value of the stock in the corporation. Section 951(b). *See also* Prop. Reg. § 1.951-1(g)(1).

[7] A foreign corporation is a CFC for a taxable year if U.S. shareholders in the aggregate actually or constructively own stock with more than 50% of the total vote or value of its shares on any day during the taxable year. Section 957(a).

[8] All terms used herein are as defined in the body of this Report.

3. Clarification should be provided for the rule that in the Hypothetical Distribution of earnings with respect to shares of a CFC, no amount is treated as distributed in redemption of stock. Example 4 in Proposed Regulation Section 1.951-1(e)(7), which illustrates that provision, should be revised. Part III.A.2(b).

4. In the Hypothetical Distribution, the rule for discounting amounts allocable to dividends in arrears on preferred stock should be clarified. Part III.A.2(c).

5. We have no objection to the rule that a CFC could potentially allocate Subpart F income to holders of preferred stock at the same time it allocates tested loss to holders of common stock. Part III.A.2(d).

B. Proposed Regulation Section 1.951A-1: General Provisions

6. We urge an amendment to the statute to take account of QBAI, interest income, and interest expense in CFCs with tested losses. Part III.B.2(a).

7. The Proposed Regulations allow all interest income that is tested income to offset interest expense that would otherwise reduce DTIR, although the statute only allows such offset for interest income that is attributable to such interest expense. If the Treasury intends to adopt this rule in final regulations, it should consider whether an amendment to the statute to confirm this result would be helpful. Part III.B.2(a).

8. The Proposed Regulations do not change the statutory rule that interest expense paid to the U.S. shareholder counts as interest expense and reduces NDTIR even though it is fully taxed to the U.S. shareholder. If the Treasury does not believe it has the authority to change this result by regulation, we urge a statutory amendment to change it. Part III.B.2(a).

9. The Proposed Regulations state that a U.S. shareholder must include CFC tested items in the U.S. shareholder's tax year that includes the last day of the CFC's taxable year on which the CFC is a CFC. We believe that this rule is inconsistent with the Code, which refers to the U.S. shareholder's tax year that includes the last day of the tax year of the CFC (regardless of the date on which it ceased to be a CFC). We believe the final regulations should be conformed to the rule in the Code. Part III.B.2(b).

10. We believe the methods of allocating QBAI and tested losses in the Proposed Regulations are reasonable. If no class of stock has liquidation value, we recommend first allocating tested loss to any shareholders that have guaranteed debt of the CFC, and then to the most senior class of common stock, unless another class of stock will in fact bear the economic loss. Also, QBAI should be allocated to participating

preferred stock by bifurcating the stock into nonparticipating preferred stock and common stock. Part III.B.2(c).

C. Proposed Regulation Section 1.951A-2: Tested Income and Tested Loss

11. If the Proposed Regulations intend to adopt purely U.S. tax principles for determining tested income and loss of a CFC, as is stated in the Preamble, the reference in the Proposed Regulations to Treasury Regulation Section 1.952-2 should be modified. Part III.C.2(a).

12. As we stated in our Prior Report, we strongly believe that net operating losses should be allowed as a carryforward either at the CFC or shareholder levels. In addition, assuming future regulations state that Section 163(j) applies to CFCs, regulations should confirm that interest deductions deferred under Section 163(j) are not subject to any restrictions on loss carryovers, since the deductions are deemed to arise in future years. Part III.C.2(a).

13. Regulations should clarify whether certain other deductions disallowed to a domestic corporation are allowed to a CFC for GILTI purposes, and provide as complete a list as possible as to any variances between income for CFC and GILTI purposes and income for a domestic corporation. Part III.C.2(a).

14. The Proposed Regulations disallow a deduction or loss attributable to a basis increase that arises from transfers between related CFCs in the transition period. If this position will be adopted in final regulations, we suggest a statutory amendment to confirm the authority of the Treasury to issue such regulations. Regulations should also confirm the mechanics of the application of the rule in several respects, including how it applies in calculating gain on the sale of an asset. Part III.C.2(b).

15. We agree with the rule in the Proposed Regulations that tested income is determined without regard to the application of Section 952(c), and the example illustrating that rule. However, due to the ambiguity in the statute, the Treasury should consider whether an amendment to the statute to confirm this result would be helpful. Part III.C.2(c).

16. Regulations should confirm that a royalty deemed paid under Section 367(d) from a CFC to its U.S. shareholder can be deductible from tested income, and not only from Subpart F income. Part III.C.2(d).

D. Proposed Regulation Section 1.951A-3: QBAI

17. In calculating the tax basis of QBAI property, we urge reconsideration of the retroactive application of the ADS depreciation rules to property placed in service before enactment of the Act. Part III.D.2(a).

18. Regulations should confirm that the use of ADS for GILTI purposes, for

either new or preexisting assets, is not a change in method of accounting, or if it is a change in method, global approval should be given for such a change. Part III.D.2(a).

19. We have no objection to the anti-abuse rule that disregards QBAI created by intra-group transfers during the transition period.

20. A separate anti-abuse rule excludes assets from QBAI if they are held "temporarily" by a CFC. We believe that there should be a presumption that the rule does not apply if assets are held for a stated period of time (such as 2 or 3 years). We do not believe a period of time based on a percentage of the depreciable life of the asset would be appropriate. Part III.D.2(b).

21. Another anti-abuse rule excludes assets from QBAI if they are held for no more than one year and reduce a GILTI inclusion. We believe this rule should be changed into a presumption that a holding period of no more than a year has a principal purpose of tax avoidance. We suggest several factors that should be strong factors in overcoming the presumption. In addition, we believe that holding periods of related CFCs in an asset should be aggregated if there is no reduction in the GILTI inclusion as a result of transfers of the asset among the CFCs. Moreover, a consolidated group should be treated as a single entity for purposes of these rules. Part III.D.2(b).

E. Proposed Regulation Section 1.951A-4: Tested Interest Income and Expense

22. The Proposed Regulations expand the statutory reference to interest income and expense to include interest equivalents. To avoid whipsaw against the government, the Code should be amended to adopt these rules or to confirm the authority of the Treasury to issue these regulations. Part III.E.

F. Proposed Regulation Section 1.951A-5: Partnerships

23. As a policy matter, we prefer a pure aggregate approach for applying the GILTI rules to domestic partnerships. If the Treasury desires to implement such an approach but believes it does not have authority to do so by regulations, we urge it to request a statutory amendment to adopt this approach or to authorize regulations to do so. If a pure aggregate approach is adopted, generous grandfathering provisions should apply to allow existing foreign corporations that are treated as CFCs under the existing rules to continue to be so treated. Part III.F.2(a).

24. We discuss a number of problems that we see under the Proposed Regulations Hybrid Approach, and we suggest some methods under that approach for determining tax basis in a partnership, and in CFCs owned by a partnership. Part III.F.2(b).

25. If the Proposed Regulations Hybrid Approach is adopted, and a partnership does not provide for pro rata ownership of partnership capital and profits, regulations should clarify the manner in which a partner is determined to be a U.S.

shareholder of a CFC owned by the partnership. At a minimum, partnership level determinations should be binding on the partner. Part III.F.2(b)(iv).

26. We agree with the Treasury that the Pure Entity Approach should not be adopted. Part III.F.2(d).

27. If the Pure Aggregate Approach is not adopted, regulations could adopt either the Proposed Regulations Hybrid Approach or the Prior Report Hybrid Approach (as suggested in the Prior Report). We do not take a position as to which of these two approaches is preferable. The Proposed Regulations Hybrid Approach will be simpler for many partners in U.S. shareholder partnerships, but will be less fair to many such partners than the Prior Report Hybrid Approach. The Proposed Regulations Hybrid Approach also introduces complexities at the partnership level that are not present in the Prior Report Hybrid Approach. Part III.F.2(e).

28. Whatever approach is adopted, it is essential that the same rules apply for both the Subpart F and GILTI regimes. Regulations should also clarify that the rules at issue apply solely for purpose of calculating Subpart F and GILTI inclusions. Part III.F.2(e).

G. Proposed Regulation Section 1.1502-51: Consolidated Section 951A

29. We strongly commend the Treasury for applying single entity principles for calculating the GILTI inclusions in a consolidated group. Part III.G.1.

30. Future regulations under Section 250 and the FTC should likewise apply single entity principles for GILTI purposes to a consolidated group. Part III.G.2(a).

31. We support the rule in the Proposed Regulations that tested losses of CFCs of all group members are allocated proportionately to tested income of CFCs of all group members, without regard to the location of the different CFCs within the group. Part III.G.2(b).

Part IV: Basis Issues

A. Introduction

32. While we accept the desire of the Treasury to prevent what may be viewed as loss duplication, we suggest several arguments that Congress rather than the Treasury should adopt or authorize basis adjustment rules. If basis regulations are to be adopted, we prefer either of the two approaches described in Part IV.G. We believe those

approaches are simpler than the approach in the Proposed Regulations and generally achieve the goals of the Proposed Regulations in preventing loss duplication. Part IV.A.

B. Proposed Regulation Section 1.951A-6: The CFC Basis Reduction Rule

33. The CFC basis reduction rule reduces the tax basis of a CFC immediately before its sale by the net used tested loss amount of the CFC. If this rule or a similar rule will be retained in the final regulations, we suggest that the Treasury request a statutory amendment to confirm its authority to issue regulations to modify the basis rules of Section 961. In addition, to support the validity of the regulations under the Administrative Procedure Act, the preamble to the final regulations should (i) further explain the nature of the double tax benefit from a tested loss that the rule is designed to prevent, and (ii) if applicable in the final regulations, explain why the rule applies to all used tested losses without regard to whether a double tax benefit from the tested loss is obtained by the U.S. shareholder. Part IV.B.2(b).

34. We believe the CFC basis reduction rule should not apply if the U.S. shareholder can show that the tested loss will not as a factual matter result in a double tax benefit. A recapture rule could apply if a second tax benefit in fact arises in the future. A simpler version of the rule would also be possible. Second, further consideration should be given to a rule allowing a taxpayer to elect to waive all or part of the use of a tested loss, in which case the waived loss would not create a used tested loss for purposes of the rule. Part IV.B.2(c).

35. We believe that in applying the CFC basis reduction rule, the method of netting used tested loss amounts with offset tested income amounts in the Proposed Regulations is appropriate. Part IV.B.3(a).

36. Clarification should be provided concerning several aspects of the CFC basis reduction rule following the sale of stock of the U.S. shareholder of the CFC. Part IV.B.3(b).

37. Clarification should be provided concerning the extent to which the basis in the stock of a CFC is treated as reduced before its sale for purposes of allocating the interest expense of the U.S. shareholder to the CFC, for purposes of the NUBIG and NUBIL rules of Section 382, and for purposes of the basis reduction rule in Section 108(b). Part IV.B.3(c)(i)-(iii).

38. We do not believe the CFC basis reduction rule should be extended to a non-corporate shareholder of a CFC. Part IV.B.3(d).

39. The definition of “disposition”, which triggers the CFC basis reduction rule, should include a Section 165(g) worthless stock deduction. We discuss, but do not take a position on, whether Sections 301(c)(2), 301(c)(3), and 1059 should apply to

distributions from a CFC by reference to the reduced basis of the CFC stock that would arise upon sale of the CFC. Part IV.B.3(e).

40. Regulations should clarify the effect of the CFC basis reduction rule in cases where there is a tax free transfer of the CFC but the rule will no longer apply by its terms, for example if the CFC is no longer a CFC after the transfer. Part IV.B.3(f).

41. Regulations should clarify the application of the CFC basis reduction rule in the case of certain Section 381 transactions. Part IV.B.3(g).

42. Regulations should confirm certain aspects of a rule that specially allocates Subpart F income that arises as a result of the CFC basis reduction rule when one CFC sells the stock of another CFC. Part IV.B.3(h).

43. Regulations should clarify the application of the CFC basis reduction rule when a domestic partnership sells stock of a CFC or a partner sells its interest in a domestic partnership holding a CFC. Part IV.B.3(i).

44. Regulations should provide relief from estimated tax penalties for taxes due as a result of the CFC basis reduction rule, for sales of CFCs prior to 30 days after finalization of the regulations. Part IV.B.3(j).

C. Proposed Regulation Section 1.1502-51: Basis Reduction for CFC Stock Held in a Group

45. Regulations should clarify whether the CFC basis reduction rule continues to apply to a member of a group that owns a CFC subject to that rule, after the member leaves the group and sells the CFC thereafter. We believe that the rule should continue to apply, and that the basis reduction should tier up in the new group (to match the increased gain resulting from the sale of the CFC in the new group). Part IV.C.2(b).

46. Regulations should clarify the results when stock of a CFC is sold from one member of the group to another member. Part IV.C.2(c).

47. The Proposed Regulations contain a special rule for consolidated groups that modifies the special allocation of Subpart F income resulting from the application of the CFC basis reduction rule when one CFC sells the stock of another CFC. We believe the special rule should be either eliminated or substantially revised. Part IV.C.2(d).

D. Proposed Regulation Section 1.1502-32: Upper Tier Basis Adjustments

48. We support the approach of the Proposed Regulations to immediately reduce the basis of the stock of a member holding stock in a CFC by the net used tested

loss amount in the CFC. Part IV.D.2(a). However, any exceptions that are added to the CFC basis reduction rule should also be incorporated into this rule. Part IV.D.2(b).

49. The Proposed Regulations offset the basis reduction in member stock if the CFC with the net used tested loss amount also has an offset tested income amount in a different year. We believe the Proposed Regulations should be revised to prevent duplication of the basis increase, once for the offset tested income amount and again for the dividend of the same amount, if the CFC pays a dividend eligible for Section 245A out of the offset tested income. Part IV.D.2(c).

50. We support the fact that a basis reduction in stock of a CFC under the CFC basis reduction rule is only offset by an offset tested income amount of the same CFC in a different year, as opposed to being offset by offset tested income of other CFCs owned by the same U.S. shareholder. Part IV.D.2(d).

51. The Proposed Regulations provide for a basis increase in member stock just before the member's sale of a CFC, to the extent the CFC has offset tested income and could have paid a dividend eligible for Section 245A. Regulations should clarify that this rule does not apply to the member if it joins a new group and then sells the CFC. Part IV.D.2(e).

52. Regulations should clarify the application of the consolidated return basis adjustment rules to stock of a member when the member is sold in the middle of the year. Part IV.D.2(f).

53. Regulations should illustrate the fact that the increase in basis in stock of a member for notional Section 245A dividends can not only reduce the taxable gain on the sale of the stock of the member, but also create or increase a tax loss, Part IV.D.2(g), and avoid the Section 961(d) loss disallowance rule, Part IV.D.2(h). In addition, regulations should clarify the exception to the basis increase rule for dividends that would not be eligible for Section 245A or would be subject to Section 1059, when the hypothetical dividend would be from a second tier CFC. Part IV.D.2(i). Finally, the regulation should be clarified to cover the case where the CFC in question has PTI. Part IV.D.2(j).

54. Regulations should confirm that a reduction in basis in a CFC under the CFC basis reduction rule does not tier up within a group (since there has already been a basis reduction in stock in the member). Part IV.D.2(k).

55. Regulations should clarify whether the reduction in a member's basis in the stock of another member on account of the latter's net used tested loss amount of a CFC reduces the e&p of the former member. Correspondingly, if no such reduction in e&p arises, regulations should confirm that there is no increase in the former member's

e&p on the disposition of the CFC as a result of the CFC basis reduction rule. Part IV.D.2(l).

56. Regulations should provide that in applying the loss duplication rules of -36(d) on the sale of stock of a member holding a CFC, the member's basis in the stock of the CFC should take account of the basis reduction that would arise on a sale of the CFC, and the selling shareholder's basis in the member stock should take account of the basis increase in member stock that would arise on the sale of the CFC. Part IV.D.2(n).

57. Likewise, in applying the loss disallowance rule of -36(c), the member's basis in a CFC should take account of the basis reduction that would arise on a sale of the CFC. Part IV.D.2(o).

58. Regulations should confirm that the attribute redetermination rules of the consolidated return regulations apply to the basis adjustment rules in the Proposed Regulations. Part IV.D.2(p).

59. We believe that a modification should be made to the Section 958 basis allocation rules in an internal spin-off to reflect the CFC basis reduction rule when the distributing or controlled corporation holds stock in a CFC with a net used tested loss amount. Part IV.D.2(q).

60. Final regulations should provide that, possibly subject to certain exceptions, there is no gain recognition when a member of a group is distributed in an external spin-off, and the gain would be triggered as the result of an ELA created by the upper tier basis reduction rule in -32. In addition, regulations should provide a rule for the case where boot to the distributing parent corporation exceeds the reduced, but not the unreduced, basis of the parent in the distributed corporation. Part IV.D.2(r).

E. Basis Issues in Intra-Group Reorganizations

61. The rule in -51 for nonrecognition transactions involving CFC stock among group members should be clarified to avoid a double basis reduction when there is an asset reorganization and one of the assets of the target corporation is CFC stock. Regulations should also clarify the effect of a tested loss in the year of the nonrecognition transaction. Part IV.E.2.

62. Revised Example 4 in -13(f)(7) should be further revised to prevent a double basis reduction from arising from an offset tested loss, as appears to occur in the example as written. Part IV.E.3.

F. General Basis Issues Under the Proposed Regulations

63. Regulations should determine the extent to which all shares of a CFC owned by a single U.S. shareholder are aggregated and treated as a single share, or else treated as separate shares with their own net used tested loss amounts and net offset

tested income amounts. We believe that all shares of a single class held by a single U.S. shareholder should be aggregated, with an anti-abuse rule for transactions in shares undertaken with a principal purpose of tax avoidance. We do not believe common stock and preferred stock held by a U.S. shareholder should be aggregated. Part IV.F.1.

64. The rules for basis adjustments in the Proposed Regulations are enormously complicated, and we acknowledge that some of our suggestions to make the rules work better as a technical matter and to grant taxpayer relief will make them even more complicated. We express our concern about the complexity of the rules, both in the corporate nonconsolidated and consolidated return contexts, and in the partnership context. Many taxpayers will have to deal with enormous complexity in making the necessary calculations, and the results will be difficult if not impossible for IRS revenue agents to audit. Part IV.F.2.

65. Consideration should be given to a broader reevaluation of the -32 basis adjustment rules to account for the fact that dividends from CFCs may now be eligible for Section 245A and will nevertheless give rise to a basis increase in the stock of the member receiving the dividend. Part IV.F.3.

G. Our Preferred Approaches to Avoid Loss Duplication

66. We believe that either of our two alternative approaches to basis reduction would be preferable to the approach in the Proposed Regulations. Under our preferred approach, a CFC with offset tested income would have its e&p reduced by the amount of its offset tested income, a CFC with used tested loss would have its e&p increased by such amount, and basis would shift from the stock of the tested loss CFC to the basis of the tested income CFC to the extent of the lesser of the existing basis of the tested loss CFC or the amount of the used tested loss. Alternatively, the e&p adjustments could be made without the basis shifts. Although these rules might require legislation and would raise their own complexities, we believe they would be simpler to administer than the existing proposed rules and would generally achieve the goals of the Proposed Regulations in preventing loss duplication. Part IV.G.

III. General Discussion and Recommendations

A. Proposed Regulation Section 1.951-1: Amounts Included in Gross Income of U.S. Shareholders

1. *Background*

Proposed Regulation Section 1.951-1(e) contains rules for determining a U.S. shareholder's pro rata share of a CFC's Subpart F income for a taxable year. These rules, subject to certain modifications, also govern the allocation of a CFC's tested income, tested loss, qualified business asset investment ("**QBAI**"), tested interest expense and tested interest income (each, a "**CFC tested item**"), all of which are components of the GILTI calculation.[9]

The Proposed Regulations require the allocation of Subpart F income among shareholders of a CFC based on how the CFC would distribute its current earnings and profits ("**e&p**") in a hypothetical distribution to its shareholders on the last day of the CFC's taxable year on which it is a CFC (the "**Hypothetical Distribution**").[10] In effect, each U.S. shareholder's percentage share of the CFC's Subpart F income is equal to the percentage of the CFC's current e&p that would be allocable to that U.S. shareholder in the Hypothetical Distribution. Current e&p for purposes of this calculation is the greater of (x) current e&p as determined under Section 964 and (y) the CFC's Subpart F income, increased by its tested losses (if any), plus the CFC's tested income.[11]

For purposes of the Hypothetical Distribution, distributions within each class of stock are assumed to be made pro rata with respect to each share of stock in that class.[12] Distributions between classes of stock are generally based on the "distribution rights of each class of stock on the hypothetical distribution date . . . taking into account all facts and circumstances related to the economic rights and interest" in current e&p of that class.[13] Certain legal rights, however, are limited or disregarded in calculating the Hypothetical Distribution, including (i) rights to redemption, (ii) dividends that accrue at less than the applicable federal rate ("**AFR**") and (iii) other restrictions and limitations on distributions.[14]

Finally, Proposed Regulation Section 1.951-1(e)(6) contains a broad anti-abuse rule (the "**Anti-Avoidance Rule**") that is headed "Transactions and arrangements with a principal of reducing pro rata shares."

2. *Comments*

(a) *The Anti-Avoidance Rule*

The Anti-Avoidance Rule states the following:

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[9] Prop Reg. § 1.951A-1(d)(1).

[10] Prop Reg. § 1.951-1(e)(1)(i).

[11] Prop Reg. § 1.951-1(e)(1)(ii). References to e&p in this Report take these adjustments into account.

[12] Prop Reg. § 1.951-1(e)(2)-(3).

[13] Prop Reg. § 1.951-1(e)(3).

[14] *See* Prop Reg. § 1.951-1(e)(4)(i) (rights to redemption); Prop Reg. § 1.951-1(e)(4)(ii) (preferred stock with dividends accruing at less than AFR); Prop Reg. § 1.951-1(e)(5) (other restrictions and limitations on distributions).

> For purposes of this paragraph (e), any transaction or arrangement that is part of a plan a principal purpose of which is avoidance of Federal income taxation, including, but not limited to, a transaction or arrangement to reduce a United States shareholder's pro rata share of the subpart F income of a controlled foreign corporation, which transaction or arrangement would avoid Federal income taxation without regard to this paragraph (e)(6), is disregarded in determining such United States shareholder's pro rata share of the subpart F income of the corporation.[15]

The rule also applies for purposes of allocating CFC tested items under Proposed Regulation Section 1.951A-1(d), including allocations with respect to QBAI. There is no significant discussion of the rule in the preamble to the Proposed Regulations (the "**Preamble**"), and no example of the application or nonapplication of the rule in the Proposed Regulations.

The location of the Anti-Avoidance Rule in the Proposed Regulations, as well as the heading of the section,[16] suggests that it is intended to be limited to transactions or arrangements that distort allocations of a fixed amount of Subpart F income (or a CFC tested item) among CFC shareholders. Under this construction, the IRS's sole remedy for a breach of the rule would be to reallocate reported income among shareholders to eliminate the distortion created by the relevant transaction or arrangement. In other words, the IRS would not be able to challenge the aggregate amount of Subpart F income (or CFC tested item), but only the manner in which such amount is allocated. Similarly, under this interpretation, the rule would be limited to reallocations of income of the CFC among the *actual* Section 958(a) U.S. shareholders of the CFC. In particular, the rule would not allow the IRS to allege that a transfer of CFC stock by a U.S. shareholder to a related or unrelated third party had a principal purpose of the avoidance of tax, with the result that the income of the CFC should be allocated to the former shareholder (possibly forever). This interpretation of the rule is consistent with the heading of the rule quoted above, and the passing mention of the rule in the Preamble. We believe this is the appropriate scope of the rule.

However, the plain language of the Anti-Avoidance Rule arguably extends the rule much farther. The rule would disregard "any transaction or arrangement that is part of a plan a principal purpose of which is avoidance of Federal income taxation" in calculating a U.S. shareholder's share of a CFC's Subpart F income (or CFC tested item). This language can be interpreted to extend beyond transactions that affect the sharing of items among shareholders, to transactions that reduce the total amount of income that would be allocable by the CFC or that shift income allocations to new shareholders. For instance, the rule could apply to the purchase (rather than lease) of QBAI property by a

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[15] Prop Reg. § 1.951-1(e)(6).

[16] *Cf*. Section 7806(b) (no inference to be drawn from the location of any section within the Code or descriptive matter relating thereto).

single CFC, or alternatively a CFC raising funds by a borrowing rather than by an equity contribution from its shareholders. In both cases, the result could be a reduction in the GILTI inclusion of the shareholders and thus "the avoidance of Federal income taxation" by the shareholders.

This broad construction of the rule makes it, in effect, a general anti-abuse rule for the entire Subpart F and GILTI regimes. Any transaction that had the effect of reducing a U.S. shareholder's Subpart F income or GILTI inclusion would be at risk, even if it would satisfy the economic substance doctrine[17] and other statutory and common law doctrines.

We believe that this interpretation is far too broad, and that Proposed Regulation Section 1.951-1(e)(6) should be limited to the potential reallocation of the reported amount of Subpart F income or tested income among the U.S. shareholders actually owning Section 958(a) stock in the CFC. If the IRS wishes to challenge the amount of reported income, it should be required to apply other rules, including the economic substance doctrine or other anti-abuse doctrines. Likewise, a transfer of CFC stock is already subject to the usual rules of tax ownership, and the results of the transfer are already subject to those other doctrines.

We acknowledge that the Treasury might have concerns about transfers of ownership, particularly among related parties, for the purpose of avoiding Subpart F or GILTI inclusions. Moreover, our proposed interpretation would preclude the Proposed Regulations from applying to such actions as the conversion of common stock of a CFC into convertible debt for purposes of avoiding GILTI inclusions. However, transfers of ownership among related parties (and conversions of equity into convertible debt) are accepted throughout the Code unless a specific statutory or common law anti-avoidance doctrine applies. We do not believe a special, broader anti-abuse rule should apply solely to transfers of equity in a CFC for purposes of allocating CFC income under the Subpart F and GILTI regimes.

If the narrow interpretation of the rule is intended, Proposed Regulation Section 1.951-1(e)(6) should be clarified accordingly. Examples should also be provided to illustrate transactions that would and would not be disregarded under the rule. In particular, we believe that if some shareholders of a CFC are issued common stock and others are issued preferred stock, absent unusual circumstances and assuming material economic difference between the two classes, the resulting allocations of income to the two classes should be respected even if there was a partial tax motivation for issuance of the two classes.[18]

[17] *See* Section 7701(o).

[18] Likewise, we do not believe the Proposed Regulations should apply to mid-year sales of CFC stock with an alleged principal purpose of avoiding tax on the seller's share of Subpart F or tested income for the year of sale. *See* Prior Report at 50-58. This is a mechanical problem that should be fixed, if desired by the Treasury, by a specific regulation or statutory change applicable to all taxpayers, rather than by an anti-

If, contrary to our recommendation, this narrow scope of the Anti-Avoidance Rule is rejected by the Treasury, and the broader interpretation is adopted, the rule should be moved to a separate section of the final regulations, and its scope should be clarified.

Finally, the Proposed Regulations would have the final regulation apply on January 1, 2018, for calendar year taxpayers.[19] Regardless of the ultimate scope of the final regulation, this rule should be clarified to state whether a transaction occurring before the effective date can potentially be a tax avoidance transaction that is disregarded in a taxable year to which the regulation applies. If so, a transaction that occurred decades ago with a purpose of avoiding Subpart F income (and that heretofore was considered to be effective in doing so) could be disregarded at all times in the future. We do not believe this degree of retroactivity is reasonable (or likely intended).

Thus, even if the narrow interpretation of the regulation is adopted, we believe the final regulation should not apply to transactions occurring before the general effective date of the final regulation. In fact, this issue should not arise to a material degree under GILTI, because there could not have been an intent to avoid the GILTI regime much before the date of enactment of the Act. As to the application of the narrow rule to Subpart F, the regulation could apply to transactions before the date of publication of the Proposed Regulations only if the regulation qualified under Section 7805(b)(3) as a regulation to prevent abuse. However, few if any Treasury Regulations have been issued in reliance on this provision, and we question whether this regulation is critical enough to justify its application to transactions before the date the Proposed Regulations were published.

Moreover, if the broader interpretation of the Proposed Regulations is adopted, the result will be rules that taxpayers could not reasonably have predicted from the language of the Act. We acknowledge that Section 7805(b)(2) authorizes regulations under the Act to be retroactive to the date of enactment if they are issued within 18 months of enactment, and as noted above Section 7805(b)(3) authorizes retroactive regulations to prevent abuse. However, taxpayers who believed that they had satisfied the existing anti-abuse rules at the time of their transaction should not retroactively be potentially subject to a new, much broader, anti-abuse rule. As a result, if the broader interpretation of the Proposed Regulations is adopted, we do not believe it should apply to transactions that occurred before the date of publication of the Proposed Regulations. Moreover, given the novelty and uncertainty concerning such a broad interpretation, arguably it should not apply to transactions occurring before the date the regulations are finalized.

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abuse rule that depends on the motive for a sale. *See, e.g.,* Section 1377(a)(1) (taxing a shareholder of an S corporation on its pro rata share of income of the S corporation for its entire taxable year, without regard to ownership of the stock on any particular day during the year).

[19] Prop. Reg. § 1.951-1(i).

(b) *Hypothetical Redeeming Distributions*

Proposed Regulation Section 1.951-1(e)(4)(i) states that, in the Hypothetical Distribution, no amount of current e&p shall be treated as being distributed in redemption of stock (whether or not such a distribution would be treated as a dividend under Section 302(d)), in liquidation, or as a return of capital. This rule limits the general rule of paragraph (e)(3), which requires the taxpayer to take into account all facts and circumstances in determining how the Hypothetical Distribution would be allocated between classes of stock. The following example (Example 4 in Proposed Regulation Section 1.951-1(e)(7)) applies this provision:

> **Example 1.** *Hypothetical redeeming distributions.* FC1 has outstanding 40 shares of common stock and 10 shares of 4% nonparticipating, voting preferred stock with a par value of $50x per share. Pursuant to the terms of the preferred stock, FC1 has the right to redeem at any time, in whole or in part, the preferred stock. FC2 owns all of the preferred shares. USP1, wholly owned by FC2, owns all of the common shares. For Year 1, FC1 has $100x of e&p and $100x of Subpart F income within the meaning of Section 952. In Year 1, FC1 distributes as a dividend $20x to FC2 with respect to FC2's preferred shares.
>
> **Analysis.** If FC1 were treated as having redeemed any preferred shares, the redemption would be treated as a distribution to which Section 301 applies under Section 302(d) due to FC2's constructive ownership of the common shares. However, under paragraph (e)(4)(i) of this section, no amount of e&p is distributed in the Hypothetical Distribution to the preferred shareholders on the date of the Hypothetical Distribution as a result of FC1's right to redeem, in whole or in part, the preferred shares. FC1's redemption rights with respect to the preferred shares cannot affect the distribution of current e&p in the Hypothetical Distribution to FC1's shareholders. As a result, the amount of FC1's current e&p distributed in the Hypothetical Distribution with respect to FC2's preferred shares is $20x and with respect to USP1's common shares is $80x. Accordingly, under paragraph (e)(1) of this section, USP1's pro rata share of FC1's Subpart F income is $80x for Year 1.

Presumably, paragraph (e)(4)(i) is intended to preclude FC1 from allocating any e&p to FC2's preferred shares in the Hypothetical Distribution based on their redemption right. Under the facts of the example, allocating Subpart F income with respect to the preferred stock's redemption right would allow such income to escape U.S. taxation.

We find Proposed Regulation Section 1.951-1(e)(4) and the accompanying example puzzling. As an initial matter, the Hypothetical Distribution involves a distribution of current e&p, which is specially defined as the greater of normal e&p or Subpart F income plus tested income. Given this definition, it is difficult to see how any such distribution (other than a distribution in redemption of stock) could be a return of capital.

Furthermore, to the extent paragraph (e)(4)(i) is intended to limit the broad scope of paragraph (e)(3), the example's facts are not relevant to that provision. The example states that a distribution in redemption would be treated as a dividend for tax purposes under Section 302(d). Yet nowhere in paragraph (e)(1) or (e)(3) are the tax consequences of a distribution treated as relevant under the Hypothetical Distribution. Similarly, the example states that $20x is actually distributed as a dividend to FC2 even though (e)(1) provides that the Hypothetical Distribution does not take into account actual distributions during the year. This is again not relevant to the issue of whether the redemption right has consequences for purposes of the Hypothetical Distribution.

The example may have been intended to illustrate the different point, stated in paragraph (e)(4)(i), that allocations under the Hypothetical Distribution are to be made without regard to the fact that (i) if such a distribution was actually made, the CFC would have chosen to (or been required to) use part of the cash to redeem some of its stock, and (ii) such a redemption of stock might have been a dividend for tax purposes. We believe the example would better illustrate the concerns of (e)(4)(i) if it involved either this fact pattern or an actual redemption of stock.

(c) *Preferred Stock with Low Dividend Rate*

Proposed Regulation Section 1.951-1(e)(4)(ii) provides a special rule applicable to CFCs with a class of redeemable preferred stock with cumulative dividend rights and dividend arrearages that do not compound at least annually "at a rate that equals or exceeds the applicable Federal rate" under Section 1274(d)(1). For such a class of preferred stock, the amount of the CFC's current e&p distributed to it in the Hypothetical Distribution may not exceed the amount of dividends actually paid during the taxable year with respect to that class of stock, plus the current present value of the unpaid current dividends of that class. Paragraph (e)(4)(ii) specifies that, for purposes of determining this present value, the currently unpaid dividends should be discounted to the current time by the AFR "that applies on the date the stock is issued", assuming the dividends are paid at the mandatory redemption date.

The beginning of paragraph (e)(4)(ii) is unclear as to which AFR governs for purposes of triggering the requirement to discount future dividends. We suggest clarifying, consistent with the remainder of the provision, that the relevant AFR is the "AFR that applies on the date the stock is issued for the term from such issue date to the mandatory redemption date." While the use of the current AFR would be more economically correct, it would make no sense to initially test the need to discount future payments at a different rate than the rate actually used to discount those payments if the requirement to discount is triggered.

(d) *Allocations of Subpart F Income and Tested Loss*

Under the Proposed Regulations, Subpart F income is allocated independently of tested income/loss in the Hypothetical Distribution. As a result, a CFC could potentially allocate Subpart F income to preferred shareholders while allocating tested loss to common shareholders.

Consider the following example (based on Example 7 in Proposed Regulation Section 1.951-1(e)(7)):

> **Example 2.** *Allocations of Subpart F income and tested loss*. Assume that USP1 owns all the common stock of FC1, and USP2 owns all the preferred stock with an annual accrual of dividends of $1,200 and no dividend arrearages. For Year 1, FC1 has $8,000 of e&p, $10,000 of Subpart F income, and $2,000 of tested loss. FC1's current e&p is $10,000, the greater of the e&p of FC1 determined under Section 964 ($8,000) or the sum of its Subpart F income and tested income ($10,000). Accordingly, for Year 1, FC1 allocates USP1 $8,800 of Subpart F income and USP2 $1,200 of Subpart F income. Under Proposed Regulation Section 1.951A-1(d)(4)(i), FC1's $2,000 tested loss is allocated to USP1's common shares to the extent they have positive value.

Under Section 951(c)(2)(B)(ii), the Subpart F income must be taxable to FC1's shareholders notwithstanding the tested loss. Logically, this income should be allocated to USP2, the preferred stockholder, up to its preference. The question then is whether the tested loss should simply be allocated to USP1, the common stockholder, or instead be allocated to USP2 to the extent of its Subpart F income and then to USP1.

We have no objection to the approach in the Proposed Regulations. Arguably, it is less economically correct than first allocating tested losses to USP2 to match its Subpart F income. Indeed, on different numbers, FC1 could allocate $1,200 of Subpart F income to preferred stockholders and $1,200 of tested loss to common holders, even though it has no net e&p. But the approach adopted by the Proposed Regulations is simpler, and preferred stockholders would generally not expect to be allocated tested losses from a CFC until theirs is the only capital remaining. Moreover, there is currently no provision in the Proposed Regulations that would ensure that, if the rules first allocated tested loss to USP2 to the extent of its Subpart F allocations, there would be a corresponding "catch up" allocation of tested income in future periods to USP2 to reflect FC1's actual payment of a dividend to USP2. Thus, absent further changes in the regulations, an alternative approach could result in USP2 receiving no net income allocation even though it received a $1,200 dividend in year 1.

B. Proposed Regulation Section 1.951A-1: General Provisions

1. *Background*

Proposed Regulation Section 1.951A-1 sets out general provisions governing the calculation of a U.S. shareholder's yearly GILTI inclusion (the "**GILTI inclusion amount**").[20] A "**CFC inclusion year**" is any taxable year of a foreign corporation at any time during which it is a CFC, and the "**CFC inclusion date**" is the last day of a CFC inclusion year on which the foreign corporation is a CFC. The GILTI inclusion amount is included in the gross income of the shareholder in the shareholder's "**U.S. shareholder inclusion year**," which is the taxable year of the U.S. shareholder that includes the CFC inclusion date.

The GILTI inclusion amount, with respect to a U.S. shareholder for a U.S. shareholder inclusion year, is the excess (if any) of its "net CFC tested income" for the year, over its "**net deemed tangible income return**" (or "**NDTIR**") for the year. A U.S. shareholder's "**net CFC tested income**" is the excess, if any, of (x) the aggregate of such U.S. shareholder's pro rata share of the tested income of each of its CFCs with tested income for the year ("**tested income CFCs**"), over (y) the aggregate of such U.S. shareholder's pro rata share of the tested loss of each of its CFCs with a tested loss for the year ("**tested loss CFCs**").[21]

"**NDTIR**" is the excess, if any, of the U.S. shareholder's "**deemed tangible income return**" ("**DTIR**"), or 10% of the aggregate of such U.S. shareholder's pro rata share of QBAI of each tested income CFC for the year, over the U.S. shareholder's "**specified interest expense**" for the year. Specified interest expense is defined as the excess, if any, of the U.S. shareholder's pro rata share of the tested interest expense of each of its CFCs, over such U.S. shareholder's pro rata share of the tested interest income of each of its CFCs.

Paragraph (d) provides that, subject to certain exclusions, CFC tested items will be allocable to shareholders consistent with the rules applicable to Subpart F income.[22]

2. *Comments*

(a) *Interest Expense and Interest Income*

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[20] Prop Reg. § 1.951A-1(c)(1).

[21] Prop Reg. § 1.951A-1(c)(2).

[22] Prop Reg. § 1.951A-1(d)(1). Specific rules apply for allocations of the various CFC tested items. *See* Prop Reg. § 1.951A-1(d)(2) (tested income); Prop Reg. § 1.951A-1(d)(3) (QBAI); Prop Reg. § 1.951A-1(d)(4) (tested loss); Prop Reg. § 1.951A-1(d)(5) (tested interest expense); Prop Reg. § 1.951A-1(d)(6) (tested interest income).

We note first that the interest expense of tested loss CFCs is included in the calculation of specified interest expense and therefore reduces NDTIR, even though the QBAI of tested loss CFCs is disregarded in calculating NDTIR. This result is especially burdensome and unfair to taxpayers when the tested loss CFC has both specified interest expense and QBAI. In that case, the interest expense reduces the benefit of QBAI in tested income CFCs and the taxpayer gets no benefit for the QBAI in the tested loss CFC. However, as discussed in the Prior Report,[23] this result is consistent with the statute and the conference agreement. The Preamble confirms that the adoption of this approach in the Proposed Regulations is intentional.[24] Nevertheless, given the unfairness of the rule, if the Treasury does not feel it can change this result by regulations, we urge it to request an amendment to the statute to take account of both QBAI and interest income and expense in tested loss CFCs.[25]

Second, Section 951A(b)(2)(B) reduces DTIR of a U.S. shareholder by interest expense that reduces tested income (or increases tested loss) of the shareholder, except to the extent interest income "attributable" to that expense is included in tested income of the U.S. shareholder. At a minimum, this means that if a CFC pays interest to anyone, the interest expense would generally be specified interest that reduces NDTIR, but if the interest is paid to a CFC that has the same shareholder, so that it increases the tested income from that CFC allocated to the same shareholder, then the interest expense is not specified interest and does not reduce the shareholder's NDTIR. This rule makes sense because there is no net tax benefit to the shareholder from the interest expense so there is no logical reason to reduce the shareholder's NDTIR by the expense.

However, Proposed Regulation Section 1.951A-1(c)(3)(iii) is more favorable to taxpayers. It provides that specified interest expense is reduced by *all* interest income included in the tested income of the U.S. shareholder (subject to certain exceptions), even if earned from unrelated parties. In particular, there is no requirement of any connection between the interest expense and interest income in order for the exclusion from specified interest expense to apply. Accordingly, if a U.S. shareholder has a CFC that pays $100x of interest to a third party, and another CFC that receives $100x of interest from a different third party that is included in tested income, the shareholder will have $0 of specified interest expense, even if the interest income is plainly not related in any way to the interest expense.

This result arguably makes sense as a policy matter. It appears that the purpose of the rule for specified interest expense is that debt-financed assets should not count as QBAI, with "first dollars" of debt being allocated to QBAI. Since money is fungible, it

[23] *See* Prior Report at 62.

[24] *See* Federal Register GILTI at 51078-79.

[25] Merely disregarding interest expense in tested loss CFCs would allow tested loss CFCs to borrow and cause the proceeds to be used to purchase QBAI in tested income CFCs, with no reduction in DTIR for the interest expense on the borrowing.

can be argued that the appropriate measure of debt-financing for QBAI would be the net debt of all the shareholder's CFCs, or net interest expense of those CFCs, rather than gross interest expense paid to unrelated parties. (On the other hand, it can also be argued that a CFC by CFC approach, except for debt between CFCs, as provided in the statute also makes sense.) The Preamble further justifies the result in the Proposed Regulations on the ground that a requirement to trace interest income to interest expense would be administratively burdensome, especially if different CFCs are held by different U.S. shareholders.[26]

Nevertheless, it is not the most natural reading of the statute to say that all interest income is "attributable to" all interest expense. If that was the intent, the statute normally would have been written differently. Therefore, if the Treasury intends to adopt this rule in final regulations, it should consider whether an amendment to the statute to confirm this result would be helpful.[27]

Third, we have considered the treatment under the Proposed Regulations of interest expense paid by a CFC to its U.S. shareholder. Consider the following example:

> **Example 3.** *Interest on debt to U.S. shareholder.* USP owns all the stock of CFC1. At the beginning of Year 1, USP loans $100 to CFC1 at an interest rate of 10%. In Year 1, assume CFC1 has $100 of gross tested income, $90 of DTIR, and $10 of interest expense on the loan from USP. USP will have net CFC tested income of $90 and NDTIR of $80, resulting in a GILTI inclusion amount of $10. USP will also have $10 of interest income attributable to the loan.

The interest expense paid by CFC1 to USP reduces DTIR, even though USP includes it in its gross income. Both the narrow and the broad versions of the rule in the preceding section prevents a reduction in DTIR when the interest expense gives rise to interest income that is included in tested income of another CFC of the shareholder.

Here, the interest expense gives rise to interest income that is directly taxed to the U.S. shareholder at a 21% rate rather than the 10.5% rate for tested income of another CFC, with the deduction being at the 10.5% rate in either case. Nevertheless, the relief granted from reduction in NDTIR when the interest is paid to a sister CFC does not apply when the interest is paid to USP. The result is an additional GILTI inclusion equal to the amount of interest expense. The same results would apply if the interest income were paid to a sister CFC that reported the interest income as Subpart F income, with the U.S. shareholder paying tax on that income at a 21% rate, since the exclusion from reduction in NDTIR only applies to interest income included in tested income under GILTI.

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[26] Federal Register GILTI at 51078.

[27] While the proposed rule is generally pro-taxpayer, it could adversely affect a taxpayer if a higher GILTI inclusion would be sheltered by FTCs and yet would result in a higher tax basis in the CFC.

These results are not logical. The statute clearly contemplates that interest paid by a CFC to a sister CFC and taxed as tested income to the U.S. shareholder does not reduce NDTIR. Given that rule, there is no good reason for interest expense to reduce NDTIR if it is paid directly by the CFC to the U.S. shareholder and taxed at regular rates, or paid to a sister CFC and taxed as Subpart F income to the U.S. shareholder at regular rates. While we understand the constraints of the statute, the Treasury took a liberal interpretation of the statute in the related interpretation discussed above. If the Treasury does not believe it has the authority to adopt these positions by regulation, we urge a statutory amendment to avoid a reduction in NDTIR for interest expense of a CFC when the related interest income is included in the income of the U.S. shareholder (directly or as Subpart F income) at regular tax rates. We note that in the case of interest paid directly to the U.S. shareholder by a CFC (the fact pattern that will arise in the great majority of cases), the tracing of interest income and expense should be relatively simple.

(b) *Taxable Year of GILTI Inclusion*

As described above, a U.S. shareholder must include CFC tested items for a given CFC inclusion year in the U.S. shareholder inclusion year that includes the CFC inclusion date, which is the last date during the CFC inclusion year that the foreign corporation is a CFC.[28] Consider the following example:

> **Example 4.** *Timing of GILTI inclusion.* USP, a calendar-year taxpayer, owns all of the stock of CFC1, a June 30 taxpayer. On December 31, 2018, USP sells all the stock (or 51% of the stock) of CFC1 to FC, an unrelated foreign corporation, at which point CFC1 ceases to be a CFC. The CFC inclusion year is the CFC tax year ending on June 30, 2019, and the CFC inclusion date is December 31, 2018. Thus, USP must include its share of the CFC tested items of CFC1 for the 2019 CFC inclusion year of CFC1 on its 2018 tax return.

As an initial matter, we note that this timing rule is inconsistent with Section 951A(e)(1), which states that the pro rata share of tested income is taken into account "in the taxable year of the United States shareholder in which or with which the taxable year of the controlled corporation ends." This reference is to the taxable year of the U.S. shareholder that includes the last day of the CFC inclusion year, not the year that includes the CFC inclusion date as in the Proposed Regulations. Moreover, the statute here is the same as has long been applicable to Subpart F income under Section 951(a)(1) and Treasury Regulation Section 1.951-1(a)(2).[29] The Preamble contains no explanation for the Proposed Regulations' divergence from the statute on this point.

[28] Prop Reg. §§ 1.951A-1(b), (e)(4).

[29] The same rule applies to the inclusion of income by a shareholder of a "qualified electing fund" under the PFIC rules. Section 1293(a)(2).

On the facts of Example 4, the statute would require USP to reflect the CFC tested items of CFC1 on its 2019 tax return, not its 2018 tax return as in the Proposed Regulations. Consider an even more extreme example:

> **Example 5.** *Close of CFC inclusion year after filing date.* USP, a calendar-year taxpayer, owns all of the stock of CFC1, a November 30 taxpayer. USP sells the stock of CFC1 to FC, an unrelated foreign corporation, on December 31, 2018, at which point CFC1 ceases to be a CFC. The CFC inclusion date is December 31, 2018, and USP must include its share of the CFC tested items of CFC1 for CFC1's year ending November 30, 2019, on USP's 2018 tax return.

Under these facts, the Proposed Regulations would require USP to file its 2018 tax return taking into account the CFC tested items of CFC1 for CFC1's taxable year ending November 30, 2019, even though that date is after the due date for USP's 2018 tax return.

We urge that final regulations adopt a rule that the "CFC inclusion date" is the last day of the CFC inclusion year, rather than the last date in the CFC inclusion year that the foreign corporation is a CFC. Such a rule is necessary for the regulations to be consistent with the language of the GILTI provisions of the Code as well as with the preexisting Subpart F rules, which are not changed by the Act or the Proposed Regulations. If a CFC has both Subpart F income and tested income in the same taxable year of the CFC, it would not be logical for the Subpart F income and tested income to be included in different taxable years of the U.S. shareholder.

Practical reasons also support this conclusion. The determination of a U.S. shareholder's GILTI inclusion amount depends on the tested income, tested loss, interest income, interest expense and QBAI of the CFC for the entire CFC inclusion year. These items are not known or even knowable on the CFC inclusion date (as it is defined in the Proposed Regulations), because they depend on events that occur through the end of the CFC inclusion year. It is not logical to require a U.S. shareholder to report income on a tax return for a taxable period that ends before the amount of income allocable to the taxable period can be determined. It is also difficult to see the policy justification for this result, since the "all events' test" is not satisfied until all the CFC tested items are determinable on the last day of the CFC inclusion year.

Moreover, a U.S. shareholder may not even know until the end of the CFC inclusion year whether it was a U.S. shareholder on the CFC inclusion date. Consider the following example:

> **Example 6.** *Inability to determine U.S. shareholder status as of CFC inclusion date.* Assume the same facts as Example 4, but that FC sells the stock of CFC1 to USP2, an unrelated U.S. corporation, on June 29, 2019. Under the Proposed Regulations, the CFC inclusion date is now June 30, 2019. Thus, USP2 must include its share of the CFC tested items of CFC1

> on its 2019 tax return, rather than USP including its share of those items on its 2018 tax return.

In fact, absent a narrowing of the current ownership attribution rules, this same result would arise if FC retained the stock of CFC1, did not have a U.S. subsidiary on December 31, 2018, and first formed a U.S. subsidiary on June 29, 2019. At that point, because of constructive ownership of 100% of CFC1 by the new U.S. subsidiary,[30] CFC1 would again become a CFC and the CFC inclusion date would be June 30, 2019. Here, USP is relieved of any obligation to report its share of tested income of CFC1 even though there is no U.S. shareholder with Section 958(a) ownership on the CFC inclusion date to report such income.

Accordingly, even an all-knowing USP will not be able to know for sure whether it was a U.S. shareholder of CFC1 on the CFC inclusion date until the last day of the taxable year of CFC1. USP must "wait and see" until the end of the CFC inclusion year to determine not only the components of its GILTI inclusion amount, but also whether it needs to perform any calculation in the first place.

We note that the pro rata share of the tested income of a CFC for a CFC inclusion year to be allocated to a U.S. shareholder is based on the U.S. shareholder's stock ownership on the CFC inclusion date.[31] However, while this rule is necessary to determine the *pro rata amount* to be allocated to the U.S. shareholder that has sold its stock on that date, this is not relevant for determining the *timing* of the inclusion to the U.S. shareholder.

In addition, the Proposed Regulations should be clarified in one respect. Proposed Regulation Section 1.951A-1(c)(2) defines net CFC tested income as the aggregate of the U.S. shareholder's pro rata share of the tested income of each tested income CFC "for the year." The only year that is referred to in this subsection is the "U.S. shareholder inclusion year." However, tested income is a CFC-level concept, and the reference should be to the CFC inclusion year that includes the CFC inclusion date that is within such U.S. shareholder inclusion year. Similar ambiguities exist in paragraphs (c)(3)(ii) and (iii).

(c) *Allocations of QBAI and Tested Loss*

The Preamble requests comments on "proposed approaches for determining a U.S. shareholder's pro rata share of a CFC's QBAI and tested loss, including how (or

[30] Sections 958(b), 318(a)(3)(C).

[31] Prop. Reg. § 1.951A-1(d)(1). The same rule applies under Subpart F, see Section 951(a)(2)(A).

whether) to allocate tested loss of a CFC when no class of CFC stock has positive liquidation value."[32] We offer several comments on this topic.

First, Proposed Regulation Section 1.951A-1(d)(3) currently allocates QBAI of a tested income CFC in proportion to the allocation of tested income until the amount of QBAI is equal to ten times tested income (i.e., the point where DTIR attributable to the tested income fully offsets the CFC's tested income). Any remaining QBAI ("**excess QBAI**") is allocated solely to common shares (and not to preferred shares). In effect, this rule ensures that preferred shareholders do not receive QBAI that can be used to shelter tested income allocated to them from other CFCs.

We believe this method of allocation is reasonable. Preferred shareholders have a debt-like claim on the CFC and should not receive tax benefits that could, in effect, create a negative tax rate on their fixed allocation of income from a CFC.

Note, however, that this rule can sometimes create extreme results. Consider the following example:

> **Example 7.** *Excess QBAI.* USP1 owns all the common stock of CFC1, and USP2 owns all the preferred stock with a par value of $10,000 and a dividend of 10%. In year 1, CFC1 has $100 of current e&p and tested income, and $10,000 of QBAI. All $100 of CFC1's current e&p is distributed on the preferred shares in the Hypothetical Distribution, so USP2 is allocated all $100 of CFC1's tested income. Under paragraph (d)(3), CFC1 allocates to USP2 the first $1000 of QBAI; the remaining $9000 of QBAI is allocated to USP1.

Given CFC1's small amount of tested income, it allocates the vast majority of its QBAI to USP1, the holder of its common stock. This disproportionate allocation will partially be reversed in future years to the extent there is sufficient tested income in those years, since that tested income will be allocated to the arrearages on the preferred stock in the Hypothetical Distribution[33] and will bring with it a proportionate share of QBAI for those years. In this sense, the Proposed Regulations pair QBAI and tested income allocations to preferred stock as much as possible, without creating an excess allocation of QBAI in Year 1 that may or may not be used. Moreover, absent a cap on the amount of QBAI allocated to preferred stock, it would be necessary to adopt an offsetting reduction in the QBAI allocated to preferred holders in a later year, to ensure such holders do not doubly benefit when there is tested income that will permit QBAI to be used.

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[32] Federal Register GILTI at 51074.

[33] Under Prop. Reg. § 1.951-1(e)(4)(iii), such catch-up allocations of tested income only arise to the extent a dividend arrearage exceeds accumulated e&p of the CFC on the date the preferred stock was issued (or December 31, 1962, if later).

Second, we believe that the allocation method for tested losses in Proposed Regulation Section 1.951A-1(d)(4)(i)(C) is also logical. A CFC's tested losses are allocated based on a Hypothetical Distribution of e&p equal to the amount of tested loss but, subject to two exceptions, only to the common shareholders. When the common stock has no liquidation value, paragraph -1(d)(4)(iii) allocates tested loss to classes of stock with liquidation value, the most junior first. In addition, paragraph (d)(4)(ii) allocates tested loss to preferred shares to the extent the tested loss reduces the e&p accumulated since the issuance of those preferred shares to an amount below the amount necessary to satisfy any accrued but unpaid dividends with respect to such preferred shares.

These results seem appropriate since they reflect the economic burden borne by the different classes of stock as a result of the tested loss.

Third, if no class of stock has positive liquidation value, the loss will likely be borne by creditors. We recommend first allocating tested loss to any shareholders that have guaranteed the debt. Then, it seems most logical to allocate any remaining tested loss to the most senior class of common stock, since that class has the most to lose from the equity becoming more and more negative (except for preferred stock, but it does not seem logical to allocate losses to them in excess of their liquidation right and accrued dividends). An exception should be made if it can be demonstrated that another class of stock will in fact bear the economic loss.

Fourth, the Proposed Regulations should be revised to provide a rule for the allocation of QBAI with respect to convertible preferred stock or participating preferred stock. This is stock that has a fixed dividend and minimum liquidation value, but participates in increases in value above a stated floor in a manner comparable to common stock. Logically, this stock should be bifurcated into preferred stock (to the extent of the fixed dividend and liquidation right) and common stock (to the extent that the participation right is "in the money"), and QBAI should be allocated to each piece separately. For example, the 10x limit should apply to the fixed portion of the preferred stock, and the excess QBAI should be allocated to both the regular common stock and the participating portion of the preferred stock.

C. Proposed Regulation Section 1.951A-2: Tested Income and Tested Loss

1. *Background*

Proposed Regulation Section 1.951A-2 contains rules relating to the determination of tested income and tested loss of a CFC. Paragraph (b)(1) defines "**tested income**" as a CFC's gross tested income (as defined below) for a CFC inclusion year, over allowable deductions (including taxes) that are properly allocable to the CFC's gross tested income for that CFC inclusion year. Paragraph (b)(2) defines "**tested loss**" as the reverse of tested income (i.e., such allowable deductions over gross tested income).

Consistent with Section 951A(c)(2)(A), paragraph (c) defines "**gross tested income**" as the gross income of the CFC for the CFC inclusion year without regard to certain items, including (i) effectively connected income, (ii) Subpart F income, (iii) income that would be Subpart F income but is excluded under the "high tax" exception of Section 954(b)(4) and Treasury Regulation Section 1.954-1(d), (iv) dividends received by the CFC from related parties and (v) foreign oil and gas extraction income (as defined under Section 907(c)(1)).

Tested income and tested loss are calculated in a manner consistent with Treasury Regulation Section 1.952-2, which governs the calculation of a CFC's Subpart F income.[34]

2. *Comments*

(a) *Application of Treasury Regulation Section 1.952-2*

The Treasury has requested comments on the proposed application of rules under Treasury Regulation Section 1.952-2 for purposes of determining Subpart F income, tested income and tested loss.[35]

As noted in the Preamble, Treasury Regulation Section 1.952-2 generally requires that tested income or tested loss of a CFC be determined by treating the CFC as a domestic corporation taxable under Section 11 and by applying the principles of Section 61 and the regulations thereunder.[36] That being said, as discussed in the Prior Report, Treasury Regulation Section 1.952-2 effectively adopts GAAP principles unless those principles would have a "material effect" as compared to the calculation under U.S. tax principles.[37] If the intent of the Proposed Regulations is to adopt pure U.S. tax principles, the reference to Treasury Regulation Section 1.952-2 should be modified.

The Treasury has also requested comments on other approaches for determining tested income or tested loss, including whether additional modifications should be made to Treasury Regulation Section 1.952-2 for purposes of calculating GILTI. We offer two possible modifications.

First, Treasury Regulation Section 1.952-2(c)(5)(ii) states that net operating loss ("**NOL**") carryforwards are not taken into account for purposes of calculating Subpart F

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[34] Prop. Reg. § 1.951A-2(c)(2).

[35] In particular, the Preamble requests comments on whether a CFC should be entitled to the deduction under Section 245A for purposes of calculating tested income. Federal Register GILTI at 51075. This is discussed in NYSBA Tax Section Report No. 1404, *Report on Section 245A* (October 25, 2018), at 17-26 ("**Section 245A Report**").

[36] Treas. Reg. § 1.952-2(a).

[37] Treas. Reg. §§ 1.952-2(b)(1), (c)(2); Prior Report at 28.

income. By application of this regulation to GILTI, NOL carryforwards cannot be taken into account in calculating tested income, so no NOL carryforwards are allowed at all under GILTI. As discussed in the Prior Report, this rule might make sense under Subpart F, which is limited to e&p and reduces Subpart F income by qualified deficits,[38] but we do not believe it is the proper rule under GILTI, which has neither such concept.

The Prior Report discussed the allowance of NOL carryforwards at either the CFC or U.S. shareholder level, and recommended allowing carryforwards at the U.S. shareholder level.[39] The failure to allow carryforwards, at least at the CFC level, is clearly not required by the Code. It also is quite unfair. If a U.S. shareholder has a single CFC with a tested loss in Year 1 and equal tested income in Year 2, the shareholder has no economic gain over the period. Yet absent the allowance of carryforwards, the shareholder owes tax on 100% of the tested income in Year 2 without credit in any year for the tested loss.

The failure to allow carryforwards is also inconsistent with the idea that the GILTI provisions effectively create a worldwide tax system with foreign income being taxed at a lower rate than the U.S. rate. Such a system presupposes that major deductions that would be allowed to a U.S. corporation would be allowed to a CFC. As a result, we continue to strongly believe that carryforwards of losses should be permitted at either the U.S. shareholder level or the CFC level.

We continue to prefer a carryforward of NOLs at the U.S. shareholder level, as recommended in the Prior Report. We acknowledge, however, as we did in the Prior Report, that there is less statutory authority for this approach than for allowing carryforwards at the CFC level. As a result, if the Treasury does not feel it has authority to allow NOL carryforwards at the U.S. shareholder level, we recommend allowing carryforwards at the CFC level, notwithstanding the complexities discussed in the Prior Report. We readily acknowledge that this will cause additional complexity under the basis adjustment rules of Proposed Regulation Section 1.951A-6(e) and the consolidated return basis adjustment rules under Proposed Regulation Section 1.1502-32. However, we do not believe that the complexities of basis calculations justify the disallowance of loss carryforwards and the resulting taxation of noneconomic profits.

In any event, assuming future regulations state that Section 163(j) applies to CFCs, regulations should also confirm that interest disallowed under Section 163(j) is not subject to any restrictions on loss carryovers. The statute treats such interest as incurred in the following year, and in the following year it is not an NOL deduction under Section

[38] *See* Prior Report at 35.

[39] *See* Prior Report at 33-44.

172. Additional issues arise under Section 163(j) that are beyond the scope of the Proposed Regulations but should be covered in subsequent regulations.[40]

Second, because the GILTI inclusion amount is based on tested income (and is not limited to e&p), it is likely that Congress intended that some deductions that are disallowed for U.S. income tax purposes (but reduce e&p) would also be disallowed for purposes of calculating tested income. This would logically be the case for items like fines and penalties, which should be disallowed for a CFC just as they would be for a U.S. corporation.

That being said, there are other deductions that are disallowed to a U.S. corporation for which it is less clear, as a matter of policy, whether the disallowance should also apply to a CFC. In particular, consideration should be given as to whether it is appropriate to disallow deductions for compensation paid by a CFC that would be disallowed to a domestic corporation under Section 162(m)[41] or Section 280G.[42] The final regulations should contain as complete a list as possible of any variances intended from taxable income of a domestic corporation.

(b) *Disqualified Basis from Transition Period Transfers*

The GILTI rules become effective for a CFC for the first taxable year of the CFC beginning after December 31, 2017. As a result, for a CFC with a fiscal year tax year, the rules do not apply to the period from January 1, 2018, to the end of the first tax year that ends in 2018 (the "**transition period**"). This potentially allows taxpayers to create gain in a CFC during the transition period that will not result in tested income, with the resulting benefit of loss or deduction in related CFCs that will reduce GILTI inclusions in periods when the GILTI rules are effective.

To deal with this possibility, Proposed Regulation Section 1.951A-2(c)(5) disallows a deduction or loss attributable to "**disqualified basis**", which is basis resulting from the transfer between two related CFCs of certain depreciable or amortizable property ("**specified property**") during the transition period. This exclusion does not

[40] For example, a mismatch of tested income and tested deduction will arise (at least temporarily) if a CFC pays interest to a related CFC and the interest deduction is disallowed under Section 163(j), although the payor CFC might be entitled to the deduction in future years. A similar mismatch would arise if the interest was paid to a U.S. shareholder. On the other hand, if the interest is included in income of the payee CFC and the deduction is disallowed under Section 163(j), query whether the U.S. shareholder should have an increase in specified interest income, which could allow an increase in NDTIR.

[41] Section 162(m) disallows deductions in excess of $1 million for compensation paid to "covered employees" of a publicly traded corporation or, after the enactment of the Act, a foreign private issuer.

[42] Section 280G disallows deductions for "excess parachute payments" made to "disqualified individuals" under Section 280G(c), with "disqualified individuals" defined to include the highest 1% paid individuals (up to 250) of the taxpayer.

apply to the extent the selling CFC had effectively connected income on the transfer, or the U.S. shareholder recognized Subpart F income as a result of the transfer.

This provision is notable in a number of respects. First, motive is not relevant—the deduction and loss are disallowed if they arise from any property transfers that create disqualified basis. Second, the rule applies to all depreciable or amortizable property, not just tangible property that is QBAI. Thus, the rule is materially broader than the comparable provision under Proposed Regulation Section 1.951A-3(h)(2), discussed in Part III.D.2(b), which is applicable to QBAI arising from similar transfers of certain depreciable property. Third, the basis of the relevant assets is respected for all other purposes of the Code.

We acknowledge the argument that as a matter of policy, a transfer between related parties during the transition period should not produce a costless step up in tax basis for GILTI purposes. That being said, the provision has no specific statutory basis in the GILTI provisions of the Act. The Preamble cites only Section 7805(a) and the Conference Report to the Act[43] as authority.[44] The Conference Report states that the conferees intended that "non-economic transactions intended to affect tax attributes" such as tested income and tested loss should be disregarded.[45]

However, the language in the Conference Report is not supported by any specific grant of authority in the Code, and the Proposed Regulations cover more transactions than the "non-economic transactions" referred to in the Conference Report. As a result, if the Treasury intends to continue to take this position, we suggest that it request a statutory amendment to confirm its authority to adopt this position.

The final regulations should also clarify the mechanics of the application of paragraph (c)(5). Under that paragraph, if an asset has both disqualified basis and non-disqualified basis, the deduction or loss is treated as allocated proportionately between disqualified and non-disqualified basis.[46] Disqualified basis is reduced or eliminated in the same manner. Consider the following situation:

> **Example 8.** *Amortization of disqualified basis.* CFC1 has an intangible asset with a basis of $150 and sells it to CFC2 for $300 during the transition period. Assume that CFC2 is required to amortize the $300

[43] H. Rep. 115-466 (2017) (the "**Conference Report**").

[44] Federal Register GILTI at 51075-76. The Preamble cites this authority by cross reference to the analogous QBAI rules.

[45] Conference Report at 645.

[46] Prop. Reg. § 1.951A-2(c)(5)(i).

basis over a new 15-year holding period, or $20 per year. The disqualified basis is the $150 basis step up, which is half of the asset's total basis.

In the first year, half of the $20 annual amortization deduction is disallowed, and the disqualified basis is reduced to $140. Accordingly, we believe that, after Year 1, the asset should have a total basis of $280 for purposes of this rule (the cost minus the entire amortization deduction of $20) with a disqualified basis of $140. Under this approach, half of each remaining year's amortization deduction will be attributable to disqualified basis, and so annual amortization of $10 will be allowed.

This approach should be confirmed. The alternative would be to have the adjusted basis of the asset for purposes of the rule be reduced only by the deduction allowed in calculating tested income. For example, the adjusted basis would be $290 after the first year, $280 after the second year, and so on. This approach would be complex and illogical, since it would increase the ratio of disqualified basis to total basis over time and change the allowed amortization deduction each year.

Next, consider the application of the rule upon the sale of an asset:

> **Example 9.** *Disqualified basis upon sale.* Assume the same facts as Example 8. After five years, total amortization of $50 (rather than $100) has been allowed, and CFC2 will hold the asset with a total adjusted basis of $200, $100 of which is disqualified basis using the assumed rule above. The asset is sold at that time to a third party.

Since the loss attributable to disqualified basis is disregarded for determining tested loss, the remaining tax basis for calculating tested loss is $100. However, paragraph (c)(5) states that the deduction attributable to disqualified basis is disregarded for determining both tested income and tested loss. Regulations should confirm that this means that for purposes of calculating tested income on a sale of the asset, the prior deductions attributable to disqualified basis (which were in fact disallowed) must likewise be disregarded.

In the example, this rule would mean that the amount of disqualified deductions ($50) must be added back to the existing basis ($200) before calculating gain. In effect, this is the original cost basis of $300, minus the $50x of deduction allowed in the calculation of taxable income. The result is a regular tax basis of $200, a basis of $100 for determining tested loss on a sale, and a basis of $250 for determining tested gain on the sale. Therefore, if the sale to the third party was for $250, there would be no gain.

This is the only logical approach. If the basis for gain was lower, the U.S. shareholder in Example 9 would have more overall tested income following a sale of the asset (from disallowed deductions plus the inclusion of offsetting tested income) than if no transaction in the transition period had been done in the first place. In the absence of such a transaction, the initial basis of $150 would have been reduced by $50 of deductions, and on a later sale to a third party for $250, there would have been $150 of gain, or $100 of net taxable income. In the actual transaction, the sale to CFC2 for $300 gave rise to $150 of gain followed by $50 of deductions, or $100 of net taxable income so far, and the results of a sale to a third party for $250 are the same only if no additional gain is recognized on that sale.

(c) *Application of Section 952(c)*

Proposed Regulation Section 1.952-2(c)(4) provides that tested income and deductions allocable to tested income are determined without regard to the application of Section 952(c). Section 952(c)(1)(A) provides that Subpart F income for a year is limited to current e&p for the year, and Section 952(c)(2) provides that if the (c)(1)(A) limitation applies for a year, then the excess of e&p in a future year over Subpart F income in the future year is recharacterized as Subpart F income in the future year. In effect, this is a "catch-up" provision for Subpart F when the e&p limitation initially applies.[47]

Under Section 951A(c)(2), tested income does not include "any gross income taken into account in determining the Subpart F income of the corporation." Arguably, therefore, if a CFC has income that is not Subpart F income for the year because of the e&p limitation under Section 952(c)(1)(A), it might be treated as tested income for the year, notwithstanding the catch up provision in Section 952(c)(2). The Proposed Regulations resolve this ambiguity by in effect stating that if an item would be Subpart F income without regard to the e&p limit, it remains potential Subpart F income in a future year with e&p under Section 952(c)(2), rather than becoming tested income in the current year because it is not currently Subpart F income.

The Proposed Regulations illustrate the rule with an example. In year 1, the CFC has $100 of what would be Subpart F income (referred to herein as "**notional Subpart F income**"), and a non-Subpart F loss that reduces e&p to $0. In year 2, the CFC has $100 of tested income and $100 of e&p. The example states that there is no Subpart F income in year 1 because of the e&p limitation in Section 952(c)(1)(A). In year 2, there is $100 of Subpart F income under Section 952(c)(2) because of the e&p in year 2, and there is also $100 of tested income.

We agree with the conclusion in the example that the notional Subpart F income in year 1 should be excluded from tested income notwithstanding the fact that Section 952(c)(1)(A) also excludes it from Subpart F income in year 1. Absent such a rule, every item of Subpart F income that was in excess of e&p would become tested income for the year. This would leave no room for the application of Section 952(c)(2) in future years, which we do not believe should be read out of the Code. As a statutory matter, this conclusion is based on the fact that Section 951A(c)(2)(A)(i)(II) excludes from gross tested income any gross income taken into account in determining Subpart F income, and

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[47] Section 952(c)(2) is needed, and the issue in this section arises, because, unlike the rule in Section 951A(c)(2)(B)(ii) that tested losses do not reduce e&p for Subpart F purposes, there is no such rule for other non-Subpart F expenses and deductions that reduce e&p. An alternative solution that would require legislation would be a rule that created a separate tracking of e&p solely for Subpart F purposes.

Section 952(c)(2) takes the year 1 Subpart F income into account in year 2 (as discussed below).

We also agree with the result in the example that there is $100 of Subpart F income in year 2. Under Section 952(c)(2), there is $100 of e&p in excess of Subpart F income in year 2, so $100 of e&p in year 2 is recharacterized as Subpart F income.

Finally, we agree with the result in the example that there should also be $100 of tested income in year 2. It can be argued that as a policy matter, there should not be an inclusion of $100 of tested income in year 2 because this would result in a total inclusion of $200 of income in year 2 as a result of a single item of $100 of tested income in year 2. Arguably this result would be surprising and unfair to taxpayers.

However, failure to include the $100 of tested income in year 2 would result in that income being permanently exempt from tax. Such a result would in effect allow the non-tested, nondeductible expense in year 1 to offset the tested income in year 2, which is inconsistent with the rule that only losses allocable to gross tested income can reduce tested income. Such a result would also have elements of randomness (and provide an opportunity for tax planning), since the tested income would clearly be included in year 2 if the nondeductible expense had occurred in year 2 rather than year 1.

As a matter of statutory construction, the conclusion in the Proposed Regulations is not entirely clear. Section 951A(c)(2)(A)(i)(II) excludes from gross tested income any gross income taken into account in determining Subpart F income. Therefore, since Section 952(c)(2) converts the year 2 e&p into Subpart F income, and the e&p arises from the tested income, arguably the tested income is "taken into account" in determining the year 2 Subpart F income, and so Section 951A(c)(2)(A)(i)(II) prevents the income from being tested income at the same time.

On the other hand, it can be argued that Section 951A(c)(2)(A)(i)(II) should not be interpreted to prevent the inclusion. That provision is intended merely to give a priority to Subpart F income over tested income, not to exclude any items of income from taxation altogether. Likewise, Section 951A(c)(2)(A)(i)(II) was likely not intended to apply twice in this manner, (1) first in year 1 to treat the notional Subpart F income as not being tested income because is "taken into account" in year 2 under Section 952(c)(2), and (2) again in year 2 to treat the actual tested income as not being tested income because that income is also "taken into account" in that year by Section 952(c)(2).

Moreover, as a technical matter, Section 951A(c)(2)(A)(i)(II) only applies to the tested income in year 2 if that income is "gross income taken account in determining Subpart F income" in year 2. Subpart F income is determined in year 2 solely on the basis of Section 952(c)(2), which looks solely to the e&p in year 2. Even if the same underlying operating income gives rise to both tested income and e&p in year 2, either tested income or e&p can exist without the other. As a result, the tested income should not be said to be "taken into account" in year 2 under Section 952(c)(2).

Finally, when the tested income and e&p in year 2 arise from different sources, clearly Section 952(c)(2) does not take the tested income into account in year 2, so Section 951A(c)(2)(A)(i)(II) does not prevent the tested income from being included in income. This means that under the view that there is no inclusion of $100 of tested income in year 2 in the example in the Proposed Regulations, tracing of tested income and e&p would be required to determine the applicability of Section 951A(c)(2)(A)(i)(II) to the tested income in year 2. This level of complexity is not apparent on the face of the statute and was likely not intended.

As a result, we believe the position of the Proposed Regulations is at least a reasonable interpretation of the Code. However, because of the ambiguity in the statute, if the Treasury wishes to adopt this position in final regulations, it should consider whether an amendment to the statute to confirm this result would be helpful.

(d) *Deemed Royalties under Section 367(d)*

The Proposed Regulations should be clarified to confirm that deemed royalties under Section 367(d) can be deducted from tested income. These deemed royalties arise when a U.S. person transfers certain intangible property to a transferee foreign corporation in a transaction subject to Section 351 or Section 361. In effect, the U.S. transferor is treated as selling the intangible property for a deemed royalty, which is characterized as ordinary income over its useful life.

Treasury Regulation Section 1.367(d)-1T(c)(2)(ii) provides that the transferee foreign corporation may treat this as an expense against "gross income subject to Subpart F, in accordance with the provisions of Treasury Regulation Sections 1.954-1(c) and 1.861-8." It further provides that "[n]o other special adjustments to earnings and profits, basis, or gross income" shall be permitted because of the deemed royalty. The concern is that tested income might not be considered gross income subject to Subpart F, and that the deemed royalty could only be used to reduce Subpart F income.

On the one hand, Section 951A is part of Subpart F of the Code (which runs from Section 951 to Section 965). Thus, as a technical matter, even though GILTI inclusions are not "Subpart F income" under Section 952(a), they are "subject to Subpart F" and, therefore, deemed royalties can be allocated against tested income. Proposed Regulation Section 1.951A-2(c)(3) might also allow the allocation of Section 367(d) deductions because those may be allocated "under the principles" of Section 954(b)(5).

On the other hand, Treasury Regulation Sections 1.954-1(c) and 1.861-8, referred to in the Section 367(d) regulation quoted above, specifically deal with Subpart F income. This could be read to prohibit the allocation of deemed royalty expense to tested income (which is not Subpart F income), although this argument is weakened by the fact that GILTI income did not exist at the time those regulations were adopted. If this interpretation applies, the deemed royalty income could be taxed as an income inclusion to the U.S. shareholder without an offsetting deduction against tested income. This would be neither fair to the taxpayer nor consistent with the intent of Section 367(d).

D. Proposed Regulation Section 1.951A-3: QBAI

1. *Background*

Proposed Regulation Section 1.951A-3 contains rules for calculating the QBAI of a CFC. Consistent with Section 951A(d)(1), for a tested income CFC, QBAI is defined as the average of the CFC's aggregate adjusted bases as of the close of each quarter of all "specified tangible property" that is used in a trade or business of the CFC and is depreciable under Section 167.[48] "**Specified tangible property**" is defined as tangible property (generally, property depreciable under Section 167(a)) used in the production of gross tested income. A tested loss CFC is deemed to have no QBAI.

The basis of specified tangible property is determined using the alternative depreciation system of Section 168(g) ("**ADS**").[49] This applies to all specified tangible property, even if it was placed into service before enactment of the Act. The definition is not affected by future changes in law unless the law specifically and directly amends the definition of QBAI.

Proposed Regulation Section 1.951A-3(f) contains special rules for calculating QBAI for short taxable years. Proposed Regulation Section 1.951A-3(h) sets out two anti-abuse rules for transfers of specified tangible property that produce additional QBAI.

2. *Comments*

(a) *Application of Alternative Depreciation System*

We are concerned about the complexity created by applying ADS to all specified tangible property placed in service before enactment of the Act. While CFCs may already use the ADS system to determine depreciation on much of their specified tangible property, the Preamble acknowledges that this will not always be the case. Therefore, taxpayers will be required to recalculate the basis of all non-ADS specified tangible property at the effective date of the GILTI rules as if they were already being depreciated under ADS, solely for purposes of calculating QBAI.

Tested income and loss, meanwhile, will be determined for GILTI purposes based on the actual tax basis of the assets, so a single asset might have two different tax bases for purposes of the GILTI rules. In fact, they may have a third basis for purposes of calculating e&p and therefore Subpart F income of the CFC. Of course, these rules apply to assets newly placed in service, but it is much easier to apply rules prospectively to new assets than retroactively to preexisting assets.

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[48] Prop. Reg. § 1.951A-3(c)(1).

[49] Prop. Reg. § 1.951A-3(e).

Moreover, Section 250(b)(2)(B) incorporates the GILTI basis calculation for purposes of calculating the foreign-derived intangible income ("**FDII**") deduction of a U.S. corporation. Thus, absent a modification in the FDII regulations, the rule in the Proposed Regulations will require retroactive application of ADS to all domestic tangible assets of every U.S. corporation claiming a FDII deduction. This will be even more burdensome unless the taxpayer has available a comprehensive record of when assets are placed in service, etc., and access to a computer system that allows a hypothetical calculation of past depreciation on such assets to be done quickly.

We do not believe that these results are compelled by Section 951A(d)(3), which states that the calculation of the basis of specified tangible property will disregard changes in law enacted after the Act. This does not require that ADS be applied retroactively to assets placed into service before enactment of the Act. The Preamble states that this approach is necessary to avoid distortion of QBAI to the U.S. shareholder,[50] but we are not aware of how distortion could arise for previously acquired property. We urge reconsideration of the retroactive application of ADS to property placed in service before enactment of the Act.

In addition, regulations should confirm that the use of ADS by the U.S. shareholder in calculating its DTIR from QBAI of its CFCs, for either new or preexisting assets, is not a change in the shareholder's method of accounting. Alternatively, if such use is a change in method of accounting, global approval under Section 446(e) should be given for this change by all taxpayers. The concern is that if ADS was not used previously by the U.S. shareholder, the shareholder is using ADS for the first time in calculating an "item" (i.e., DTIR) in the shareholder's taxable income, and this could be viewed as a change in method of accounting.[51]

(b) *Anti-Abuse Rules*

Proposed Regulation Section 1.951A-3(h) contains two broad anti-abuse rules that, if triggered, require a tested income CFC to disregard some or all of the basis of its specified tangible property in calculating its QBAI. Both of these rules are arguably supported by Section 951A(d)(4), which allows the Secretary to issue regulations or guidance to prevent the avoidance of the purposes of the QBAI rules, including (x) with respect to property transferred or held "temporarily" and (y) where the avoidance of the QBAI rules is "a factor in the transfer or holding of such property."

[50] Federal Register GILTI at 51076.

[51] Rev. Proc. 2015-13, Section 2.02, provides that "[a] change in method of accounting occurs when the method of accounting to be used by the taxpayer for an item (or that would be used if the taxpayer had the item in the year of change) in computing its taxable income for the year of change is different than the taxpayer's established method of accounting used (or that would have been used if the taxpayer had the item in the immediately preceding year) to compute the taxpayer's taxable income for the immediately preceding taxable year."

First, Proposed Regulation Section 1.951A-3(h)(2) reflects the fact that a sale of depreciable tangible property during the transition period can not only create a tax-free step up in asset basis for purposes of calculating tested income (as described above), but can also result in an increase in tax basis in such assets for QBAI purposes. Thus, paragraph (h)(2) excludes from QBAI all of a CFC's basis in specified tangible property created by a taxable transfer of specified tangible property between related CFCs during the transition period. This rule, however, does not apply to the extent that a selling CFC has effectively connected income on the sale, or a U.S. shareholder of the selling CFC reports gain on the sale as Subpart F income.

This rule is a per se rule, in that a good business purpose does not allow the creation of QBAI as a result of a transfer during the transition period. By contrast, the Conference Report to the Act states the intent of the conferees that the transactions to be disregarded are "non-economic transactions intended to affect tax attributes of CFCs and their U.S. shareholders....to minimize tax under this provision." Nevertheless, the Proposed Regulations are authorized by Section 951A(d)(4) if the Treasury could reasonably conclude that these restrictions are appropriate to prevent the avoidance of the purposes of the QBAI rules.[52] Accordingly, we have no objection to this rule.

Second, under Proposed Regulation Section 1.951A-3(h)(1) (the "**Temporary Ownership Rule**"), specified tangible property is disregarded for purposes of calculating QBAI if a tested income CFC acquires such property "with a principal purpose of reducing the GILTI inclusion amount" of a U.S. shareholder, and the tested income CFC holds the property "temporarily." Furthermore, any specified tangible property that is held for less than twelve months is automatically treated as being held "temporarily" and "with a principal purpose of" reducing the GILTI inclusion amount of any U.S. shareholder, if such property actually reduces any such GILTI inclusion amount (the "**One-Year Rule**"). Neither the Temporary Ownership Rule nor the One-Year Rule is limited to transfers within the transition period.

In general, we believe the Temporary Ownership Rule is consistent with Section 951A(d)(4), which grants authority for regulations that target property held temporarily for purposes of avoiding the QBAI rules. However, the Temporary Ownership Rule provides no limit on how long an ownership period can be and still be considered "temporary." Rather, the only reference point is the existence of the One-Year Rule, which suggests that a holding period of more than one year can be temporary, since otherwise the basic Temporary Ownership Rule would be superfluous. Indeed, the acquisition of an asset for any specified intended period, e.g., five or ten years, could be considered temporary.

Given that there is similar uncertainty with the "a principal purpose" standard that is a prerequisite for the Temporary Ownership Rule, we urge the Treasury to adopt a presumption that, if specified tangible property is held by a CFC for more than a

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[52] Conference Report at 645.

specified period of time, the Temporary Ownership Rule will not apply. The specified period would logically be a fixed period of time (e.g., 2 or 3 years). We considered the possibility of a period of time based on a percentage (such as 25% or 33%) of the depreciable life of the asset, but we do not think that the depreciable life of an asset is related to the question of whether use of the asset is "temporary."

We also believe the One-Year Rule should be substantially narrowed. Any holding of specified tangible property for less than twelve months will result in the entirety of its basis being lost for QBAI purposes. This rule will apply even if there is a good business purpose, and no tax avoidance purpose, for the acquisition and disposition of the property. This result does not seem correct as a policy matter, or consistent with Section 951A(d)(4), which authorizes regulations to prevent the avoidance of the purposes of the QBAI rules.

There are many ways that an asset could be held for less than one year that are not inconsistent with the purposes of the QBAI rules. Consider the following examples:

> **Example 10.** *One-Year Rule.* CFC1 has specified tangible property that it purchased on January 1, 2019. On November 30, 2019, CFC1 sells the specified tangible property after deciding that the asset (or the entire related business) is not working out. The specified tangible property does not count towards CFC1's QBAI calculation. The same result would arise even if CFC1 replaced the sold property with other specified tangible property with the same or a higher tax basis, and the aggregate holding period of both properties was more than a year.
>
> **Example 11.** *One-Year Rule applies to seller of CFC because of post-sale disposition of CFC assets.* CFC1 has specified tangible property that it purchased on January 1, 2019. On November 30, 2019, USP1, CFC1's sole shareholder, sells its stock in CFC1 to a non-U.S. person, and CFC1 ceases to be a CFC. The purchaser causes CFC1 to sell the specified tangible property on December 15, 2019. USP1 has the GILTI inclusion for 2019, but the specified tangible property does not count towards CFC1's QBAI calculation for USP1.
>
> **Example 12.** *One-Year Rule applies to buyer of CFC because of post-sale disposition of CFC assets.* Same as Example 11, except USP1 sells the stock of CFC1 to a U.S. purchaser USP2 and CFC1 remains a CFC for all of 2019. USP2 has the GILTI inclusion for 2019. The GILTI inclusion disregards the QBAI attributable to the specified tangible property, since that property was held for less than one year, even though it was acquired prior to USP2's acquisition of CFC1.
>
> **Example 13.** *One-Year Rule applies to seller of entity because of Section 338(g) election.* CFC1 has specified tangible property that it purchased on January 1, 2019. On November 30, 2019, CFC1's sole shareholder USP1

> sells the stock of CFC1 to USP2, and USP2 makes a Section 338(g) election with respect to the sale. The specified tangible property does not count towards CFC1's QBAI calculation for USP1.
>
> **Example 14.** *One-Year Rule applies to buyer of entity after Section 338(g) election.* On January 1, 2019, USP1, CFC1's sole shareholder, sells its stock in CFC1 to USP2. USP2 makes a Section 338(g) election with respect to the sale. USP2 disposes of certain unwanted assets of the business (including certain specified tangible property) on December 15, 2019. The specified tangible property does not count towards USP2's QBAI calculation. If a Section 338(g) election had not been made, the one-year holding period might have been met for many of these assets.

These examples demonstrate that the One-Year Rule can create perverse results and uneconomic incentives. In some cases, U.S. shareholders will have an incentive to cause related CFCs to hold their assets beyond the one-year period to ensure QBAI is not lost, even if the shareholder desires to sell those assets for good business reasons. Moreover, the outcome under the One-Year Rule can depend upon the actions of an unrelated buyer or seller of the stock of a CFC for which the U.S. shareholder may not have knowledge or control. The outcome can also depend upon whether a sale of stock of a CFC is accompanied by a Section 338(g) election, which bears no logical connection to whether basis in an asset should count as QBAI.

Consequently, we urge that the One-Year Rule be converted from an automatic rule into a presumption that specified tangible property held for less than 12 months is held temporarily and for a principal purpose of reducing a U.S. shareholder's GILTI inclusion amounts. The taxpayer should be entitled to rebut this presumption by showing that the acquisition and/or disposition of the specified tangible property was motivated by a good business purpose.

In addition, a strong factor in overcoming the presumption should be that an asset used in the business is not acquired in contemplation of a subsequent disposition within one year, and the ultimate disposition occurs in a transaction with an unrelated third party or as part of a disposition of an entire going concern. Another strong factor should be that an asset disposed of within a year is replaced by an asset with a similar use and having a tax basis at least as high as the basis of the original asset, and the aggregate holding period is more than a year.

In addition, regulations should provide that the rule is applied by tacking the holding periods of related CFCs, as long as any transfers between the CFCs do not result in a reduction in the GILTI inclusion amount of the U.S. shareholder. For example:

> **Example 15**. *No decrease in GILTI inclusion amount from related-party transfer of specified tangible property*. USP owns CFC1, which purchases specified tangible property on January 1, 2019. On September 30, 2019, CFC1 either (1) transfers the property to its wholly owned subsidiary

> CFC2 in a Section 351 transaction, or (2) sells the property to a related CFC2 wholly owned by USP for an amount less than or equal to its QBAI tax basis on that date. CFC2 holds the property for a period beyond January 1, 2020.

The One-Year Rule literally applies in these cases, since CFC1 has held the property for less than a year and the ownership of the property by CFC1 has reduced the GILTI inclusion of USP for 2019. However, the One-Year Rule would not have applied if CFC1 had held the property for the entire year, and we are assuming that USP has obtained no benefit from the transfer of the property among the CFCs. As a result, there is no reason for the One-Year Rule to apply to CFC1. (We note that the Temporary Ownership Rule would likely not apply to these facts because that rule requires a purpose of reducing USP's GILTI inclusion amount.)

If the One-Year Rule were applied by automatically tacking the holding period of related CFCs, that would allow groups to move QBAI among CFCs from year to year to obtain the maximum benefit of QBAI (e.g., by moving specified tangible property out of tested loss CFCs). Our proposed rule is intended to prevent such tax planning by allowing tacking of holding periods only if there is no reduction in GILTI inclusion arising from the transfers between related CFCs.

Similarly, in tacking the holding periods of related CFCs, and in determining whether there is a reduction in the GILTI inclusion amount of a U.S. shareholder, the regulations should treat a consolidated group as a single entity. As discussed in Part III.G.1, Proposed Regulation Section 1.1502-51 adopts this principle, and that principle should apply here as well.

E. Proposed Regulation Section 1.951A-4: Tested Interest Income and Expense

Proposed Regulation Section 1.951A-4 provides rules for determining tested interest expense and tested interest income of a CFC. "Interest expense" is defined broadly to include any expense or loss treated as interest under the Code, in addition to any other expense or loss incurred in one or more related transactions in which "the use of funds is secured for a period of time," if such expense or loss is "predominantly incurred in consideration for the time value of money."[53] "Interest income" has a comparably broad definition that picks up interest and interest equivalents.[54]

However, Section 951A(b)(2)(B) refers only to interest income and interest expense, not to interest equivalents. If the Treasury intends to adopt the position of the Proposed Regulations, we believe it should request an amendment to the statute to include interest equivalents, or to authorize regulations to include interest equivalents, for

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[53] Prop. Reg. § 1.951A-4(b)(1)(ii).

[54] Prop. Reg. § 1.951A-4(b)(2)(ii).

this purpose.[55] Since the regulations cover both interest income and interest expense, there is a particular risk of whipsaw to the government unless the validity of the regulations is clear.

F. Proposed Regulation Section 1.951A-5: Partnerships

1. *Alternative Approaches to CFCs Held by Partnerships*

Proposed Regulation Section 1.951A-5 provides rules for determining the GILTI inclusion amount for partners of a domestic partnership, where the partnership itself is a U.S. shareholder of a CFC (a "**U.S. shareholder partnership**" and such a CFC, a "**partnership CFC**"). Any particular partner of a U.S. shareholder partnership may itself be a U.S. shareholder with respect to any particular partnership CFC (a "**U.S. shareholder partner**") or may not itself be a U.S. shareholder with respect to any particular partnership CFC (a **non-U.S. shareholder partner**").

Before discussing the Proposed Regulations in detail, we describe four possible ways that the GILTI rules could be applied to a partnership CFC. We start with the approach that treats the partnership most as an entity, and gradually move to the approach that treats the partnership most as an aggregate of its partners.

(a) *The Pure Entity Approach*

Under a pure entity approach (the "**Pure Entity Approach**"), a U.S. shareholder partnership would calculate a single GILTI inclusion amount with respect to its entire ownership interest in all partnership CFCs, and then allocate to each partner its distributive share of that GILTI inclusion amount. The CFC tested items that make up the partner's share of the partnership GILTI inclusion amount cannot be aggregated with any items of the partner attributable to CFCs it holds outside of the partnership ("**non-partnership CFCs**"), regardless of whether the partner is itself a U.S. shareholder of the partnership CFCs or non-partnership CFCs.

(b) *The Proposed Regulations Hybrid Approach*

The Proposed Regulations do not adopt a pure aggregate or pure entity approach for all partners of a U.S. shareholder partnership. Rather, they adopt a hybrid approach (the "**Proposed Regulations Hybrid Approach**") under which aggregate principles apply to U.S. shareholder partners of a partnership CFC, and entity principles apply to non-U.S. shareholder partners of a partnership CFC.[56]

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[55] *See* NYSBA Tax Section Report No. 1393, *Report on Section 163(j)* (March 28, 2018), at 13 (discussing the authority for proposed regulations that take the same position for purposes of Section 163(j)).

[56] Prop. Reg. § 1.951A-5(c).

More specifically, if any partners of the U.S. shareholder partnership are non-U.S. shareholder partners for all the partnership CFCs, the U.S. shareholder partnership calculates a single GILTI inclusion amount with respect to all the partnership CFCs. The partnership then allocates to each such partner that partner's distributive share of the partnership's GILTI inclusion amount. As in the Pure Entity Approach, these partners cannot aggregate the CFC tested items—e.g., tested income or NDTIR—from the partnership with other CFC tested items (notably including tested loss) that they have based on their ownership of non-partnership CFCs.

By contrast, if a partner of a U.S. shareholder partnership is a U.S. shareholder partner with respect to a particular partnership CFC, the U.S. shareholder partner treats the U.S. shareholder partnership as a foreign partnership with respect to that CFC. The U.S. shareholder partner is then deemed to directly hold its indirect interest in the particular partnership CFC under Section 958(a). The U.S. shareholder partner includes its distributive share of CFC tested items of the particular CFC on its partner-level calculation of its GILTI inclusion amount. That calculation includes the U.S. shareholder's non-partnership CFCs, so that the shareholder can aggregate, say, tested losses from the partnership CFC with tested income from a non-partnership CFC.

If a partner of a U.S. shareholder partnership is a U.S. shareholder partner with respect to some, but not all, of the partnership CFCs, the U.S. shareholder partnership must recalculate its own GILTI inclusion amount for that partner. That calculation takes into account the CFC tested items only for those CFCs with respect to which the partner is a non-U.S. shareholder partner. The partner takes into account the CFC tested items from the CFCs for which it is a U.S. shareholder partner, and its share of the partnership level GILTI inclusion that only takes into account the CFCs for which it is a non-U.S. shareholder partner.

(c) *The Prior Report Hybrid Approach*

In the Prior Report, we suggested an alternative hybrid approach (the "**Prior Report Hybrid Approach**"). First, the domestic partnership is treated as an entity for purposes of determining whether its foreign corporate subsidiaries qualify as CFCs and, therefore, whether CFC tested items should be taken into account by its partners.[57] Then, aggregate principles apply to treat these CFC tested items as included in the partner-level calculation of the GILTI inclusion amount for each partner, regardless of whether a partner is itself a U.S. shareholder. This approach allows all partners to aggregate CFC tested items of partnership CFCs with CFC tested items of non-partnership CFCs.[58]

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[57] Prior Report at 91.

[58] As discussed in the Prior Report at 86-87, we would also allow a corporation that is not a U.S. shareholder of a CFC to claim FTCs and Section 250 deductions with respect to tested income of the CFC passed through from the partnership. Both are available to a domestic corporation without a requirement

(d) *The Pure Aggregate Approach*

Under a pure aggregate approach (the "**Pure Aggregate Approach**"), all partners look through the domestic partnership in determining whether they are U.S. shareholders of a partnership CFC, in the same manner that they would look through a foreign partnership. The status of a domestic partnership as a U.S. shareholder is irrelevant. If they are themselves U.S. shareholders, partners are treated as in the Proposed Regulations Hybrid Approach and the Prior Report Hybrid Approach. If they are not themselves U.S. shareholders, they do not include in their calculation of the GILTI inclusion amount any CFC tested items from the partnership CFCs.

(e) *Summary of Approaches*

The four approaches described above can be illustrated in the following example:

> **Example 16.** *Outcomes under different partnership approaches.* PRS is a U.S. shareholder partnership that wholly owns one partnership CFC, CFC1. CFC1 has tested income of $100 and no other CFC tested items. PRS has two domestic partners, X Corp (a 95% partner) and Y Corp (a 5% partner). The outcome of each of the four approaches is summarized in the following chart:

	X Corp.	Y Corp.
Pure Entity Approach	$95 GILTI inclusion amount	$5 GILTI inclusion amount
Proposed Regulations Hybrid Approach	$95 tested income	$5 GILTI inclusion amount
Prior Report Hybrid Approach	$95 tested income	$5 tested income
Pure Aggregate Approach	$95 tested income	no income inclusion

The Preamble asks for comments on whether approaches other than the Proposed Regulations Hybrid Approach, including the Pure Entity Approach and the Pure Aggregate Approach, would more appropriately harmonize the provisions of the GILTI regime, particularly in light of the compliance and administrative burdens of the various approaches.[59]

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that the corporation be a U.S. shareholder, and, in any event, the only reason the corporation has a GILTI inclusion from the partnership is because the partnership is a U.S. shareholder.

[59] Federal Register GILTI at 51080.

2. *Discussion of Alternative Approaches*

(a) *Pure Aggregate Approach*

As a policy matter, we reiterate our preference for the Pure Aggregate Approach as stated in a 2007 report.[60] We believe that approach better carries out the purposes of the GILTI and Subpart F rules, since the purposes of those rules are unrelated to the question of whether stock in a foreign corporation is owned by a U.S. or a foreign partnership. We therefore believe that no GILTI calculation should be made at the partnership level, and a domestic partnership owning stock in a foreign corporation should be looked through (just as is a foreign partnership) in determining whether a foreign corporation is a CFC and in testing for a partner's status as a U.S. shareholder of a CFC.

The current tax regime, under which the status of a foreign corporation as a CFC can be elective depending on whether the corporation is held through a domestic or foreign partnership, is difficult to justify on policy grounds. The current rules also encourage nonproductive tax planning to avoid CFC status, or to avoid CFC inclusions by U.S. persons that are not themselves U.S. shareholders of a CFC, by causing a foreign corporation to be held by a foreign rather than domestic partnership.

We acknowledge that the Pure Aggregate Approach is inconsistent with Treasury Regulation Section 1.701-2(f), Example 3, adopted almost 25 years ago, which treats a U.S. partnership as a U.S. shareholder of a CFC regardless of the nature of its partners. It may also be inconsistent with Section 7701(a)(30), which states that a U.S. person includes a domestic partnership. In fact, taxpayers often rely on the example in the Section 701 regulations to treat a CFC owned by a U.S. shareholder partnership as a CFC rather than a PFIC, and the IRS has issued private letter rulings confirming this position.[61]

Moreover, the drafters of Section 951A presumably were aware of this background when they determined that inclusions under Section 951A are to be treated in the same manner as Subpart F inclusions. There is no indication that Congress intended either to adopt a rule for partnership shareholders of CFCs under GILTI that was different than the rule under Subpart F, or to change the rules applicable to both GILTI and Subpart F. Indeed, it would be even more inconsistent with the structure of Sections 951 and 951A, or with the statutory definition of CFC and U.S. shareholder and their use throughout the Code, if a particular foreign corporation could be a CFC for Subpart F purposes and not for GILTI purposes. Perhaps for these reasons, the Preamble rejects the

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[60] NYSBA Tax Section Report No. 1124, *Report on Differences between Domestic and Foreign Partnerships* (January 3, 2007), at 11 (the **"2007 Report"**).

[61] *See, e.g,* PLR 201106003 (Feb. 11, 2011); PLR 200943004 (Oct. 23, 2009).

Pure Aggregate Approach on the basis that such a result is "not clearly contemplated in [S]ection 951A or its legislative history and is inconsistent with [S]ection 951."[62]

However, Section 951A places significantly more weight than before on the characterization of domestic partnerships as U.S. shareholders of CFCs. In particular, (1) gross tested income is significantly more expansive than Subpart F income, (2) calculating the GILTI inclusion amount is significantly more complicated than calculating a Subpart F inclusion, and (3) in the context of GILTI, a significant portion of the calculations are done at the U.S. shareholder level.

Likewise, from the point of view of a non-U.S. shareholder partner of a U.S. shareholder partnership, the amount at stake in applying entity rather than aggregate principles is far higher than before, since all tested income rather than only Subpart F income is now taxable to a U.S. shareholder. The stakes are particularly high for an individual and possibly corporate non-U.S. shareholder partner that would not be entitled to a Section 250 deduction under an entity or hybrid approach to partnerships. We therefore believe that this is an appropriate time for the issue to be reconsidered.

The authority for a reconsideration of this issue by regulations would include the fact that general entity/aggregate principles have applied to partnerships at least since the enactment of the Internal Revenue Code of 1954 and are reflected in the legislative history thereof.[63] These principles are now codified in Treasury Regulation Section 1.701-2, which states that entity or aggregate principles should apply based on the purpose of the applicable rule.

For example, in 2007, the Treasury adopted Treasury Regulation Section 1.871-14(g)(3) under the portfolio interest rules. This regulation applies aggregate principles to look through a domestic or foreign partnership to determine if a non-U.S. partner is a 10% shareholder of a U.S. corporation owned by the partnership. A 10% shareholder of the U.S. corporation is ineligible for the portfolio interest exception to withholding tax on interest paid by the corporation.

Although that regulation did not change a long-established rule to the contrary, the greatly increased significance of the entity/aggregate issue in light of the enactment of GILTI seems to provide a "new" occasion to reconsider the issue. Finally, when Congress indicated that it was treating GILTI inclusions in the same way as Subpart F

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[62] Federal Register GILTI at 51079. In the 2007 Report, we also stated that we believed that adoption of the Pure Aggregate Approach would require a legislative change. 2007 Report at 10.

[63] "Both the House provisions and the Senate amendment provide for the use of the 'entity' approach in the treatment of the transactions between a partner and a partnership which are described above. No inference is intended, however, that a partnership is to be considered as a separate entity for the purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions." H.R. Conf. Rep. No. 2543, 83rd Cong., 2d Sess. 59 (1954).

income, there is no indication that it was focusing on the existing noneconomic rule for domestic partnerships.

Moreover, even aside from general entity/aggregate principles, Section 7701(a)(4) states that the term "domestic", when applied to a partnership, means a partnership created or organized under the laws of the United States or a state thereof, "*unless . . . the Secretary provides otherwise by regulations*" (emphasis added). This exception has not been interpreted by the Treasury to be limited to recharacterization of domestic partnerships for all purposes of the Code. Rather, it was recently relied upon by the Treasury in adopting temporary regulations to require an otherwise domestic partnership to be treated as a foreign partnership for purposes of a particular Code provision.[64]

Likewise, Notice 2010-41, Section 4.01, relies on Section 7701(a)(4) to state that regulations will be issued to treat certain domestic partnerships owned by foreign corporations as foreign partnerships solely for purposes of certain Subpart F inclusion provisions of the Code. In fact, the Proposed Regulations themselves implement this rule for purposes of Subpart F, and expand it to GILTI.[65] The Preamble states that this rule is based on Notice 2010-41,[66] which as noted above is itself based on Section 7701(a)(4).[67]

Therefore, the Treasury already believes that at least in some circumstances, including circumstances involving Subpart F and GILTI, it is appropriate to issue regulations under Section 7701(a)(4) treating a domestic partnership as foreign. While the application of Section 7701(a)(4) has been limited so far to much narrower fact patterns, arguably the same authority could be used to treat a domestic partnership as foreign for purposes of determining the existence of a CFC and of a U.S. shareholder of a CFC for purposes of the Subpart F and GILTI provisions of the Code.

Nevertheless, if the Treasury desires to implement the Pure Aggregate Approach but believe that it does not have the authority to do so by regulations, we urge it to request a statutory amendment to adopt this approach or to authorize regulations that would do so.

However, as noted above, taxpayers now often rely on the existing rule for domestic partnerships in order to treat a foreign corporation owned by a domestic partnership as a CFC rather than a PFIC. It would be unfair to such taxpayers to change

[64] Treas. Reg. § 1.721(c)-6T(b)(4) treats a domestic partnership as foreign solely for purposes of certain partnership reporting provisions. T.D. 9814, Jan. 23, 2017; Section X(a) of its preamble explains that this provision is based on Section 7701(a)(4).

[65] Prop. Reg. § 1.951-1(h).

[66] Federal Register GILTI at 51082.

[67] Separate proposed regulations would adopt the same rule for purposes of Section 965. *See* Prop. Reg. § 1.965-1(e).

suddenly the rule for existing foreign corporations treated as CFCs, so that the CFCs would become PFICs. As a result, if future legislation or regulations adopt the Pure Aggregate Approach, we believe that generous grandfather provisions should apply to allow existing foreign corporations that are held by domestic partnerships and treated as CFCs under the existing rules to continue to be so treated, either permanently or at least for an extended period of time such as 10 years. Domestic partnerships holding grandfathered CFCs (not discussed further herein) would need to be subject to one of the approaches other than the Pure Aggregate Approach during the grandfather period. In any event, a regulation issued in reliance on Section 7701(a)(4) could only apply to partnerships organized after the regulation was proposed.[68]

(b) *Proposed Regulations Hybrid Approach*

If the Pure Aggregate Approach is not adopted, then non-U.S. shareholder partners of a Partnership CFC will be taxed, in one way or another, on their share of GILTI income from the CFC. In any particular U.S. shareholder partnership, there might be a large number of these partners, each owning a small percentage of the U.S. shareholder partnership. The Prior Report Hybrid Approach (discussed below) will require these partners to make their own GILTI calculations, even if they own no interests in any CFC except through the partnership. The major advantage of the Proposed Regulations Hybrid Approach, as compared to the Prior Report Hybrid Approach, is that these calculations are all done by the U.S. shareholder partnership, and a simple GILTI inclusion number is passed through to the non-U.S. shareholder partners.

We do not minimize the administrative benefit provided by this aspect of the Proposed Regulations. However, we see a number of problems with the Proposed Regulations Hybrid Approach.

(i) *Lack of Ability to Offset at the Partner Level*

A partner that is a non-U.S. shareholder partner of one or more partnership CFCs must include in income its share of the partnership GILTI inclusion amount for those CFCs, even if the partner has unused tested losses or excess NDTIR from non-partnership CFCs. The non-U.S. shareholder partner of one or more partnership CFCs will also lose the opportunity to use tested losses or NDTIR from those CFCs against tested income from non-partnership CFCs. This inability to offset will also exist for partnership CFCs held through different domestic partnerships. These results are unfair and uneconomic to the non-U.S. shareholder partners. They will also be greatly exacerbated if tested losses cannot be carried over, at either the shareholder or CFC level.

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[68] Section 7701(a)(4) was amended by P.L. 105-34 to allow regulations to change the status of domestic partnerships, but Section 1151(b) of that Public Law states that regulations under that provision can only apply to partnerships organized after the date determined under Section 7805(b) without regard to (b)(2).

(ii) *Procedural Complexity*

The Proposed Regulations Hybrid Approach requires a U.S. shareholder partnership to determine whether each of its partners is a U.S. shareholder partner or a non-U.S. shareholder partner for each partnership CFC. In many cases, this will require the U.S. shareholder partnership to determine whether and to what extent each of its partners has separately held interests in each partnership CFC—directly and through attribution—and how these amounts change over time. The partnership needs to know the information in order to calculate the partnership level GILTI inclusion amount for each of its partners. Many partners will not be willing to give this information to their partnerships and should not be required to do so.

One way of addressing this problem would be to permit a partner that is U.S. shareholder partner of a partnership CFC, but whose interest in such CFC held through the partnership would not itself make it a U.S. shareholder partner of the CFC, to disregard its separately held ownership in the partnership CFC. This would allow such U.S. shareholder partner to accept its share of the partnership's GILTI inclusion amount (instead of its share of the partnership's CFC tested items). However, this could lead to tax planning opportunities, since segregation of partnership-level CFC tested items can be more favorable to the partner than an aggregate approach.

This problem could also be avoided if the U.S. shareholder partnership did not make its own calculation of a GILTI inclusion amount, but rather was required to pass through, to all its partners, the component parts of its partnership-level GILTI inclusion amount calculation. Each partner would be required to make its own *partnership-level* calculation of the GILTI inclusion amount, excluding those partnership CFCs for which it is itself a U.S. shareholder, and incorporate the remaining partnership CFCs into its *partner-level* calculation of the GILTI inclusion amount. This would reach the same dollar result as the Proposed Regulations, but the calculations would always be done at the partner level. However, if this were the end result, we see no reason to adopt this general approach instead of the Prior Report Hybrid Approach, discussed in Part III.F.2(c).

(iii) *Computational Complexity*

The Proposed Regulations Hybrid Approach can also create enormous computational complexity. Any U.S. shareholder partnership could have numerous partnership CFCs, and its partners could themselves be U.S. shareholders for any combination of those CFCs. As a result, a separate, personalized partnership-level calculation of GILTI inclusion for each partner would be required, taking into account only the partnership CFCs for which the partner is a non-U.S. shareholder. The number of required calculations could be very high, and these calculations could produce results for particular partners that are higher or lower than the baseline partnership-level GILTI inclusion amount.

Consider a simple example:

> **Example 17.** *Possible calculations of partnership GILTI inclusion amount.* PRS is a U.S. shareholder partnership that owns 50% of each of two partnership CFCs, CFC1 and CFC2. The partnership's share of CFC1's tested income is $50, and the partnership's share of CFC2's tested income is $100; there are no other CFC tested items. The partnership has a partnership level GILTI inclusion of $150. However, any particular partner might be required to report its pro rata share of a partnership GILTI inclusion of $0 (if it is a U.S. shareholder partner of both CFCs), $50 (if it is a U.S. shareholder partner of CFC2 only), $100 (if it is a U.S. shareholder partner of CFC1 only), or $150 (if it is not a U.S. shareholder partner of either CFC). Note also that if CFC1 instead had a tested loss of $100, the partnership level GILTI inclusion from CFC1 alone would be $0, but the partnership level tested income and tested loss calculation for individual partners for CFC1 alone could range from $100 of tested loss to $100 of tested income.

Indeed, if there are *n* partnership CFCs, there are (2^n – 1) possible partnership-level calculations of GILTI inclusion amounts for individual partners. This number reflects every potential combination of partnership CFCs for which one or more partners is a U.S. shareholder and the other partners are not.[69] The possible number of computations increases quickly with the number of partnerships CFCs—there are 31 potential calculations with five partnership CFCs, and 1,023 calculations with 10 CFCs. While the need for such a large number of calculations would likely rarely arise in practice, and the total number of calculations would never exceed the number of partners, the mere possibility of this need raises serious questions about the administrability of the general approach.

The Proposed Regulations also do not discuss the consequences for a partner of a U.S. shareholder partnership whose status shifts from being a U.S. shareholder partner of a CFC to being a non-U.S. shareholder partner of a CFC, or vice versa. This could arise either from a purchase or sale by the partner itself of equity in the partnership or of stock in a partnership CFC, or by the purchase or sale by the partnership of stock in a partnership CFC. This change in status would mean shifting from entity to aggregate treatment, or vice versa. It seems that a fairly complex set of rules would be needed, since CFC attributes that had been "locked up" within the partnership (e.g., net used tested loss amounts in a CFC) would now become partner attributes, or vice versa. The methodology for calculating basis in the partnership, and in the CFC, would also change.

(iv) *Allocation Issues*

In order to apply the Proposed Regulations Hybrid Approach, the U.S. shareholder partnership must first determine which of its partners are U.S. shareholder

[69] These numbers do not include the computation for the case where no partner of the partnership is a U.S. shareholder of any partnership CFC.

partners of each partnership CFC. As discussed in the 2007 Report,[70] it is unclear how this determination should be made in the absence of pro rata ownership of capital and profits over the life of the partnership. At a minimum, the U.S. shareholder partnership's determination of a partner's indirect ownership of a CFC should be binding on its partners to ensure that the government is not whipsawed. In addition, it would be helpful if regulations addressed whether this determination should be made based on each year's rights to capital or earnings, or based on projected future rights as determined either initially or as adjusted over time.[71]

In addition, if a partner is a non-U.S. shareholder partner of one or more partnership CFCs, it must report its share of the partnership level GILTI inclusion calculated on its behalf. In the absence of pro rata ownership of partnership capital and profits, potentially this inclusion item could be allocated in the same manner that an increase in the Section 704(b) book value of the stock of the CFC (equal to the amount of the partnership-level GILTI inclusion) would be allocated upon a revaluation of partnership assets.

However, this could be quite complex, because the partnership-level GILTI inclusion for different partners can be different because the inclusion for each partner only takes account of the partnership CFCs for which the particular partner is not a U.S. shareholder. It is also unclear how overall partnership priority allocations can be taken into account in allocating the partnership level GILTI inclusion when there may be a different total partnership level GILTI inclusion to be allocated to different partners, and when U.S. shareholder partners of particular CFCs are reporting partnership income from those CFCs on a basis that is completely different than non-U.S. shareholder partners.

(v) *Interaction with Partnership Audit Rules*

Layered on top of these enormously complicated rules are the partnership audit rules enacted as part of the Bipartisan Budget Act of 2015.[72] Many of these computations—including the individualized calculations of the partnership's GILTI inclusion amount and basis adjustments—would be partnership items subject to audit at the partnership level. It would be enormously difficult for the IRS audit division to deal

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[70] 2007 Report at 8.

[71] There are also significant questions about how to measure a partner's rights to partnership capital and profits for purposes of these rules. For instance, in determining a partner's right to partnership capital, should the partnership use Section 704(b) capital, or capital upon a hypothetical liquidation at fair market value? Similarly, would a partner's right to partnership profits be based on allocations of Section 704(b) income or taxable income, and how would chargebacks of losses be taken into account? We note that, because similar issues present themselves any time stock is held through a partnership, any resolution for purposes of the GILTI rules could have broader implications throughout the Code.

[72] *See* Sections 6221-6241.

with these items, especially with respect to those determinations that are partly made at the partnership level and partly at the partner level.

For example, if a partner is a U.S. shareholder of a partnership CFC, and the items of the CFC passing through from the partnership to the partner are considered subject to partnership level audit, then some of the numbers going into the U.S. shareholder's calculation of a single GILTI inclusion amount will be subject to audit of the partnership under the partnership audit rules. Yet the items passing to the shareholder from CFCs held directly by the shareholder (or through other partnerships) will be subject to an entirely separate audit. Regulations should maximize the scope of items that will be subject to partnership-level audit, to prevent the need for multiple audits of individual partners to the extent possible.

(vi) *Incentive for Foreign Partnerships*

The Proposed Regulations Hybrid Approach can be avoided if a partnership that will hold CFCs is formed as a foreign partnership, or if an existing domestic partnership is redomiciled as a foreign partnership. The complexity of the Proposed Regulations Hybrid Approach may increase the incentives to use foreign rather than domestic partnerships. This will have the additional consequence of eliminating current GILTI inclusions for non-U.S. shareholders of partnership CFCs, since the foreign partnership will not itself be a U.S. shareholder of a CFC.

(vii) *Tax Basis*

The treatment of tax basis under the Proposed Regulations Hybrid Approach will be enormously complex. We believe the complexity will be greater than under the Prior Report Hybrid Approach because of the mixture of calculations required by the Proposed Regulations Hybrid Approach at both the partnership and partner levels. These calculations affect both the basis of each partner in its partnership interest and the partnership's basis in each CFC with respect to each partner.

If a partner is a non-U.S. shareholder partner of one or more partnership CFCs, the partner should clearly increase its outside tax basis in the U.S. shareholder partnership by the amount of any partnership level GILTI inclusion amount allocated to it. Similarly, since entity principles apply, under Section 961(a), the partnership's inside basis in the partnership CFCs should be increased to the extent of any GILTI inclusion amount determined at the partnership level and allocated to such partners under Proposed Regulation Section 1.951A-6(b)(2). Moreover, as discussed in Part IV.B.3(i), the partnership should disregard the CFC basis adjustment rule under Proposed Regulation Section 1.951A-6(e) in determining its gain or loss allocable to such partners on a sale of a CFC, because these partners will not be entitled to a Section 245A deduction on distributions from the CFC.

The treatment of U.S. shareholder partners is even more complex. Suppose the U.S. shareholder partnership allocates tested income to a U.S. shareholder partner and the partner does not have tested loss or NDTIR to offset that amount. The resulting GILTI inclusion amount should be treated comparably to a Subpart F inclusion of the partnership that is allocated to the U.S. shareholder partner, and therefore increase the partner's outside basis in its partnership interest. This should be the case even though the allocation is not an allocation of partnership income.

Suppose, instead, that the U.S. shareholder partner has tested income from the partnership that is fully offset by tested losses or NDTIR allocated to it from a non-partnership CFC. Arguably, the U.S. shareholder partner should get outside-basis credit for the tested income, provided that such partner could claim a deduction under Section 245A if the CFC paid a dividend to the partnership and Section 1059 would not apply to the dividend. Such a rule is similar to "Rule 3" discussed in Part IV.D.1 in the consolidated return context, and would preserve the benefit to the partner of the exempt income from the CFC if the partner sells the partnership interest. This rule would also avoid the need for "self-help" (through payment of a dividend from a CFC to the partnership) to achieve the same basis increase in the partnership interest by having the CFC make a tax-free distribution to the partnership.

On the other hand, such outside-basis credit in the partnership interest seems peculiar when no taxable income is passed through from the partnership. In that connection, it is not clear why a loss should be allowed to the extent it arises from the increase in tax basis. Such a result would be inconsistent with Section 1248, which recharacterizes gain to the extent of untaxed e&p but, if the gain is less than the amount of untaxed e&p, does not allow the creation of untaxed gain and a deductible loss.

Instead of such a basis increase, another approach would be to have the partner's sale of the partnership interest give rise to Section 1248 gain, and for the Section 751 amount relating to Section 1248 to be eligible for dividend treatment under Section 245A. This approach seems more appropriate than a basis increase for untaxed income. It puts the partner in a position similar to the position of holding the stock in the CFC directly, and either selling the stock or contributing it to the partnership after taking into account the CFC tested items of the CFC.

The authorities do not support the treatment of the Section 751 amount in this situation as a dividend.[73] However, those authorities arose before the enactment of Section 1248(j), which clearly contemplates that gain on sale of the stock of a CFC that is attributable to untaxed earnings of the CFC should be eligible for Section 245A. We urge

[73] Gain on the sale of stock of a foreign corporation that is subject to Section 1248 is treated as an unrealized receivable under Section 751(c), so that gain realized on the sale of a domestic partnership interest, to extent attributable to such stock (a "Section 751(c) amount"), has been treated by the Treasury as ordinary income but not as a dividend. *See* T.D. 9345, Federal Register Vol. 72, No. 145, July 30, 2007, 41442-41450 at 41443; T.D. 9644, Federal Register Vol. 78, No. 231, Dec. 2, 2013, 72394-72449 at 72419-20. The correctness of this view under current law is beyond the scope of this Report.

that regulations treat the Section 751 amount arising under Section 1248 as a dividend eligible for Section 245A.[74]

Suppose next that the U.S. shareholder partner has a net used tested loss amount (defined below) in a partnership CFC at the time the partner sells its partnership interest. As discussed in Part IV.B.3(i), under Proposed Regulation Section 1.951A-6(e), a U.S. shareholder directly owning stock of a CFC in this circumstance would reduce its basis in the CFC immediately before the sale of the stock by such amount. Logically the partner should reduce its basis in the partnership interest by this amount immediately before selling the interest, or else a U.S. shareholder of a CFC could routinely avoid the tax cost of that regulation by holding a CFC through a partnership.

Such a basis reduction in the partnership interest is analogous to Rule 1 (discussed in Part IV.D.1) in the consolidated return context, which requires an immediate basis reduction in the stock of a member of a consolidated group to reflect the net used tested loss amount of a CFC held by the member. The basis reduction is also analogous to Proposed Regulation Section 1.951A-6(e)(1)(iii), which requires a reduction in the basis of the equity in a foreign entity (other than a CFC), when the foreign entity holds stock in a CFC with a net used tested loss amount and the U.S. shareholder of the CFC sells the equity in the foreign entity.

A technical way to reach this result would be to require the partnership to reduce its basis in the CFC, with respect to a selling partner, by the partner's net used tested loss amount in the CFC, and then to treat the basis reduction as a noncapital, nondeductible expense of the partnership under Section 705(a)(2)(B) allocable to the selling partner. This would reduce the selling partner's basis in the partnership interest accordingly.

Turn now to the calculation of the U.S. shareholder partnership's basis in partnership CFCs. Pure entity principles cannot apply, since they would create enormous disparities depending on whether a U.S. shareholder partner held its interest directly or through a partnership.

> **Example 18.** *Partnership's inside basis in tested income CFC.* PRS is a U.S. shareholder partnership that wholly owns one partnership CFC, CFC1. PRS has one 50% corporate partner, USP1, and ten 5% partners. USP1 separately owns 100% of CFC2. In Year 1, CFC1 has tested

[74] Other issues will also arise if the partner that is a U.S. shareholder of the CFC receives untaxed tested income through the partnership. For example, rules would be needed for the treatment of capital accounts and Section 704(b) book value of the stock in the CFC. This would be particularly complicated if some partners were U.S. shareholders of a particular CFC and other partners were not, and because the same income of a partnership CFC might be taxable tested income to some U.S. shareholder partners and offset tested income to other U.S. shareholder partners. These rules would be far more complicated than today's rules for CFCs owned through a domestic or foreign partnership, because the Subpart F rules do not involve the aggregation of CFCs at either the partnership or partner levels.

> income of $100x and CFC2 has tested loss of $50; neither has any other CFC tested items.

Under the Proposed Regulations, PRS's own GILTI inclusion amount is $100, of which $50 is allocated to the non-U.S. shareholder partners. Separately, USP1 is allocated $50 of tested income, which is fully offset by the tested loss of separately-owned CFC2. If pure entity principles applied, PRS's basis in CFC1 would increase by $100. However, if USP1 directly held its indirect interest in CFC1, there would be no basis increase, so the aggregate basis increase in CFC1 would be $50.

The disparity in basis results is even greater if the partnership CFC has a tested loss.

> **Example 19.** *Partnership's inside basis in tested loss CFC stock.* Assume the same facts as Example 18, but that, in Year 1, CFC1 has tested loss of $100 and CFC2 has tested income of $50. After Year 1, PRS sells CFC1 to a third party.

Under pure entity principles, the sale of CFC1 would not trigger any downward basis adjustment under Proposed Regulation Section 1.951A-6(e), since CFC1's tested loss did not offset the tested income of any partnership CFCs. However, from the perspective of USP1, USP1's $50 share of the tested loss of CFC1 was used to offset $50 of tested income from CFC2, and so its allocable share of basis in CFC1 should be reduced by $50. It is therefore necessary to separately compute the basis of USP1 in CFC1 to give effect to the aggregate treatment accorded to USP1 under Proposed Regulation Section 1.951A-5(c).

As a result, it seems necessary for a U.S. shareholder partnership to be treated as having a separate basis in each partnership CFC with respect to each partner, as follows:

1. For CFCs for which a particular partner is a non-U.S. shareholder partner, the partnership's basis in each such CFC with respect to such partner is determined based on the personalized partnership-level GILTI inclusion amount calculated for that partner.

2. For each CFC for which a particular partner is a U.S. shareholder partner, the partnership's basis for such partner in each such CFC is determined as if such partner owned the CFC directly.

3. To the extent a particular U.S. shareholder partner is treated as having a net used tested loss amount in a partnership CFC, the partnership must be treated as having reduced its basis in the CFC with respect to such partner by such amount immediately before a disposition of the CFC. The U.S. shareholder partner would have to tell the partnership whether it had used a tested loss of the partnership CFC against its own tested income.

Under these rules, even if none of the partners is a U.S. shareholder with respect to a particular CFC, the partnership could have different bases in the CFC stock with respect to different partners, because of the potential status of those partners as U.S. shareholders of other partnership CFCs. The reason is that the individualized partnership-level GILTI calculations to different partners might make different use of the tested income and tested loss of the particular CFC. Moreover, a U.S. shareholder partnership will frequently not know its basis in some or all of its partnership CFCs with respect to some or all of its partners. The separate basis for each partner will depend on (i) whether the partner is a U.S. shareholder partner of the particular CFC, (ii) if so, whether it is able to utilize the tested losses of the partnership CFC in the calculation of its own GILTI inclusion amounts, and (iii) if not, whether or not it is a U.S. shareholder in other partnership CFCs.

Separate bases will create considerable complexity. If a purchaser buys a partnership interest without a Section 754 election being in effect, does the purchaser succeed to the basis that the selling partner had in each of the partnership CFCs? If a partnership distributes stock in a partnership CFC to a partner in a nonliquidating distribution, what does it mean for Section 732 to give the partner a carryover tax basis in the distributed property?

These rules will also increase the complexity of applying Sections 734 and 743 to partnership CFCs. For example, if Section 754 applies to a partner's purchase of its partnership interest, normally the partner would be treated as having a basis in the stock of each partnership CFC equal to the portion of the purchase price allocated to that stock. Logically this rule should apply even to a partnership CFC for which the particular partner is a non-U.S. shareholder, even though the partnership computes a GILTI inclusion for that partner with respect to that CFC at the partnership level.

However, as discussed in the preceding paragraph, the partnership may have a different tax basis in each CFC with respect to each partner, and this basis will need to be taken into account in determining the amount of the Section 754 step up for the particular CFC for the particular partner. This determination will be particularly complicated where a U.S. shareholder partner sells some or all of its partnership interest to a non-U.S. shareholder partner and, as a result, transforms the (now former) non-U.S. shareholder partner into a U.S. shareholder of a partnership CFC. Finally, it is also not clear how Section 734 can be applied to a distribution of a CFC to a partner, when the partnership may have a different basis in that CFC with respect to each partner.

Implementing these rules would be extremely complicated, although some of these issues might come up today with CFCs held through a foreign partnership. The partnership would calculate the basis of each partnership CFC for each non-U.S. shareholder partner of the CFC. This calculation would require a separate running determination of the various partnership GILTI inclusion amounts for each such partner. (Fortunately, there would be no need for the partnership to track used tested losses and offset tested income of a CFC for these calculations, assuming as we discuss elsewhere that those concepts are not applicable to partners of a partnership that are not themselves

U.S. shareholders of the CFC.) The calculation of basis of a partnership CFC for U.S. shareholder partners of the CFC would have to be done by the partners rather than the partnership, because the basis depends upon tested income, tested loss and NDTIR of other CFCs owned by the partner.

(c) *Prior Report Hybrid Approach*

The Preamble rejects the Prior Report Hybrid Approach because it might "be interpreted by taxpayers to exempt small partners of a domestic partnership from the GILTI regime entirely."[75] We do not understand this reasoning. Regulations adopting such an approach could explicitly state that partners of a U.S. shareholder partnership are required to report their share of CFC tested items regardless of their percentage ownership of the partnership.

Rather, we view the trade-offs between the Prior Report Hybrid Approach and the Proposed Regulations Hybrid Approach to be the following. The Prior Report Hybrid Approach has the major benefit of allowing non-U.S. shareholder partners of a U.S. shareholder partnership to aggregate the CFC tested items arising from partnership CFCs with other CFC tested items arising from non-partnership CFCs. This approach does not materially increase the complexity to them of GILTI tax reporting, since they are already making a GILTI calculation based on the CFC tested items of their non-partnership CFCs. Adding additional CFCs to the calculation does not materially increase the complexity of the calculation.

However, this benefit under the Prior Report Hybrid Approach to non-U.S. shareholder partners that own non-partnership CFCs is offset by the increased complexity of tax filing obligations under that approach to non-U.S. shareholder partners that do not own any non-partnership CFCs. Those partners are not obtaining any economic benefit under the Prior Report Hybrid Approach, yet under that approach they must calculate their own GILTI inclusions based on the CFC tested items of the partnership CFCs, rather than receiving a simple pass-through allocation of a partnership GILTI inclusion.

On an overall basis, we view the Proposed Regulations Hybrid Approach as being more complex than the Prior Report Hybrid Approach. This is largely, as discussed above, because of the complexity of the GILTI calculations and basis calculations that might be required under that approach. While we do not believe that the Prior Report Hybrid Approach could be characterized as simple, we believe that on an overall basis, it is significantly less complex than the Proposed Regulations Hybrid Approach.

We also believe that the Prior Report Hybrid Approach could be made less burdensome to small partners of U.S. shareholder partnerships. For example, regulations might permit partners to irrevocably elect into the Pure Entity Approach, subject to an anti-abuse rule, if they own less than a de minimis share of the partnership (e.g., 2%).

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[75] Federal Register GILTI at 51079.

This would permit small partners avoid individualized calculations of the GILTI inclusion amount and outside basis. Given a small de minimis threshold and an anti-abuse rule, the potential for abuse (and the potential revenue loss to the fisc even in nonabusive situations) seems limited, even if the election were allowed on a partnership-by-partnership basis.

(d) *Pure Entity Approach*

The Pure Entity Approach is by far the simplest. However, it is clearly rejected in the Preamble,[76] and, we believe, for good reasons. The Preamble recognizes that fragmenting the ownership of U.S. shareholder partners in partnership CFCs can significantly change results under Section 951A, which presents an "inappropriate planning opportunity as well as trap for the unwary."[77] We agree that the Pure Entity Approach is unfair to U.S. shareholder partners because it does not allow aggregation with CFC tested items from outside the partnership. We rejected this approach in the Prior Report and we continue to agree that it should not be adopted.

We acknowledge that this approach would be similar to the existing treatment of Subpart F income under Section 951. However, Subpart F does not involve the blending of CFC-level items such as tested income and loss, NDTIR, and specified interest income and expense at the shareholder level, so that approach under Subpart F does not create the discontinuities that it would create for GILTI.

(e) *Conclusions*

As a policy matter, we support the Pure Aggregate Approach. If this approach is not adopted, we do not take a position between the Proposed Regulations Hybrid Approach and the Prior Report Hybrid Approach. While the reporting obligations under the former approach will be simpler for many partners in U.S. shareholder partnerships, that approach will also be less fair to many such partners that own interests in CFCs through more than one partnership, or both through partnerships and directly. The Proposed Regulations Hybrid Approach also introduces complexities at the partnership level that are not present in the Prior Report Hybrid Approach. We do not support the Pure Entity Approach.

Finally, whichever approach is adopted, it is essential that the same rules apply for both Subpart F and GILTI. Moreover, under any approach, final regulations should clarify that the partnership rules are unchanged except for the purposes of calculating Subpart F income and GILTI inclusions. For example, all items that are ordinarily determined at the partnership level, such as deductions of the partnership, should be determined on an entity basis, just as today.

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[76] Federal Register GILTI at 51079.

[77] *Id.*

G. Proposed Regulation Section 1.1502-51: Consolidated Section 951A

This section of the Report discusses aspects of the -51 regulation that do not relate to tax basis. Tax basis issues are discussed in Part IV.

1. *Background*

The Proposed Regulations determine how GILTI inclusions are calculated by members of a consolidated group. In general, the aggregate of the GILTI inclusions by group members will be the same as if the group was a single corporation. We strongly commend the Treasury for adopting this approach. The Prior Report discussed the potential disadvantages to taxpayers, and the possibility for taxpayers to engage in nonproductive tax planning, in the absence of such single entity treatment for a consolidated group.[78] We urge that no changes be made in the final regulations that will weaken this single entity treatment.

The following terminology will be used in this section and the remainder of the Report:

(a) P is the parent of a consolidated group.

(b) M is a member of the group. If more than one member is involved, they will be referred to as M1, M2, etc. For simplicity, unless otherwise indicated, any M is a first tier wholly owned subsidiary of P.

Each member of the group is allocated the tested income arising from the stock it owns in CFCs with positive tested income (a tested income CFC). All tested losses from CFCs with tested losses (a tested loss CFC), NDTIR from tested income CFCs, and specified interest are aggregated, and then reattributed back to the members with tested income in proportion to that tested income. Each member then calculates its own GILTI inclusion.[79]

> **Example 20**. *Allocation of tested loss in a group.* M1 owns CFC1 with $100 of tested income and CFC2 with $100 of tested loss. M2 owns CFC3 with $100 of tested income. M1 and M2 each retains its gross tested income of $100. However, the tested loss of CFC2 is allocated 50% to M1 and 50% to M2, even though M1 owns 100% of CFC2. As a result, M1 and M2 each has a GILTI inclusion of $50. The same would be true if CFC2 was instead a subsidiary of CFC1, or CFC1 was instead a subsidiary of CFC2, or if CFC2 was instead owned by M2.

[78] Prior Report at 17-27.

[79] Prop. Reg. § 1.1502-51(b).

As discussed in Part IV, the CFC basis reduction rule applies to reduce the tax basis of the stock of the CFC in the hands of a member, upon the member's disposition of the stock, by the member's net used tested loss amount in the stock.[80] However, for a CFC owned by any group member, used tested losses and offset tested income are calculated and apportioned on a group-wide basis taking account of the reallocation of tested losses.[81] In Example 20, CFC1 and CFC3 each has offset tested income of $50, and CFC2 has a used tested loss of $100.

2. *Comments*

(a) *Foreign Tax Credits and Section 250*

It is critical that the single entity treatment arising under the Proposed Regulations also apply to foreign tax credits and the Section 250 deduction. It is important, therefore, that future regulations allow a group to have an FTC based on the overall tested income of tested income CFCs of the group, the overall tested loss of tested loss CFCs, the overall foreign taxes paid by tested income CFCs, and an overall inclusion percentage for the group under Section 960(d)(2).

In addition, the Section 250 deduction is limited to 50% of the taxable income of the U.S. corporation with the GILTI inclusion. Regulations under Section 250 should allow the Section 250 deduction on the basis of the taxable income and GILTI inclusion of the group as a whole. Logically that deduction would be allocated to members in the same manner as tested losses, etc. are allocated, so that even a member with no separate taxable income can be allocated a Section 250 deduction.

For example, suppose M1 has a CFC with tested income of $100, M1 has an unrelated loss of $100, the group as a whole has taxable income of $100 before any Section 250 deduction (i.e., other members of the group have $100 of unrelated income), and there are no other CFCs. M1 has a GILTI inclusion of $100. The Section 250 deduction should be $50 based on the $100 of taxable income of the group as a whole, even though M1 has no taxable income of its own. Likewise, the deduction of $50 should be allocated to M1, leaving M1 with a separate company loss of $50. This does not violate the rule in Section 172(d)(9) that a Section 250 deduction cannot create a net operating loss, since no net operating loss is being created for the group as a whole or is being carried to a different year.

(b) *Allocation of Tested Losses*

We have considered whether, as a policy matter, tested losses of a CFC owned by a member M should instead be allocated first to M to the extent M has tested income from other CFCs, with any excess tested loss of M's CFCs allocated proportionately to

[80] Prop. Reg. § 1.1502-51(c)(1).

[81] Prop. Reg. §§ 1.1502-51(c)(2), (c)(3).

other members with tested income (the "**priority allocation rule**"). In Example 20, the question is whether the tested loss of CFC2 should instead be allocated entirely to M1, so that M1 has no GILTI inclusion and M2 has a $100 GILTI inclusion.

The priority allocation rule allocates to each member an amount of GILTI inclusion that better reflects the economic results to the members. On the other hand, the rule in the Proposed Regulations (the "**pro rata allocation rule**") prevents the location in the group of a tested loss CFC from affecting the amount of GILTI inclusion to any member, or the amount of used tested loss and offset tested income for any CFC.[82] The pro rata allocation rule therefore reduces the benefit of, and need for, uneconomic tax planning and is more consistent with single entity treatment of a consolidated group.

The priority allocation rule would also require reconsideration of the allocation of QBAI. In Example 20, suppose M1 has $1000 of QBAI. Under a single entity approach there is $100 of net tested income and $1000 of QBAI giving rise to $100 of NDTIR, so there is no GILTI inclusion. Under the pro rata allocation rule in the Proposed Regulations, the NDTIR is allocated in proportion to gross tested income, i.e., $50 to M1 and $50 to M2, so there is still no GILTI inclusion.

However, under the priority allocation rule, it would not be possible to allocate QBAI or NDTIR in proportion to tested income of tested income CFCs and still achieve the same result as if the group was a single entity. In Example 20, since M1 has no *net* tested income, any allocation of QBAI to M1 would "waste" the QBAI and the total GILTI inclusion would exceed the inclusion under single entity principles and the Proposed Regulations.

Rather, to achieve the single entity result under the priority allocation method, QBAI would have to be allocated among members in proportion to the net tested income of each member. The same would be true for specified interest expense, which reduces NDTIR. These group-wide allocations, without priority to the member generating the QBAI or specified interest expense, are inconsistent in principle with allocating tested losses of a member's CFC first to the tested income of the same member. Likewise, to achieve the equivalent of single entity treatment under the priority allocation rule, foreign tax credits would still have to be determined on a group wide basis with a single inclusion percentage for the group, without priority to the member generating the credits.

The priority allocation rule is also more economically correct, and fairer, to minority owners of members of a group, assuming the group has a typical tax sharing agreement among members. In Example 20, a minority shareholder in M1 would have an economic detriment from the tax liability allocable to M1 notwithstanding M1's lack of

[82] Under the priority allocation rule, any particular CFC might have a different used tested loss or offset tested income than under the pro rata rule. In Example 22, CFC1 would have $100 of offset tested income and CFC3 would have no offset tested income. The allocation of used tested losses could also differ under the two methods if tested losses exceeded tested income, and some members had both tested income and tested loss CFCs.

net income from CFC1 and CFC2. Likewise, a minority shareholder in M2 would get an economic windfall from the reduced tax liability on M2 arising as a result of a tested loss in a subsidiary of M1. However, similar uneconomic results could arise to minority shareholders even under the priority allocation rule, e.g., if one member has a CFC subsidiary with tested income, and another member has a CFC subsidiary with a tested loss.

The solution to this problem under the approach of either the Proposed Regulations or the priority allocation rule would be a revised tax sharing agreement among members. The revised agreement would provide that a member receiving the benefit of a tested loss from another member's CFC would reimburse that member for the resulting tax benefit, just as it would typically reimburse another member for the use of the member's NOL.

Finally, the priority allocation rule is more economically correct for purposes of the SRLY rules, since it better reflects the economic income of each member of the group. If a member has a SRLY loss carryover to a taxable year, the pro rata allocation rule may permit too much, or too little, of the SRLY loss to be absorbed in the taxable year as compared to the economically correct amount.

Taking these factors into account, we believe that on balance the pro rata allocation approach of the Proposed Regulations is the better approach, and we support it. We also note that in a consolidated group with wholly owned subsidiaries, it appears to us that the location of GILTI inclusions is only relevant for SRLY and basis purposes. The Proposed Regulations make enormous efforts to deal with the basis consequences arising from the pro rata approach. With the modifications we suggest in Part IV, we believe that the Proposed Regulations would adequately deal with basis issues arising from the pro rata allocation method. As a result, we do not believe that the economic distortions caused by the pro rata allocation method are a sufficient reason to reject it.

IV. Adjustments to Tax Basis

A. Introduction

As discussed in more detail in this Part, the Proposed Regulations create a detailed and complex set of rules that require, in some circumstances, (1) a reduction in the basis of the stock of a CFC immediately before the stock in the CFC is sold, (2) if the stock in the CFC is owned by a member M of a consolidated group, with P owing M, a reduction in P's basis in M at the time the CFC has a tested loss, even before the stock in the member or the CFC is sold and before M reduces its basis in the stock of the CFC, and (3) an increase in P's basis in M either on a current basis when the CFC has tested income, or in other cases immediately before the stock in the CFC is sold.

Because of timing differences between item (1) and item (2), these rules create disparities between the inside asset basis and outside stock basis in M, and these disparities raise additional complexities. Yet more complexity arises because item (3) provides a basis increase in M stock when there is not an equivalent basis increase in the CFC stock.

The theory behind the Proposed Regulations is that if a corporation is a U.S. shareholder of two CFCs, one with tested income and the other with tested loss, the tested loss can potentially give rise to a double tax benefit to the shareholder. First, the tested loss offsets the tested income, thereby reducing the GILTI inclusion of the shareholder and allowing the CFC with tested income to pay a tax-free dividend to the shareholder. Second, the tested loss will generally correspond to an economic loss in the stock of the CFC with the tested loss, and allow that stock to be sold with a tax loss.

We accept the general desire of the Treasury to prevent what may be viewed as loss duplication, although we suggest certain changes to the Proposed Regulations below. More fundamentally, however, we believe there are at least three arguments for excluding all of these nonstatutory basis adjustments from final regulations.

First, as discussed below, it is by no means clear that the Code and the applicable case law authorize regulations to adjust the tax basis of stock in a CFC in this manner. Moreover, while Section 1502 no doubt authorizes the consolidated return basis adjustments, those adjustments would be illogical and create inconsistencies in the absence of the underlying basis adjustments in the stock of the CFC.

Second, even if a court would say that the adjustments to CFC stock basis are valid, there is no express authority in the Code for regulations to adjust tax basis of stock in a CFC in this manner, nor any statutory guidance as to how basis should be adjusted. There are several choices that can be made to adjust basis and/or e&p at the CFC level, including the method in the Proposed Regulations and other alternatives we discuss below. All of the choices are inherently overinclusive and underinclusive. Arguably these policy decisions should be made by Congress rather than by the Treasury.

Finally, the issue of loss duplication from tested losses is but one version of a broader set of fact patterns involving the recognition of loss on the sale of stock of a foreign corporation. All of these fact patterns arise because in many cases, the Code now allows for the tax-free return under Section 245A of untaxed profits of a foreign corporation, at the same time a loss on the sale of stock of a foreign corporation is allowed subject to Section 961(d).[83] None of these other fact patterns are subject to special rules under either the Code or the Proposed Regulations.

For example, if a U.S. corporation is a 10% shareholder of a foreign corporation that is not a CFC, the shareholder is not subject to a GILTI inclusion but can withdraw its share of the profits tax free under Section 245A. If the shareholder happens to own stock in another foreign corporation with an equal amount of allocable loss, the shareholder can

[83] Section 961(d) effectively disallows a loss to the extent of distributed earnings that were eligible for Section 245A.

sell the stock in that corporation at a loss. This combination of tax-free income and recognized loss is in substance the same result that the Proposed Regulations are trying to prevent in the GILTI context. Similarly, if a U.S. shareholder owns a CFC with a tested loss, the stock can be sold at a loss, while if the CFC has tested income that is sheltered by NDTIR, the corresponding gain is tax-free to the extent of e&p. The Code makes no attempt to eliminate this lack of symmetry. To be sure, in none of these cases is the shareholder using a loss in one CFC to shelter income in another CFC that would otherwise be taxable to the shareholder, and so arguably the considerations are different.

Arguably Congress rather than Treasury regulations should determine the extent to which basis adjustments are appropriate to change the results in these different fact patterns. On the other hand, it can be argued that the specific issue addressed by the Proposed Regulations is the clearest case of the double use of a loss, will frequently come up under GILTI, and should be addressed by regulations even though a more comprehensive solution to the problems created by Section 245A must necessarily await Congressional action.

In the remainder of this Part IV, we first describe the basis adjustment rules in the Proposed Regulations and provide a detailed set of comments. Then, with this background, we describe in Part IV.G two alternative approaches to ameliorate or eliminate loss duplication. We prefer those other approaches to the approach in the Proposed Regulations because we believe they are simpler and generally achieve the goals of the Proposed Regulations in preventing loss duplication. We acknowledge, however, that they may raise additional issues of authority. We have not had time to fully consider all the detailed rules that would be necessary under these alternative approaches, but we would be happy to consider these issues further if the Treasury is interested in pursuing these approaches.

B. Proposed Regulation Section 1.951A-6: The CFC basis reduction rule

1. *Summary of Proposed Regulation*

This Proposed Regulation introduces several key concepts. The "**offset tested income amount**" of a CFC for a particular year with respect to a U.S. shareholder is the tested income of the CFC allocable to the shareholder that is offset at the shareholder level by tested losses of other CFCs allocable to the shareholder.[84] Likewise, the "**used tested loss amount**" of a CFC for a particular year with respect to a U.S. shareholder is the tested loss of the CFC allocable to the shareholder that offsets tested income of other CFCs allocable to the shareholder. Tested losses of CFCs with tested losses are allocable proportionately against tested income of CFCs with tested income.

In addition, for any U.S. shareholder and any CFC, (a) the CFC's aggregate used tested loss amount with respect to the shareholder for all taxable years to date, is

[84] Prop. Reg. § 1.951A-6(e)(1)(i).

compared to (b) the CFC's aggregate offset tested income amount with respect to the shareholder for all taxable years to date. If (a) exceeds (b), the excess is the "**net used tested loss amount**" of the CFC with respect to the shareholder at that time. If (b) exceeds (a), the excess is the "**net offset tested income amount**" of the CFC with respect to the shareholder at that time.[85]

As a substantive matter, immediately before the disposition of Section 958(a) stock of a CFC owned directly or indirectly by a domestic corporation that is a U.S. shareholder, the tax basis of the stock of the CFC is reduced by the net used tested loss amount, if any, attributable to the stock that is disposed of. If the basis reduction exceeds the basis in the stock immediately before the disposition, then such excess is treated as gain from the sale of such stock. This rule is referred to as the "**CFC basis reduction rule**."

The CFC basis reduction rule can be illustrated by the following examples. Unless otherwise indicated, all examples assume that U.S. shareholder S is a domestic corporation that directly owns 100% of CFCs indicated as CFC1, CFC2, etc.[86]

> **Example 21.** *Used tested loss and offset tested income; single year*. In year 1, CFC1 has $100 of tested income and CFC2 has $100 of tested loss. Therefore, S has no net tested income and no GILTI inclusion. However, CFC1 has $100 of offset tested income, and CFC2 has $100 of used tested loss. The net used tested loss amount for CFC2 is $100 at the end of the year. Moreover, since there is no GILTI inclusion, there is no change in S's basis in the stock of CFC1 or CFC2 under Section 961.

> **Example 22**. *Used tested loss and offset tested income; two years*. Same facts as Example 20 in year 1, but in year 2, CFC1 has $100 of tested loss and CFC2 has $100 of tested income. For year 2, CFC1 has $100 of used tested loss and CFC2 has $100 of offset tested income. At the end of year 2, both CFCs have a $0 net used tested loss amount and net offset tested income amount, since in each case, the CFC has an equal used tested loss in one year and offset tested income in the other year.

In Example 21, if S sells the stock of CFC2 at the end of year 1, the tax basis of CFC2 will be reduced by the net used tested loss amount of $100. The stated rationale for this reduction in basis is the following. Absent additional facts (discussed in Part IV.B.2(a)), the tested loss of CFC2 reduces the GILTI inclusion of S by $100. In addition, CFC1 would normally have $100 of e&p that it can distribute to S on a tax free

[85] Prop. Reg. §§ 1.951A-6(e)(2), (e)(3).

[86] The considerations are different for individuals, who (at least in the absence of a Section 962 election) are not entitled to the deduction under Section 245A in the case of a tested income CFC, and are not required (and, as discussed below, should not be required) to reduce basis in a tested loss CFC.

basis under Section 245A, without any reduction in S's basis in CFC1.[87] The value of CFC1, and the tax basis in CFC1, would be the same as before year 1, and so any built-in gain is unchanged. If no dividend was paid but the stock of CFC1 was sold, the gain attributable to the $100 of tested income would be tax free under Section 1248(j).

In addition, CFC2's tested loss would reduce the value of CFC2, assuming a corresponding economic loss. Absent the Proposed Regulations, S could sell the stock of CFC2 at an increased loss or reduced gain on account of such tested loss. On these facts, the tested loss has thus provided a double tax benefit to S. As noted above, the purpose of the Proposed Regulations is to prevent this double tax benefit.

Notably, the Proposed Regulations do not eliminate the incentive to taxpayers to create income in one CFC and an equal loss in another in order to obtain this tax benefit. In particular, any time S is planning on selling the stock of CFC1, it can first have CFC1 sell its assets at a gain equal to the stock gain, and avoid the GILTI inclusion by having another CFC such as CFC2 sell its own assets at an equal loss. There is no GILTI inclusion, the cash proceeds on the sale of CFC1 are received tax-free, and the basis reduction in CFC2 stock is deferred.

2. *Policy Issues*

(a) *Not Always a Double Tax Benefit*

The Preamble justifies the basis reduction on the ground it is necessary to prevent the double tax benefit from the tested loss. We consider first exactly what is meant by preventing a double benefit. Even in the simple case in Example 21, the used tested loss of CFC2 eliminates a GILTI inclusion that would otherwise be taxed to S at 10.5%. Absent the Proposed Regulations, the capital loss on the sale of stock of CFC2 would potentially result in a tax savings of 21% to S if it had other capital gain.

The Proposed Regulations are therefore reducing this potential tax savings of 31.5% of the net used tested loss amount to a tax savings of 10.5% of the net tested loss amount. This is more than eliminating a double benefit from the tested loss—it is eliminating the potential 21% benefit that would arise in the absence of tested income, and converting that into a deduction against income otherwise taxable at 10.5%.

Put another way, the basis reduction is causing S to pay tax at a 21% rate on the increased gain or reduced loss on the sale of the CFC (assuming no exempt gain under Section 1248), while the tested loss only provided a benefit at the 10.5% rate. S would actually be better off if CFC1 had tested income, and CFC2 had tested loss, in different

[87] An exception is Section 961(d), which would effectively disallow a loss on the stock to the extent of the Section 245A dividend.

taxable years, since that might lead to income taxed at 10.5% and a loss on the CFC2 stock providing a 21% benefit.[88]

On the other hand, arguably it is correct to say that rate differentials should be disregarded in determining whether net used tested loss without a basis reduction gives rise to a double tax benefit. After all, tested income, whether or not offset, is taxed at 10.5% but can result in reduction of corporate tax of the U.S. shareholder at the 21% rate.

In any event, accepting the Preamble's concept of a double tax benefit from a tested loss, a key aspect of the Proposed Regulations is that it reduces basis of a CFC *without regard to whether, as a factual matter, the net used tested loss amount provides both (i) the "first" tax benefit to the U.S. shareholder by offsetting tested income of the shareholder, and (ii) the "second" tax benefit by allowing the stock of the tested loss CFC to be sold at an increased loss or reduced gain*. As will be seen below, in many cases the shareholder with tested income will receive no net tax benefit from a reduction in its tested income, and it might even receive a net detriment. Likewise, in many cases the shareholder will receive no net tax benefit from owning stock of a CFC that had a used tested loss.

In those cases, the net used tested loss amount of a CFC does not provide a double tax benefit to the shareholder, and the need to prevent such a double benefit does not provide a justification for the basis reduction. This result can arise in a number of situations based on the simple fact pattern of Example 21:

NDTIR/QBAI: Suppose that S had enough NDTIR, from the QBAI held by its CFCs with positive tested income, to eliminate its entire GILTI inclusion. The tested loss from CFC2 then provided no tax benefit to S.

To be sure, there might be other good policy reasons for the Proposed Regulations to reduce basis in CFC2 in this case. Absent such reduction, there would be an incentive for S to arrange its business activities so that some of its CFCs had positive tested income and NDTIR, and others had tested losses. The tested losses would be "wasted" if they were in the same CFCs as the tested income and NDTIR, but a loss in a different CFC could give rise to a tax loss on sale of the stock of that CFC. The basis reduction in the Proposed Regulations would eliminate the incentive for this uneconomic tax planning, but could not be justified by the need to prevent double deductions.

Foreign tax credits: Suppose S had enough foreign tax credits from CFC1 to wipe out its U.S. tax liability on its $100 GILTI inclusion from CFC1 standing alone. On these facts, in Example 21, the foreign tax inclusion percentage for S under Section 960(d) would be zero because of the offsetting tested income and tested loss. In form, the tested loss of CFC2 is reducing the GILTI inclusion of S. However, in substance, the

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[88] The Proposed Regulations would not provide a basis reduction in the stock of CFC2, assuming the tested loss was not a used tested loss in the year it arose.

tested loss is not reducing the taxes of S below what they would have been in the absence of the tested loss, so there is no double benefit from the tested loss.

Section 956: Suppose the tested income of CFC1 was inadvertently used to acquire a Section 956 asset in the current year, and, if the recently proposed regulations under Section 956 apply,[89] Section 245A would not apply to a dividend from CFC1 (e.g., because S's stock in CFC1 is debt for foreign tax purposes and thus the dividend would be a hybrid dividend not eligible for Section 245A). Absent the tested loss in CFC2, the GILTI inclusion would be $100, the tax would be $10.50, and the Section 956 amount would be tax-free PTI. With the tested loss, there is no GILTI inclusion, and the $100 is taxed to S at the ordinary 21% rate. (Foreign tax credits might reduce both the GILTI and Section 956 calculations.) The tested loss has actually increased the tax liability of S before foreign tax credits. While this detriment would be offset by a tax loss on the sale of the stock of CFC2, there is no double benefit from the tested loss.

No e&p: Suppose CFC1 has no e&p, because of an expense that reduces e&p but is not allowed as a deduction in computing tested income. Assume S sells the CFC1 stock for $100 in excess of its preexisting basis. If CFC2 has tested loss of $100, there is no GILTI inclusion and there is no deemed dividend on the sale because of the lack of e&p. Therefore, S has $100 of capital gain on the sale taxed at 21%. Absent the used tested loss, S would have a $100 GILTI inclusion from CFC1, the basis in CFC1 would increase by $100, and there would be no gain on the sale of the stock. The tested loss has increased S's tax liability by converting $100 of GILTI inclusion to $100 of capital gain. Again, a loss on the sale of the stock of CFC2 would offset this increase in tax liability but would not be a double benefit from the tested loss.

Section 1059: Suppose CFC1 pays a dividend of its $100 of e&p, and that dividend is an extraordinary dividend under Section 1059. Section 1059 applies if a dividend of sufficient size is paid by CFC1 to S before S has held the CFC1 stock for two years. In that case, the dividend is still tax free to S under Section 245A, but S's tax basis in CFC1 is reduced by $100. As a result, the tested loss of CFC2 has prevented an upfront GILTI inclusion of $100 from CFC1, but at the cost of the basis reduction. When the stock of CFC1 is sold, overall there has been no second benefit to S from the tested loss, except for timing.

This example illustrates the complexity of determining whether a double tax benefit of a tested loss arises. At the time the CFC2 stock is sold, if the dividend of the CFC1 tested income has not yet been paid, it may not yet be clear whether it will be later paid in a manner subject to Section 1059. Even if the dividend has been paid and the basis in CFC1 was already reduced under Section 1059, the failure to reduce the basis in CFC2 will cause the CFC2 tested loss to result in a double tax benefit upon the sale of the

[89] REG-114540-18, Federal Register Vol. 83, No. 214, November 5, 2018 at 55324-55329. This proposed regulation turns off Section 956 to the extent the U.S. shareholder of CFC1 would be eligible for Section 245A on a dividend from CFC1.

CFC2 stock. However, this second tax benefit would be offset upon a sale of the CFC1 stock at its reduced basis. Therefore, any basis reduction in the stock of CFC2 designed to prevent a double use of the tested loss on sale of CFC2 would logically have to be either not made in the first place, or else reversed upon the sale of CFC1 with a reduced basis.

Sale of Tested Income CFC at a Loss. The tested loss of CFC2 will likewise not provide a double tax benefit if S sells the CFC1 stock with a loss effectively disallowed under Section 961(d). That section provides that if CFC1 pays a dividend to S to which Section 245A applies, then (unless Section 1059 applies), S's basis in CFC1 is reduced by the amount of the dividend for purposes of calculating loss on a sale of CFC1.

For example, assume S owns a single CFC1 with an initial basis of $100 and value of $100. Assume $100 of tested income, and a distribution of the tested income as PTI. The shareholder has a GILTI inclusion of $100 and an ending tax basis of $100. If the shareholder sells the stock for $0, a tax loss of $100 is allowed. If instead S also owns CFC2 with a tested loss of $100, there is no GILTI inclusion. The distribution of $100 from CFC1 is eligible for Section 245A, and assuming no extraordinary dividend, the basis of $100 remains unchanged. However, if the stock is sold for $0, Section 961(d) disallows the loss.

The existence of the tested loss in CFC2 has allowed S to avoid upfront tax on $100 of tested income from CFC1, but at a cost of a disallowed loss of $100 on sale of the stock of CFC1. Of course, since Section 961(d) only reduces basis for purposes of determining loss, if the stock is sold for $100 or more, the tested loss has offset the tested gain with no further detriment to S.

As a result, if the CFC1 stock is sold at a disallowed loss before the CFC2 stock is sold, it would be clear at that time that the tested loss would not be providing a double tax benefit. If the CFC2 stock is sold first, as in the discussion of Section 1059 above, it would not be clear at that time whether a loss would be disallowed on a future sale of CFC1 stock, thereby preventing a cumulative double benefit from arising from the tested loss of CFC2.

The same denial of a double tax benefit can arise if the CFC1 stock is sold at a loss, even in the absence of a Section 245A dividend that causes Section 961(d) to apply. Return to the example where S owns CFC1 with a basis and value of $100, and CFC1 has $100 of tested income. If the tested income results in a GILTI inclusion, the stock basis increases to $200, and if the stock is later sold for $100, there is an allowed loss of $100. No provision disallows this loss. On the other hand, if CFC2 has a tested loss of $100 that offsets the tested income of CFC1, there is no GILTI inclusion, the basis in CFC1 remains at $100, and there is no tax loss on the sale of that stock for $100. The tested loss in CFC2 has provided no benefit to the U.S. shareholder in connection with the tested income and sale of CFC1.

Inside/outside basis differences. The tested loss of CFC2 also may not provide a double tax benefit where there are disparities in inside and outside stock basis in CFC1 or CFC2. For example, suppose S bought the stock of CFC2 for $100 when CFC2 had a single asset with a basis of $200 and value of $100. CFC2 sells the asset for $100, and the tested loss of $100 offsets $100 of tested income of CFC1. The tested loss does not create a potential loss on the sale of the CFC2 stock, because that tested loss is already reflected in the cost basis of that stock. To be sure, there is arguably a policy reason to reduce S's basis in CFC1 by the amount of the tested loss, as would be the case if CFC1 were a consolidated subsidiary of S or a partnership that had S as a partner. However, the argument for such a basis reduction is arguably distinct from the duplicated loss issue in *Ilfeld* that is the claimed source of authority for the CFC basis reduction rule.

The same issue would arise if CFC1 had an asset with a basis of $0 and value of $100, S bought the CFC1 stock for $100, and then CFC1 sold the asset for $100. Absent the tested loss of CFC2, S would have a $100 GILTI inclusion that would increase the basis in CFC2 to $200, allowing the stock to be sold for $100 at a tax loss of $100. As a result, as long as S has other gain that can be sheltered with the $100 loss on the stock sale, S has obtained no net tax benefit from the tested loss of CFC2, and so logically the basis in CFC2 should not be reduced.[90]

No economic loss to match tested loss. Suppose the tested loss of CFC2 arises from an expense that does not reduce the value of the stock of CFC2, e.g., an r&d expense, or deductible start-up costs that create value. In this case, the tested loss does not create a potential second tax benefit in the form of a capital loss on the sale of the CFC2 stock. In this case, reducing the tax basis of CFC2, and creating gain when it is sold for its unchanged value, would even eliminate the single tax benefit from the tested loss that arose from offsetting the tested income of CFC1.

Future exempt income in tested loss CFC. Suppose that CFC2 has exempt income (not offset tested income) in a future year equal in amount to the tested loss in the example. The exempt income might be from a GILTI inclusion reduced by NDTIR, or from high-taxed Subpart F income. If that income is not distributed out of current e&p in the year earned, and if the tested loss in the example created negative e&p, the negative e&p will prevent such exempt income from resulting in accumulated e&p in years after the exempt income was earned. As a result, the tested loss will prevent the payment of Section 245A dividends in future years out of such exempt income, and prevent the sale of the stock at a tax-free gain on account of such exempt income. In this situation, the shareholder has not received a second benefit from the tested loss in the example.

(b) *Authority for the CFC Basis Reduction Rule*

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[90] As previously noted, if the stock loss offsets gain otherwise taxed at 21%, S is worse with the tested loss than without it.

The Code does not contain any explicit authority for the Treasury to write regulations to reduce the tax basis in stock of a CFC. In fact, Section 961 provides explicit rules for adjusting the basis of stock of a CFC. Moreover, Section 951A(c)(2)(B)(ii) (which increases e&p by tested losses for purposes of the e&p limitation on Subpart F income) is entitled "Coordination With Subpart F To Deny Double Benefit of Losses." There is no indication in the Code or legislative history that additional basis adjustments may be made by regulations to prevent duplicated losses or otherwise.

The Preamble relies on the *Ilfeld* and *Skelly Oil* cases decided by the Supreme Court.[91] However, there are several reasons that these cases might not be considered determinative in this context.

First, *Ilfeld* involved a double deduction of a single economic loss on a consolidated tax return and is generally cited in that context. It is true that the double tax benefit from a tested loss can arise in the context of a consolidated return, but that is only because a consolidated group is treated as a single corporation under the Proposed Regulations. Conceptually, the issue arises when a single U.S. corporation has multiple CFCs, some with tested income and some with tested loss.

In fact, the *Ilfeld* doctrine was recently discussed at length in the *Duquesne Light* case in the Third Circuit.[92] The court affirmed the application of *Ilfeld* to a consolidated group. It also discussed the uncertainty of whether *Ilfeld* applies outside a consolidated group, and cited several cases that arose before *Gitlitz* (discussed below) where the doctrine was so applied.

Second, *Skelly Oil* involved the common law claim of right doctrine, and neither *Ilfeld* nor *Skelly Oil* involved a specific statutory scheme that on its face provided for a double deduction. In fact, *Ilfeld* stated that "*in the absence of a provision in the Act or regulations that fairly may be read to authorize [a double deduction]*, the deduction claimed is not allowable" (emphasis added). When the Code or regulations deal specifically with the subject matter, the courts are much more willing to defer to the literal language of the Code or regulations.

For example, in *Gitlitz*,[93] the government objected to the taxpayer's proposed interpretation of the Code on the ground that it would give a "double windfall" to taxpayers. The Supreme Court summarily rejected this argument, stating that "[b]ecause the Code's plain text permits the taxpayers here to receive these benefits, we need not

[91] *Charles Ilfeld Co. v Hernandez*, 292 U.S. 62 (1934); *U.S. v Skelly Oil Co*, 394 U.S. 678 (1969).

[92] *Duquesne Light Holdings, Inc. v Comm'r*, 861 F.3d 396 (3d Cir. 2017), *cert denied* (138 S. Ct. 2651).

[93] *Gitlitz v Comm'r*, 531 U.S. 206 (2001).

address this policy concern."[94] Even in the consolidated return context, courts reject reliance on *Ilfeld* when the regulations are clear and specific.[95] Arguably the existence of Section 961, dealing specifically with tax basis, is enough to satisfy this requirement.

Third, the *Ilfeld* line of cases deals with a double deduction. The consequences of a used tested loss are both a single deduction to the shareholder (through offset of tested income) and the failure to reduce basis of the loss CFC. However, the failure to reduce basis may not give rise to an actual loss on the sale of the stock of the loss CFC, but rather to a reduced gain on the sale of the stock.[96] The Code and regulations clearly make this distinction in various rules.[97] We are not aware of *Ilfeld* being applied to require the creation of income or gain, as opposed to denying a loss considered to be duplicative (although the Supreme Court has arguably characterized *Ilfeld* in broader terms).[98] Therefore, it is possible that *Ilfeld* would at most justify a rule disallowing losses on the sale of the stock of the tested loss CFC, as opposed to a basis reduction rule that also increases the amount of taxable gain on the sale.

On the other hand, if *Ilfeld* applies to disallow duplicative losses in a consolidated group, the logic seems even more applicable for disallowing duplicative losses in a single corporation. Here, the U.S. shareholder first obtains the benefit of a reduction in its tested income inclusion, then it has a potential capital loss on the stock of the tested loss corporation. In fact, the regulations have long prohibited double deductions in a single corporation[99] and this principle was recently applied by the Federal Circuit.[100] Moreover, notwithstanding Section 961, it can be argued that Congress was not purporting to

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[94] *See also Brown Shoe Co. v. Comm'r*, 339 US 583 (1950) (property contributed to capital by a nonshareholder had a depreciable basis). This result was changed by Section 362(c).

[95] *See, e.g., Woods Investment Co. v Comm'r*, 85 T.C. 274 (1985).

[96] As noted above, a tested loss may not give rise to *either* an increased loss or reduced gain to the shareholder, if the shareholder's stock basis is purchased basis that already reflects the loss.

[97] *E.g., compare* Section 1059 (reducing basis by the nontaxed portion of a dividend), *with* Section 961(d) (reducing basis by the amount of a Section 245A dividend only for purposes of calculating loss on a sale of the CFC stock).

[98] *See McLaughlin v. Pac. Lumber Co.*, 293 U.S. 351, 355 (1934) ("But a consolidated return must truly reflect taxable income of the unitary business and consequently it may not be employed to enable the taxpayer to use more than once the same losses for *reduction of income*. Losses of [taxpayer] that were subtracted from [taxpayer's] income are not *directly or indirectly* again deductible." (emphasis added)).

[99] *See* Treas. Reg. § 1.161-1 ("Double deductions are not permitted. Amounts deducted under one provision of the Internal Revenue Code of 1954 cannot again be deducted under any other provision thereof.").

[100] *See Sunoco, Inc. v. United States*, No. 2017-1402 (Fed. Cir. Nov. 1. 2018) ("Congress does not generally allow taxpayers to receive a tax benefit twice.") (denying the taxpayer an increase in cost of goods sold for an excise tax liability that was offset by a tax credit).

exclusively prescribe all the collateral effects of the GILTI rules and did not intend to preclude regulations that would deny a double tax benefit to taxpayers.

Fourth, as discussed in Part IV.B.2(a), a used tested loss will often not give rise to a double tax benefit. Nevertheless, the only rationale for the CFC basis reduction rule provided in the Preamble is to prevent a double tax benefit, and there is no explanation of why a narrower rule would not be sufficient to prevent double tax benefits. This disconnect between the rule and the explanation for the rule could prevent the rule from satisfying the Administrative Procedure Act, even if a good explanation would have validated the rule.[101] As a result, the rule might be held invalid even as to a taxpayer that does have a double tax benefit.

In light of the foregoing, if the final regulations will retain the CFC basis reduction rule or a similar rule, we suggest that the Treasury request a statutory amendment to confirm its authority to issue regulations to modify the basis rules of Section 961. Absent such legislation, the preamble to the final regulations should further explain the nature of the double tax benefit the Proposed Regulations are designed to prevent. Moreover, unless the CFC basis reduction rule is narrowed as we suggest in Part IV.B.2(c), the preamble to the final regulations should also explain why the rule applies to all used tested losses without regard to whether an actual double tax benefit is obtained by the U.S. shareholder.

(c) *Proposed Modification of the Rule*

The Proposed Regulations generally follow the approach of the statute of treating each CFC as a separate entity, and then apply principles similar to consolidated return principles to achieve economically correct results. Within the framework of the Proposed Regulations, we have the following comments.

We agree with the fact that the Proposed Regulations do not require an upfront reduction in the basis in a tested loss CFC to the extent of its used tested loss amount, even when the U.S. shareholder clearly derived a benefit from the tested loss. We acknowledge that an immediate basis reduction would be administratively simpler than to wait until the CFC stock is sold, and would more closely match the adjustments in Proposed Regulation Section 1.1502-32 described in Part IV.D.1. However, such a basis reduction would create upfront gain any time there was not sufficient basis, would still allow a CFC to recognize loss to offset tested income of another CFC any time there was sufficient basis in the former CFC, and would raise significant additional authority issues. Congress clearly did not intend there to be a net income inclusion, from a basis reduction or otherwise, merely because CFC1 has tested income and CFC2 has tested loss.

Moreover, no approach to preventing the double use of a tested loss will be fully satisfactory. The plausible times for an income inclusion are when the shareholder has

[101] *See, e.g.*, *Altera Corp. v Comm'r*, 145 T.C. 91 (2015) (currently pending before the Ninth Circuit).

taken advantage of Section 245A for its offset tested income, or taken advantage of its unreduced stock basis following a Section 245A distribution, or (as in the Proposed Regulation) disposed of the CFC2 stock.

As noted in Part IV.A, we recommend that the fundamentally different approach in Part IV.G be adopted. However, if the CFC basis reduction rule is retained, we believe it should be modified to allow an exception in at least the first of the following circumstances, and possibly the second.

First, a U.S. shareholder should be permitted to eliminate all or part of the used tested loss amount for purposes of the CFC basis reduction rule to the extent it can show, as of the time of the sale of the CFC stock, that it had not received any tax benefit from the net used tested loss amount and could not reasonably expect to receive any benefit in the future.[102] This calculation would be made on a "but for" basis, and could take into account any actual or expected offsets to the double benefit because of Section 1059 or Section 961(d). As a protection for the government against future benefits not originally taken into account, there could be a recapture rule designed to reach the same result as if those future benefits had been taken into account at the time of the sale of the CFC2 stock.[103]

We believe this is the theoretically correct rule to protect both the government and taxpayers. We acknowledge it would result in considerable additional complexity. However, the burden would be on taxpayers if they wished to take advantage of this rule, and in many cases taxpayers would be more than willing to do so. The rationale for the additional complexity is that it is quite unfair to taxpayers to require a basis reduction in the CFC stock (even below zero) if the used tested loss has not provided any tax benefit to the shareholder, or if any benefit is expected to be temporary because of future increased gain or disallowed loss on the sale of CFC1. While the purpose of the CFC basis reduction rule was to avoid a *double* benefit from a tested loss, in these cases the tested loss is providing *no* tax benefit as a result of the basis reduction.

Simplified versions of this rule would also be possible, although by looking only at a single tax year of the shareholder, they might not protect the interests of the government and taxpayers in all cases. For example, the future basis reduction could be eliminated if, solely taking account the year in which the used tested loss arose, the shareholder could show it has sufficient NDTIR to eliminate a GILTI inclusion, and/or

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[102] A rule that also looks to the receipt of an actual tax benefit is Prop. Reg. § 1.951A-3(h)(1), stating that temporarily held specified tangible property will be disregarded if, among other things, the acquisition of the property reduces the GILTI inclusion amount of a U.S. shareholder.

[103] The dual consolidated loss rules are somewhat analogous. *See* Treas. Reg. §§ 1.1503(d)-6(d), (e), providing an elective regime under which an annual certification is made that a loss used in the U.S. has not been used abroad, with a recapture of the U.S. use of the loss if a foreign use later occurs.

sufficient foreign tax credits to eliminate tax on a GILTI inclusion, without regard to any used tested losses.

We also believe that this exception to the CFC basis reduction rule would make the rule less vulnerable to challenge by taxpayers. Since the rule would only apply when the taxpayer actually received a double benefit from a tested loss, or could not show otherwise, the argument for basing the rule on *Ilfeld* is strengthened.

Second, in addition to the foregoing, consideration should be given to a rule that a U.S. shareholder would be permitted to elect to forego the tax benefit of a tested loss. The result would be as if the tested loss had not occurred.[104] This would prevent a double benefit (or even a single benefit) from directly arising from the tested loss, and there would be no net used tested loss amount to cause a basis reduction under the CFC basis reduction rule.

This elective elimination of tested loss is analogous to the rules in Treasury Regulation Section 1.1502-36(d), which is designed to prevent a duplicated loss from arising in both the stock and assets of a member of a consolidated group. For example, suppose P contributes $100 to new member M, M buys an asset for $100, and the asset declines in value to $60. Absent the regulation, P could sell the stock for $60, and M could subsequently sell the asset for $60, resulting in a double tax loss for a single economic loss.

The regulation prevents this result by requiring a reduction in the basis of the assets of M, at the time of sale of the M stock, by the duplicated loss of $40, so the M asset basis becomes $60. In addition, there is an election to cause all or any portion of the reduction in asset basis to be replaced by a reduction in stock basis. For example, the asset basis could remain at $100 if the stock basis is reduced to $60, eliminating the entire loss on the stock.

Another analogous election in the consolidated return regulations allows a group acquiring a corporation with an NOL carryover to elect to waive the carryover. The election prevents the group from suffering adverse consequences if the carryover expires (under old law) while the purchased member is in the group.[105]

Several issues would have to be addressed in developing this election to forego the use of a tested loss. As an initial matter, it would have to be determined whether the election could be for part rather than all of the tested loss of a particular CFC for a particular year, whether a U.S. shareholder with multiple tested loss CFCs in a particular year must make consistent elections for each, whether an election is binding for a

[104] We do not intend, however, that a CFC with a "real" tested loss would thereby no longer be a tested loss CFC, so that QBAI and foreign tax credits from the CFC would be available for use against the tested income of other CFCs.

[105] Treas. Reg. § 1.1502-32(b)(4).

particular CFC in future years, whether a consistent election must be made by all related U.S. shareholders, and so on. It can be argued that to the extent the waiver of a tested loss merely eliminates the double benefit associated with the particular loss, the election should be available in whole or in part, CFC by CFC, and year by year. However, to the extent the election is more favorable to the taxpayer than eliminating the double benefit of a tested loss, as discussed below, there is greater justification for a consistency requirement.

Moreover, Section 951A states that the GILTI inclusion takes account of the tested income of tested income CFCs, reduced by the tested loss of tested loss CFCs. There is no provision for an election to disregard tested losses. If the Treasury believes that a waiver is appropriate as a policy matter, we suggest that it request a statutory change.

Next, even if the election was adopted, some version of the CFC basis reduction rule would be needed for taxpayers that do not make the election. As a result, the complexity of the CFC basis reduction rule would remain, although it would apply to fewer taxpayers. The decision would then have to be made whether our first proposal above should also be adopted, both for fairness to taxpayers and to strengthen the validity of the CFC basis reduction rule under *Ilfeld*.

Finally, this election might provide a greater tax benefit to the U.S. shareholder than merely eliminating the double tax benefit from a tested loss. The election might be made even if the taxpayer has no plan to ever sell the stock in the tested loss CFC, and therefore is relatively indifferent to the CFC basis reduction rule. Note that a tested loss reduces the U.S. shareholder's FTC inclusion percentage under Section 960(d). As a result, the FTC benefit from the waiver might be greater than the reduction in net tested income from the waiver.

Similarly, if the tested income CFC was to be sold at a loss, the U.S. shareholder might elect to waive the use of tested loss in order to create a GILTI inclusion and a basis increase in the tested income CFC. This would increase tax basis at a 10.5% cost (or less if FTCs are available), thereby increasing the tax loss on the stock at a 21% benefit. In addition, unless the e&p of the CFC with the tested loss was reduced in the normal way notwithstanding the election, the election could increase the untaxed e&p of the CFC and allow the shareholder to take increased advantage of Section 245A to that extent.

The tax planning opportunities created by the rule should be taken into account in the decision of whether to adopt the rule. However, such opportunities could be mitigated by adopting various consistency requirements for the making of elections, as discussed above.

As a result, further consideration would need to be given to this proposal. We would be happy to consider it further if the Treasury believes it would be useful.

3. *Technical Issues*

(a) *The Netting Rule for Basis Reductions*

As noted above, the basis on disposition of CFC stock is reduced by the net used tested loss amount. This is the shareholder's share of the aggregate used tested loss of the CFC for all years over its share of the aggregate offset tested income of the CFC for all years. Consider Example 22 above, where CFC1 has offset tested income of $100 in year 1 and used tested loss of $100 in year 2, and CFC2 has the reverse. When the CFC1 stock is sold, the net used tested loss amount is $0, and there is no basis reduction.

This failure to reduce basis might be considered incorrect, because CFC1 could pay a tax-free dividend in year 1 without a basis reduction. The result for both years would be a decrease in value of the stock of CFC1 ($100 income and distributed earnings in year 1, $100 loss in year 2) with no reduction in stock basis. Thus, a built in loss has been created in the stock of CFC1 as a result of offset tested income.

However, we believe the netting approach in the Proposed Regulations is appropriate. In year 1, when CFC1 has offset tested income, CFC2 has a used tested loss. As a result, the basis of CFC2 will be reduced whenever it is sold in the future (and before taking account of CFC2's offset tested income in year 2) to take account of the fact that CFC1 might pay a tax exempt dividend. Since that future basis reduction already takes account of the assumed dividend, there is no reason for any further basis reduction when the dividend is actually paid. In year 2 when CFC1 has a used tested loss and CFC2 has offset tested income, the usual rules would apply.

(b) *Basis Reduction Upon the Sale of a U.S. Shareholder*

Clarification should be provided concerning the basis consequences of the sale of stock of the U.S. shareholder of a CFC. In Example 21, suppose corporation C owns all the stock of S, and C sells the stock of S to a buyer (Buyer). Assume C and S do not file a consolidated return.[106] The Proposed Regulations trigger a basis reduction in CFC2 upon the disposition of stock of a CFC owned directly or indirectly by a domestic corporation under Section 958(a). Since C does not own Section 958(a) stock of CFC2, the Proposed Regulations by their terms do not require a reduction in the tax basis of CFC2 upon the sale of S, notwithstanding the net used tested loss amount in CFC2.

The final regulations should contain an example illustrating this point to avoid any doubt. We believe this is the correct answer assuming, as discussed in the following paragraph, that the potential basis reduction continues following the sale of S. Outside of a consolidated group, S and C should be treated as separate entities, and S's basis in CFC2 should not depend upon transactions in the S stock.

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[106] The issues when C and S file a consolidated return are discussed separately in Part IV.D.

The Proposed Regulations also appear to provide that even after S is acquired by Buyer, S's disposition of CFC2 will result in a basis reduction in the CFC2 stock. In other words, it appears that the attribute of net used tested loss amount stays with S even when S is owned by a new buyer. This appears to be the correct answer as an economic matter. The CFC2 net used tested loss amount reduced the tested income of CFC1 and tax liability of S before S was sold. In addition, the cash from such offset tested income could be withdrawn from CFC1 to S, and (except if Section 1059 applies) from S to C, without any further tax or basis reduction.

On the sale of S at its reduced value, C has received a second tax benefit from the used tested loss, and it is reasonable to offset that benefit with a reduction in the basis in CFC2 when it is sold. Moreover, it would be very unusual, if not unique, outside the consolidated group and partnership contexts, for the tax basis of an asset at a lower tier (i.e., S's basis in CFC2 upon the sale of CFC2) to be affected by a transaction occurring at a higher tier (i.e., C's sale of S stock).

However, continuing to apply the CFC basis reduction rule after the purchase of the S stock creates a trap for the unwary. Any purchaser of a U.S. shareholder of a CFC would be taking the risk that the stated tax basis in the CFC is good "for today only." When the basis really matters, i.e., when the stock in the CFC is sold, the basis could go down by an undetermined amount. Knowledgeable purchasers will protect themselves with new language in many if not most acquisition agreements. However, to put unsuspecting taxpayers on notice of this new concept, we believe it is very important that the final regulations make very clear, ideally through a simple example, that the potential basis reduction in stock of a CFC can occur following a sale of the stock in the U.S. shareholder of the CFC.

(c) *Collateral Effects of Stock Basis*

Until the stock of the CFC is disposed of, there is no reduction in the basis of its stock. This could have collateral effects.

(i) *Allocation of Interest Expense*

Depending on future regulations concerning allocation of interest expense of the U.S. shareholder, the unreduced basis may result in an allocation of interest expense to the CFC for foreign tax credit purposes determined by reference to this unreduced stock basis.

This result does not seem justified, since the U.S. shareholder will not be able to take advantage of the unreduced basis when the CFC stock is sold. Moreover, the basis reduction upon a sale represents a net used tested loss amount, which would normally represent a true decline in value of the CFC. Regulations should clarify the consequences to a U.S. shareholder of unreduced basis in the stock of a CFC, where the basis will be reduced immediately before a disposition.

(ii) *NUBIG and NUBIL*

Likewise, under Section 382(h)(1), if S has a change in ownership under Section 382, net unrealized built in gain (NUBIG) and loss (NUBIL) is based on the difference between the tax basis and fair market value of the assets of S at that time.[107] In particular, recognized NUBIG of S increases the Section 382 limit of S for the year, and recognized NUBIL is treated as a loss carryover subject to Section 382.

The NUBIG and NUBIL rules are designed to put the taxpayer in the same position as if it had sold its assets on the day before the change in ownership. Gains on such assets could be offset by current NOLs without limitation, and losses on such assets that carried over to the post-acquisition period would be subject to Section 382. As a result, it seems most consistent to apply the NUBIG and NUBIL rules to a U.S. shareholder of a CFC by taking into account the future basis reduction in the stock of the CFC that would arise if the CFC were sold immediately before the change in ownership of the U.S. shareholder.[108] This would increase NUBIG, and reduce NUBIL to the extent of the potential basis reduction.

In fact, Notice 2003-65[109] defines NUBIG and NUBIL in terms of the gain or loss that would be recognized in a hypothetical sale of assets of the loss corporation immediately before the ownership change. While this Notice was obviously not drafted with the CFC basis reduction rule in mind, we believe the principle is correct and that this rule would take account of the CFC basis reduction rule. Final regulations should confirm this result.[110]

(iii) *Exempt COD income*

Regulations should also clarify the relationship between the CFC basis reduction rule and Section 108(b)(2)(E), under which a taxpayer's basis in its property can be

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[107] NUBIG and NUBIL are also relevant for Section 384 and the "separate return limitation year" rules relevant to consolidated groups.

[108] These results would be analogous to the rules for "built-in items" under Section 382(h)(6), under which items of income and deduction that are taken into account after an ownership change, but that are attributable to periods before the change date, are treated as built-in gain or loss.

[109] 2003-2 C.B. 747.

[110] A similar issue arises if a CFC has untaxed e&p on the day before the change in ownership, such as from offset tested income or from tested income sheltered by NDTIR. The U.S. shareholder's gain on a sale of the stock of the CFC would be a dividend eligible for Section 245A to the extent of the untaxed e&p. Section 1248(j). However, Section 1248(a) treats the gain as recognized gain. Since Notice 2003-65 defines NUBIG and NUBIL in terms of gain or loss recognized on a hypothetical sale, it appears to treat that gain as NUBIG even though it is effectively tax-exempt. Treasury should consider whether an upward basis adjustment for NUBIG and NUBIL purposes is appropriate in this situation.

reduced (but not below $0) to the extent of the taxpayer's exempt cancellation of indebtedness ("**COD**") income.

For example, suppose the taxpayer is a corporation whose only asset is stock of a CFC with a basis of $100 and net used tested loss amount of $80,[111] and the shareholder has exempt COD income of $60. If the unreduced basis of $100 is taken into account under Section 108(b), then that section currently reduces the basis by $60 to $40. Then, the CFC basis reduction rule reduces the basis by $40, to $0, and creates additional gain of $40, all at the time of sale of the CFC stock. However, if the cap on the Section 108(b) basis reduction is the reduced basis of $20 rather than the unreduced basis of $100, then the Section 108(b) basis reduction is $20, so the unreduced basis becomes $80 and the reduced basis on a sale becomes $0 without any additional gain recognition.

It can be argued in favor of the second approach that while the shareholder has tax basis of $100 in the stock of the CFC, it will never be able to take advantage of that tax basis. Moreover, the Section 108(b) basis reduction should be limited to the tax basis that the shareholder can ultimately use. This is the result that would arise if the tax basis in the CFC had been reduced immediately rather than deferred. The second approach is also consistent with Section 1017(b)(2), which provides that the aggregate basis of the assets of the taxpayer is never reduced below the amount of liabilities of the taxpayer. This in effect gives the debtor a "fresh start" by preventing gain recognition even if all the taxpayer's assets are disposed of solely for assumption of the taxpayer's debt.

(d) *Noncorporate U.S. Shareholders*

The Preamble requests comments concerning whether the CFC basis reduction rule should be extended to non-corporate U.S. shareholders, taking into account that they are not entitled to a dividends received deduction under Section 245A. For example, suppose that S in Example 21 is an individual.

We do not believe the CFC basis reduction rule should apply in this case. It is true that the tested loss in CFC2 both offsets the tested income in CFC1 and can result in a loss on the sale of the CFC2 stock. However, the tested income in CFC1 will be taxable to the shareholder when distributed or when the CFC1 stock is sold, so the sheltering of tax on the tested income of CFC1 is only temporary. It does not seem fair to permanently deny a real economic loss on CFC2 stock in exchange for a deferral in the taxation of earnings of CFC1.

(e) *Definition of "Disposition"*

The Preamble asks for comments on whether the definition of "disposition" of CFC stock should be broadened to include transactions that do not involve a transfer of

[111] Assume the taxpayer previously disposed of the CFC with the offset tested income.

stock, but rather take advantage of the tax basis of the stock, for example Section 301(c)(2) or Section 1059. We discuss that issue here.

First, Section 165(g) allows a loss for worthless stock and is treated as a sale of the stock for "zero." This should be treated as a disposition of the stock that reduces tax basis, since there will generally be no further opportunity to avoid the double tax benefit from the tested loss.

Next, suppose S has a "regular" tax basis of $100 in the stock of a CFC2, and a net used tested loss amount of $80 in CFC2 from its tested loss that offset tested income of CFC1. On a sale of the CFC2 stock, the tax basis is reduced to $20. Suppose now that CFC2 has no e&p, and there is a Section 301(c)(2) distribution of $20. It could be argued that this is in substance a disposition of a percentage of the stock of CFC2, based on the ratio of $20 to the fair market value of CFC2. However, we do not believe that a Section 301(c)(2) distribution of even $1 should trigger taxation of the entire net used tested loss amount of $80, or that proration requiring a valuation of CFC2 is practicable.

As a result, to the extent the distribution is no more than the reduced basis that would arise in the CFC2 stock on a sale of the stock, we do not believe any gain should be triggered on account of the CFC basis reduction rule. In the example, the tax basis would be reduced to $80 under Section 301(c)(2), and the basis upon a sale would be $0.

Now, assume the distribution to S is $100 rather than $20. If the result in the prior paragraph is accepted, that same result must also apply to the first $20 of the $100 distribution. The only question is the treatment of the additional $80. That $80, as well as the original $20, is a Section 301(c)(2) distribution based on the $100 unreduced tax basis of the CFC. However, $80 is a Section 301(c)(3) distribution based on the $20 reduced tax basis of the CFC.

It can be argued that this $80 should be taxable to S. The tax free recovery of cash in this situation would arguably be a double benefit from the $80 of the used tested loss. First, the loss reduced the tested income otherwise taxable to S by $80, and then the unreduced basis allowed a tax free distribution of $80 of cash. Moreover, if S sold all the stock of CFC2 for $100, S would recognize gain of $80. Arguably S should not be in a better tax position than this by receiving a distribution of $100 from CFC2 and *keeping* all the stock. Moreover, a distribution of the cash, combined with the issuance of new stock to a third party by CFC2, is economically equivalent to a sale of part of the CFC2 stock by S to the third party, and the CFC basis reduction rule would apply in the latter case.

Finally, CFC1 can make tax-free distributions of its $80 of e&p under Section 245A, plus an additional amount equal to S's basis in CFC1. Allowing full basis recovery in CFC2 means that CFC2 can make a tax-free distribution of the unreduced tax basis of $100. Yet if CFC1 and CFC2 were a single corporation, there would be no net e&p from offsetting tested income and loss, and the total tax-free distributions would equal the combined tax bases in CFC1 and CFC2. As a result, if Section 301(c)(2) applies to the unreduced basis in CFC2, the effect is to increase the combined available tax-free distributions by the amount of the tested income and tested loss ($80 in this case) as compared to single entity treatment of CFC1 and CFC2. This is arguably an unjustifiable result.

Under this approach, S would recognize gain of $80, and the regular tax basis would be reduced to $0.[112]

On the other hand, it can be argued that the $80 should not be taxable to S. Unlike in the case of Section 165(g), which is often the final disposition of the stock, a Section 301(c)(2) distribution does not generally result in the final disposition of stock. Thus, CFC basis reduction rule can apply to the stock of CFC2 when it is sold. Moreover, there is not necessarily a double benefit from the tested loss just because the distribution exceeds the reduced basis in CFC2. The reduced basis is merely a protective measure to prevent a double benefit from arising, but this does not mean that a double benefit in fact arises every time such basis is used for some purpose by S (as discussed in Part IV.B.2(a)). For example, taxing the $80 to S could overstate the ultimate amount of duplicated benefit from the tested loss, since after the distribution, CFC2 might have offset tested income that reduces or eliminates the pre-distribution net used tested loss amount.

Furthermore, if only the reduced basis is taken into account and S had a different basis in different shares of stock of CFC2, S might have Section 301(c)(3) gain on the low-basis shares even before its aggregate reduced basis was fully recovered, since a distribution is treated as pro rata with respect to each share.[113] Regardless of the appropriateness of this pro rata rule in a typical situation involving different blocs of stock, the failure to allow full recovery of the reduced basis in this case seems inconsistent with the purpose of the CFC basis reduction rule. The result is obviously also worse than if S had sold its high basis shares, undercutting the analogy of a Section 301(c)(2) and (c)(3) distribution to a sale of a portion of the shares.

Moreover, to the extent that S should not be taxed on distributions before it would be taxed if CFC1 and CFC2 were divisions of a single corporation, S should not be taxed on distributions from CFC2 unless and until the total distributions by CFC1 and CFC2 of (1) non e&p amounts, and (2) e&p amounts eligible for Section 245A, exceed S's

[112] Under this approach, if the net used tested loss amount exceeded S's tax basis in the CFC2 stock, there would at that point in substance be a hypothetical negative basis for purposes of Section 301(c)(2). Then, any cash distribution would be fully taxable, but the potential gain from the hypothetical negative basis would remain unchanged rather than being triggered in full. Likewise, if S transfers stock in a CFC in a Section 351 transaction or reorganization transaction and receives back boot, under this approach, the boot should be taxable if, and only if, it would be taxable based on the reduced tax basis that S would have in the CFC under the CFC basis reduction rule, but any potential gain from the hypothetical negative basis should not otherwise be triggered.

[113] *Johnson v. United States*, 435 F.2d 1257 (4th Cir. 1971); *Illinois Tool Works Inc. v Comm'r*, T.C. Memo. 2018-121 (Aug. 6, 2018).

aggregate unreduced basis in CFC1 and CFC2. Yet it would be extremely burdensome to require this calculation to be made every time a distribution is made by CFC2, and further adjustments would be needed if the Section 301(c) distribution was made by CFC2 before the non e&p amounts were distributed by CFC1. Thus, this argument runs, it is reasonable to use the unreduced basis of CFC2 for purposes of Section 301(c)(2) and (c)(3), and apply the CFC basis reduction rule when the CFC2 stock is sold.

Under this approach, no gain would be recognized by S on the distribution of $100, and S's basis in CFC2 on a sale would be $0 (reflecting the original $100 minus the $100 distribution under Section 301(c)(2)) and there would be $80 of gain pursuant to the CFC basis reduction rule, reflecting the $80 used tested loss.

We do not take a position on which of these alternatives should be adopted in final regulations. However, whichever rule is adopted, we believe the same rule should apply to Section 1059 in determining whether gain would be recognized when the reduced basis (or the unreduced basis) would be reduced below $0 by that section.

(f) *Tax Free Dispositions of CFC Stock*

The Proposed Regulations do not purport to override the provisions of the Code for tax free transactions, even to the extent that the CFC basis reduction rule results in the equivalence of a negative basis. Rather, they preserve the net used tested loss amount whenever possible.

For example, suppose US1 transfers the stock of CFC1 to a foreign corporation F in exchange for stock in F, in a tax free transaction. Assume that CFC1 remains a CFC and US1 remains a U.S. shareholder of CFC1, regardless of the status of F. In that case:

- If F sells the stock of CFC1, the basis in CFC1 is reduced by US1's net used tested loss amount in CFC1,[114] and, if F is a CFC and US1 does not own 100% of F under Section 958(a), any resulting increase in Subpart F income of F is specially allocated to US1.[115]

- If US1 sells the F stock, F is a CFC, and US1 is a U.S. shareholder of F, then US1's net used tested loss amount in F is adjusted upwards or downwards to reflect US1's net used tested loss amount or net offset tested income amount in CFC1.[116]

[114] Prop. Reg. § 1.951A-6(e)(1)(i).

[115] Prop. Reg. § 1.951A-6(e)(7).

[116] Prop. Reg. § 1.951A-6(e)(1)(ii). In addition, although not affecting the gain or loss to US1, immediately before such basis adjustment, F's basis in CFC1 is reduced by US1's net used tested loss amount in CFC1. Prop. Reg. §§ 1.951A-6(e)(1)(i), (iv).

- If US1 sells the F stock but F is not a CFC, then F is treated as a CFC with no net used tested loss amount or offset tested income amount, and US1's basis in F is reduced by CFC1's net used tested loss amount.[117]

However, the Proposed Regulations do not by their terms trigger a basis reduction upon disposition of a CFC if, at that time, the U.S. shareholder with the net used tested loss amount in the CFC is no longer a Section 958(a) U.S. shareholder of the CFC, or if the CFC is no longer a CFC.

For example, suppose that US1 is a Section 958(a) U.S. shareholder of CFC1 and has a net used tested loss amount in CFC1. CFC1 issues additional stock to a third party and either ceases to be a CFC, or remains a CFC but US1 ceases to be a Section 958(a) U.S. shareholder owning 10% of CFC1. It appears that US1 can then sell the stock of CFC1 without any basis reduction.

Similarly, suppose that US1 is a Section 958(a) U.S. shareholder of CFC1, and transfers the stock of CFC1 to foreign corporation F that might or might not be a CFC. Suppose that CFC1 ceases to be a CFC, or it remains a CFC but US1 ceases to be a Section 958(a) U.S. shareholder of CFC1.[118] It appears that F can sell the stock of CFC1 without any basis adjustment for US1's former net used tested loss amount in CFC1. Alternatively, it appears that US1 can sell the stock of F without any adjustment for its former net used tested loss amount in CFC1. The same result would arise on a Section 332 liquidation of CFC1 into US1, where the tax basis of the stock of CFC1 disappears.

Regulations should clarify the results in these cases. Under FIRPTA and Section 367, gain is triggered before an asset leaves the taxing jurisdiction of the relevant Code sections. On the other hand, those results are based on clear Code provisions or clear grants of regulatory authority. The Code does not contain such a rule for the basis reduction amount of CFCs, nor is there a specific grant of regulatory authority for such a result.

Consequently, it appears that under the Proposed Regulations, a U.S. shareholder of a CFC can avoid the adverse consequences of a net used tested loss amount in a CFC by having the CFC issue new stock to an unrelated party and cause the U.S. shareholder to lose such status. However, if a net used tested loss amount can be eliminated using this or similar methods, considerable tax planning will be possible.

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[117] Prop. Reg. § 1.951A-6(e)(1)(iii). In addition, although not affecting the gain or loss to US1, immediately before such basis adjustment, F's basis in CFC1 is reduced by US1's net used tested loss amount in CFC1. *Id.*

[118] Treas. Reg. § 1.367(b)-4(b) would require US1 to include in income, as a deemed dividend, the Section 1248 amount with respect to CFC1 in these cases, although the dividend would presumably be eligible for Section 245A.

Regulations should also clarify the result where US1 has a net used tested loss amount in CFC1, and CFC1 transfers assets to newly formed CFC2 and spins off CFC2 to US1 in a transaction described in Section 368(a)(1)(D) and Section 355 (a "**divisive D reorganization**"). It is not clear whether the net used tested loss amount remains with CFC1 or is allocated between CFC1 and CFC2.

(g) *Section 381 Transactions*

The Proposed Regulations[119] apply if a U.S. shareholder US1 has a net used tested loss or offset tested income amount with respect to a CFC (the "**acquired CFC**") that is the distributor or transferor to another CFC (the "**acquiring CFC**") in a Section 381 transaction. Then, "the domestic corporation's net used tested loss amount or net offset tested income amount with respect to the acquiring CFC is increased by the amount of the net used tested loss amount or net offset tested income amount of the acquired CFC." This raises a number of questions.

First, the final regulations should clarify that the reference to "the domestic corporation" is to the U.S. shareholder of the acquired CFC.

Second, the formula in the Proposed Regulations assumes that the acquired CFC and the acquiring CFC both have a net offset tested income amount, or both have a net used tested loss amount. The formula does not contemplate that one of the CFCs might have a net offset tested income, and the other a net used tested loss. In that case, the two numbers should be netted to get an overall net used tested loss amount or overall net offset tested income amount.

Third, as discussed in Part IV.B.3(f) concerning exchanges of stock, the Proposed Regulations do not apply if the acquired CFC merges into a foreign corporation F that is not a CFC. Alternatively, if F is a CFC but US1 is not a U.S. shareholder of F, the Proposed Regulations literally treat US1 as having a net used tested loss amount or net offset tested income amount in F. However, there is no provision that would trigger a basis adjustment upon the disposition of the stock of F by a shareholder of F that is not a U.S. shareholder of F. If the intent of the Proposed Regulations is that the net used tested loss amount in F not be triggered in this case, the Proposed Regulations would be clearer if it only applied in the first place when the U.S. shareholder of the acquired CFC is a U.S. shareholder of the acquiring CFC immediately after the transfer.

We also observe that these rules are different than the rules for "hovering deficits" that apply to a CFC that is acquired in a Section 381 transaction.[120] However, hovering deficits relate to e&p deficits of the CFC itself, and separate tracking of pre-acquisition e&p deficits of the transferor CFC is possible. Those rules would not work

[119] Prop. Reg. § 1.951A-6(e)(5).

[120] Treas. Reg. § 1.367(b)-7(d)(2).

for a shareholder level concept such as combining the U.S. shareholder's net used tested loss amount in the acquired CFC with its net offset tested income amount in the acquiring CFC.

As a result, while the need for an additional set of rules is unfortunate, we see no alternative. We also note that these rules will likely lead to at least partially tax-motivated mergers designed to reduce or eliminate the basis reduction attributable to the net used tested loss amount of a CFC.

(h) *Special Allocation of Subpart F Income*

As noted above, a special rule (the "**special allocation rule**") applies if CFC1 sells stock in CFC2, a U.S. shareholder owns less than 100% of CFC1 under Section 958(a), and the basis in the stock of CFC2 is reduced because of a net used tested loss amount in CFC2 allocable to the shareholder. In that case, any increase in Subpart F income of CFC1 attributable to the increased gain on the CFC2 stock is allocated solely to the U.S. shareholder rather than pro rata among all shareholders of CFC1.

The special allocation rule is logical. If CFC1 has additional Subpart F income because of a basis reduction in its stock in CFC2 attributable to a particular U.S. shareholder (US1), it makes sense to allocate that Subpart F income solely to US1. Moreover, it makes sense for that rule to apply only when US1 owns less than 100% of CFC1 under Section 958(a). If US1 owns 100%, it would be allocated all the Subpart F income anyway and there would be no need for the special allocation rule.

We note, however, that while the rule specially allocates an increase in Subpart F income resulting from a shareholder's net used tested loss amount in CFC2, it does not specially allocate the effects of a reduced tax loss arising on the stock sale. This can shift the burden of a net used tested loss amount from the shareholder that is allocated that amount to other shareholders of CFC1.

For example, suppose that CFC1 is owned 50% by US1 and 50% by US2, CFC1 has a basis of $100 in the stock of CFC2, US1 has a net used tested loss amount of $70 in its indirect 50% interest in CFC2, US2 has no net used tested loss amount or offset tested income amount in its indirect 50% interest in CFC2, and CFC1 sells all the stock of CFC2 for $30.

It appears that the basis of CFC1 in CFC2 is reduced from $100 to $30, resulting in no gain or loss to CFC1 on the sale. Regulations should confirm that CFC1 has an overall gain or loss taking into account its own tax basis reduced by net offset tested losses from all its U.S. shareholders. Since there is no Subpart F income to reallocate, neither US1 nor US2 has any gain or loss. Yet if US1 did not have any net used tested loss amount, US1 and US2 would each benefit from $35 of CFC1's $70 loss on the stock sale (e.g., through a reduction in Section 951(a) inclusions from CFC1's gains on other sales of stock). In effect, US2 has borne the tax cost of 50% of the basis reduction attributable to the net used tested loss amount of US1. Regulations should confirm that this is the intent of the rule. The alternative would be to allocate the entire basis reduction to US1, resulting in US1 being attributed gain of $35 on the stock sale (possibly resulting in a Subpart F inclusion) and US2 being attributed a $35 loss on the stock sale (potentially offsetting $35 of other Subpart F income allocable to US2).

As a separate matter, we note that while the Proposed Regulations specially allocate additional Subpart F income arising from the net used tested loss amount of CFC2, there is no special allocation of exempt gain to shareholders of CFC1 on the basis of their share of the net offset tested income amount of CFC2. Such tested income would normally give rise to tax exempt e&p in CFC2, and as a result the corresponding gain to CFC1 on the sale of stock of CFC2 would be tax exempt income to the shareholders of CFC1.[121]

However, different shareholders of CFC1 may have used their own tested losses to offset different amounts of the tested income of CFC2, and so the tax exempt e&p in CFC2 may not be allocable pro rata to the different shareholders of CFC1 as an economic matter. We recognize the difficulty of specially allocating exempt gain to shareholders of CFC1. However, it seems anomalous that there is a special allocation of increased gain from net used tested losses of some shareholders, but no special allocation of exempt gain corresponding to net offset tested income allocable to other shareholders.

(i) *CFCs Held by Partnerships*

The Proposed Regulations apply the CFC basis reduction rule to Section 958(a) stock of a CFC held directly or indirectly by a domestic corporation. Section 958(a) stock is stock held by any U.S. shareholder, whether a corporation or not. The Proposed Regulations do not discuss the extent to which the CFC basis reduction rule applies to stock in a CFC held by a partnership that is a U.S. shareholder of the CFC. The ambiguity arises because the partnership, as a U.S. shareholder, is a holder of Section 958(a) stock, and a corporate partner of the partnership is indirectly holding that Section 958(a) stock through the partnership.

Final regulations should clarify this issue. We believe the following principles should apply:

First, as discussed in Part III.F.1(b), if a corporate partner of the partnership is a U.S. shareholder of the CFC, Proposed Regulation Section 1.951A-5 applies aggregate principles and requires the partner to determine its own GILTI calculations. As a result, the CFC basis reduction rule should apply to the partner, just as it would if the CFC stock were held directly by the partner. This should be true if the corporate partner sells the partnership interest, or the partnership sells the stock in the CFC. It would make no sense

[121] Sections 964(e)(1) and (e)(4).

to allow a corporate U.S. shareholder of a CFC to be able to avoid the CFC basis reduction rule by merely holding the stock in the CFC through a partnership.

Second, if an individual partner of the partnership is a U.S. shareholder of the CFC, Proposed Regulation Section 1.951A-5 applies aggregate principles and requires the partner to determine its own GILTI calculations. As a result, the CFC basis reduction rule should apply to the partner to the same extent as it would if the partner owned stock in the CFC directly. As discussed in Part IV.B.3(d), we believe that an individual that is a direct U.S. shareholder of a CFC should not incur a basis reduction, since an individual is not eligible for Section 245A on dividends form the CFC, and we believe the same is true for the individual U.S. shareholder holding the CFC through a partnership.

Third, consider the corporate and individual partners of a partnership that are not themselves U.S. shareholders of the CFC. Under Proposed Regulation Section 1.951A-5, the GILTI calculation is done entirely at the partnership level and the GILTI inclusion is allocated to such partners. It can be argued that absent the application of the CFC basis reduction rule, the partnership and these partners would obtain a double benefit from the tested loss of a CFC, since the tested loss reduces the GILTI inclusion and also allows the partnership to sell the stock in the CFC at a loss.

However, none of these partners is eligible for Section 245A if the CFC with offset tested income pays a dividend of its earnings. The reason is that Section 245A only applies to 10% corporate shareholders. As a result, the benefit of the used tested loss to shelter the offset tested income from tax is somewhat illusory. Tax will have to be paid on the income when it is distributed or the stock of the CFC with tested income is sold. Consequently, we believe that the CFC basis reduction rule should not apply to the partnership level calculation of GILTI inclusion for its partners that are not U.S. shareholders of the CFC. Likewise, the CFC basis reduction rule should not be relevant for such a partner selling its interest in the partnership.

(j) *Retroactivity of Basis Reduction Rule*

The CFC basis reduction rule applies even to losses that arose before the Proposed Regulations were published. As a result, taxpayers may have unexpectedly large gains on prior stock sales, and this rule could change before being finalized. Regulations should provide relief from estimated tax penalties for underpayments attributable to not properly applying the CFC basis reduction rule for dispositions of CFCs prior to 30 days after the rule is finalized.

C. Proposed Regulation Section 1.1502-51: Basis Reduction for CFC Stock Held in a Group

1. *Summary of Proposed Regulations*

Under Proposed Regulation Section 1.1502-51(c), the CFC basis reduction rule described in Part IV.B.1 applies in the usual manner to stock of a CFC that is owned by a member M of a consolidated group. In particular, the CFC basis reduction rule reduces the tax basis of stock in the CFC in the hands of M by M's net used tested loss amount in the stock.[122] However, as would be expected, a member's net used tested loss amount or offset tested income amount in a CFC is based on the allocation of tested loss to tested income among members as determined under the usual rules for allocating tested loss to tested income among members of a consolidated group.[123] See Part III.G.1.

To illustrate, in Example 20 in Part III.G.1, CFC1 (owned by M1) and CFC3 (owned by M2) each has tested income of $100 and offset tested income of $50, and CFC2 (owned by M1) has a used tested loss of $100. Thus, under the CFC basis reduction rule, M1's basis in CFC1 goes up by M1's GILTI inclusion of $50, M2's basis in CFC3 goes up by M2's GILTI inclusion of $50, CFC1 and CFC2 each has $50 of untaxed e&p that can be distributed under Section 245A, and M1's basis in CFC2 goes down by $100 when the CFC2 stock is sold.

2. *Comments*

(a) *Single Entity Principles*

The effect of applying the CFC basis reduction rule in this manner in the consolidated return context is to make the basis reduction in a CFC the same regardless of where in a group the particular CFC is located. Moreover, the total basis reduction is always the same as if a single corporation owned all the CFCs owned by various group members. Thus, this rule carries out the single entity concept of a consolidated group, and we applaud the result.

(b) *Effects of Sale of Member Stock*

Final regulations should clarify the effects of the CFC basis reduction rule upon and following a sale of the M stock, and examples should be provided.

> **Example 23**. *Consolidated P sells M stock.* Assume that P owns M, and M owns a CFC with a used tested loss of $100. Under "Rule 1" of the -32 Proposed Regulations, discussed in Part IV.D.1, P's basis in M is reduced currently by the net used tested loss amount in the CFC. P sells the stock of M. P's gain is increased (or P's loss is reduced) by $100 under Rule 1.

As discussed in Part IV.B.3(b), outside the consolidation context, the CFC basis reduction rule does not appear to reduce M's basis in the CFC by $100 at the time of the sale of M, but appears to continue to apply to M if M leaves the P group and then sells the CFC.

[122] Prop. Reg. § 1.1502-51(c)(1).

[123] Prop. Reg. §§ 1.1502-51(c)(2), (c)(3).

Assuming this is correct, final regulations should clarify whether the same rules apply under -51(c)(1) when M was a member of the P group when the net used tested loss amount in the CFC arose, and M later leaves the P group and sells the CFC. If so, M retains its net used tested loss amount in the CFC when M leaves the group, and the CFC basis reduction rule will apply to M upon its later sale of the CFC stock.

As a technical matter, -51(c)(1) incorporates by reference the CFC basis reduction rule that applies outside the consolidated return context. Moreover, tax basis in the CFC is an attribute of M rather than the P group, and nothing in the Proposed Regulations states that the potential basis reduction is turned off when M leaves the group in which the net used tested loss amount arose.

In addition, as a policy matter, we believe that M's basis in the CFC should be treated the same after the purchase of M regardless of whether the net used tested loss amount in the CFC arose while M was a member of another group (or a nonmember of any group). It would be administratively complex and cause considerable confusion if M's tax basis in the CFC after the purchase of M depended upon whether M had previously been a member of a group (any group) when the net used tested loss amount arose.

Arguably there is less reason to apply the CFC basis reduction rule to M if the net used tested loss amount arose while M was a member of a prior group, since in that case the basis of the M stock to group members would have been reduced (and the gain on the sale of the M stock by group members increased) under Proposed Regulation Section 1.1502-32(b)(3)(iii)(C) (discussed as "Rule 1" in Part IV.D.1). However, under that rationale, the further distinction would have to be made to continue to apply the CFC basis reduction rule to M if M had been the parent of a group, since the -32 basis reduction would not apply to stock in a parent corporation and so there would not have been increased gain on the sale of the M stock.

On the other hand, as a technical matter, "tested loss amount" and "net used tested loss amount" are defined as the stated amounts "with respect to a member." Arguably, when the "member" ceases to be a "member" of the group in which the net used tested loss amount arose, its net used tested loss amount while it was in the group ceases to exist. Under this reading, the treatment of the basis of the CFC in the hands of the buyer of M would depend upon whether M had been a member of a group when the net used tested loss amount arose (without regard to whether M was the parent of the group, if the old group terminated upon the purchase of M).

As an economic matter, when M is a subsidiary in a consolidated group, there is less reason for the net used tested loss amount to carry over after M leaves the P group than if M is not a group member. In the former case, but not the latter, P's basis in M is reduced by the net used tested loss amount in the CFC under Rule 1 (discussed in Part IV.D.1). As a result, P has an increased gain on the sale of the M stock that does not exist in the nonconsolidated case. As a result, while the tested loss was used to offset tested income in the group, the basis reduction in the M stock avoids the creation of a second benefit to the group from the tested loss.

On the other hand, even in the case of a consolidated seller, the failure to reduce the basis of the CFC on its sale by M after M leaves the P group would result in an overall double benefit from the tested loss, once in the P group and once outside the P group. The P group would get a benefit from the offset of tested income, with Rule 1 denying the second benefit of loss on the sale of M, but M (and any group buying the stock of M) would get a benefit of the unreduced basis if M sold the CFC stock after leaving the P group.

An analogous situation would be the case where, instead of M owning a CFC with a tested loss of $100 that offset other group tested income of $100, M owned a U.S. group member M2 that had a current loss of $100 that offset other group tested income of $100. When that loss was used to offset the tested income, M's basis in M2 would be reduced by $100 under the existing -32 regulations, and this basis reduction would tier up to reduce P's basis in M. When P sold the stock of M, there would be additional gain of $100. Nevertheless, in the hands of the buyer of M, M's basis in M2 would retain its reduced basis and would not "snap back" when M left the P group. Based on this analogy, it would be logical for the basis reduction in -51(c)(1) to continue to apply to M after it leaves the P group.

Moreover, if -51(c)(1) provided for an immediate reduction in the basis of the CFC at the time M received the benefit of a net used tested loss amount, there is no doubt that the resulting reduced basis in the CFC would continue with M after M left the P group. It would be odd if the deferral of the reduction in basis until the sale of the CFC were to result in no basis reduction at all if the sale occurred after M left the P group, when the deferral was intended as a mere timing benefit.

On balance, therefore, we believe final regulations should retain the basis reduction rule upon the disposition of the CFC after M leaves the P group.

If final regulations adopt this approach, they should also clarify whether, if M joins a new group, the basis reduction of the CFC in the new group tiers up under -32 to members within the group. This basis reduction should not tier up in the P group because the resulting basis reduction would duplicate the Rule 1 basis reduction in the stock of M.[124] No such duplication exists in the buying group.

However, the buying group would have paid fair market value for the M stock, M's basis in the CFC would decrease on the sale of the CFC by the used tested loss amount, and M's gain would increase (or loss would decrease) by the same amount. M's gain or loss would tier up to its shareholder (New P) under the usual rules. If New P's basis in M was increased by the additional gain (or reduced loss) recognized by M as a

[124] Treas. Reg. § 1.1502-32(a)(2) prohibits duplicative adjustments to the stock of a member.

result of the reduction in basis in the CFC stock, but was not decreased by the basis reduction itself, New P would have a net increase in tax basis in M without any corresponding economic profit.[125] As a result, the reduction in CFC basis to M at the time of sale of the CFC should tier up to New P.

(c) *Taxable Intra-Group Dispositions of a CFC*

Regulations should clarify the results when stock of a CFC is sold from one member of the group to another member of the group, or distributed in a taxable transaction to another member. An example in the final regulations would be helpful.

> **Example 24**. *Intra-group sale of CFC*. P owns M1, and M1 has a CFC with a $100 net used tested loss amount. Under -32, P's basis in M1 has been reduced by $100, and M1's basis in the CFC will be reduced by $100 upon its disposition of the CFC. M1 sells the CFC to M2. Assume the CFC has no untaxed e&p, so there is no Section 1248 issue.

Presumably the M1 basis in the CFC is reduced by the net used tested loss amount, even though the sale is to another group member, but this should be clarified. If this is correct, M1's gain is increased, and the gain is deferred under the -13 consolidated return regulations. Regulations should clarify that the gain to M1 is deferred even if the gain is due to the used tested loss amount being greater than M1's basis in the CFC. The uncertainty arises because, strictly speaking, that gain arises on the basis reduction rather than on M1's sale of the CFC. However, the CFC basis reduction rule treats this gain as additional gain on the sale of the stock of the CFC, and this result is necessary in order for the consolidated group to be treated as a single entity. Moreover, the intercompany transaction rules apply to items that arise "directly or indirectly" from an intercompany transaction.[126]

In addition, final regulations should clarify that M2 does not inherit the net used tested loss amount in the CFC in the hands of M1. The basis in the CFC has already been reduced by that amount in the hands of M1 and has increased M1's gain on the sale to M2.

(d) *Special Allocation of Subpart F income*

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[125] For example, assume New P buys M for $100, and M's only asset is CFC1 with a value of $100 and net used tested loss amount of $100. If M immediately sells the CFC1 stock for $100, it will have gain of $100. If the gain, but not the basis reduction, tiers up to New P, P will have a basis of $200 in M even though M has a value of $100. Likewise, if the value of CFC1 declines and M sells the CFC1 stock for $0, M will have no gain or loss. If the basis reduction does not tier up to New P, New P will have a basis of $100 in stock of M that is worth $0. In both cases, the effect of the CFC basis reduction rule would be negated if the amount of the CFC basis reduction did not tier up.

[126] Treas. Reg. § 1.1502-13(b)(2)(i).

Under the Proposed Regulations, for purposes of determining the application of the special allocation rule described in Part IV.B.3(h) to a consolidated group, the amount of stock considered to be owned by a member of a group within the meaning of Section 958(a) includes any stock the member is deemed to own under Section 958(b) (the "**consolidation modification**").[127]

The consolidation modification raises significant questions. First, final regulations should confirm that the consolidation modification relates only to determining the applicability of the special allocation rule. That is, it only applies to the "on/off" switch in the special allocation rule that applies the rule only when the shareholder with the net used tested loss amount (the "**responsible shareholder**") owns less than 100% of the stock in CFC1 under Section 958(a).

For example, if the responsible shareholder owns 50% of CFC1 under Section 958(a), and 50% under 958(b), then it is clear that the special allocation rule does not apply and the Subpart F income of CFC1 is allocated pro rata to all Section 958(a) shareholders. Moreover, if the responsible shareholder owns 50% of CFC1 under Section 958(a) and 40% under Section 958(b), it is clear that the special allocation rule applies. Once it applies, the consolidation modification should be irrelevant, and the Subpart F income of CFC1 should be specially allocated to stock owned under Section 958(a) by the responsible shareholder, not stock owned under Section 958(b) by that shareholder. The latter category might even include stock directly held by non-group members, such as by an individual owner of the parent of the group, yet it would not include stock held under Section 958(a) by third parties where the responsible shareholder was not a Section 958(b) owner. These distinctions would defeat the purpose of the special allocation rule and would be quite illogical.

Second, the purpose of the 100% trigger for the consolidation modification is unclear. If the group as a whole owns 100% of CFC1 under Section 958(a) and thus the responsible member owns 100% under Sections 958(a) and (b), there is no special allocation of the additional Subpart F income to the responsible member. Then, when CFC1 sells CFC2, all members of the group that own CFC1 immediately before the sale are allocated proportionately, based on their ownership of CFC1, the Subpart F income of CFC1 attributable to the responsible member's net used tested loss amount in CFC2. In fact, multiple members might be responsible members, with the result that the aggregate net used tested loss amount of the group in CFC2 is allocated to all the members in proportion to their Section 958(a) ownership in CFC1.

This approach is consistent with the rule that allocates tested losses of a tested loss CFC proportionately to all members with tested income, without a priority allocation to a shareholder of the CFC that has tested income. However, this approach is inconsistent with the fact that when multiple members own a first tier CFC, and they all sell their stock in the CFC, the net used tested loss amount attributable to each member

[127] Prop. Reg. § 1.1502-51(c)(4).

increases the gain of the member itself and is not allocated pro rata to all members holding stock in the CFC.

Moreover, if a pro rata allocation of the additional Subpart F income among group members owning CFC1 is appropriate when the group owns 100% of CFC1 under Section 958(a) and (b), it seems equally appropriate when the group owns less than 100% of CFC1. The existence of non-group interests in CFC1 should not affect the methodology for the members to share their own aggregate net used tested loss amounts among themselves. In fact, the 100% ownership requirement for turning off the special allocation rule makes that rule elective. If the group owns 100% of CFC1 but desires the special allocation rule to apply, it can have CFC1 issue one share of its stock (perhaps nonvoting preferred stock) to an unrelated third party.

The 100% ownership requirement to turn off the special allocation rule also creates an undesirable cliff effect. If the responsible member has 99.9% Section 958 ownership in CFC1, the increased Subpart F income attributable to that member is allocated entirely to that member. The rule changes dramatically if the member reaches 100% ownership. The rule can also be a trap for the unwary. A third party that is unexpectedly determined to own one share of CFC1 (even debt treated as preferred stock for tax purposes) can cause the special allocation rule to apply when it was not expected to.

Third, it is not logical for the 100% ownership test under the consolidation modification to count stock held outside the group towards the requisite 100% ownership. Suppose the members together own 50% of the stock of CFC1 and the individual owner of the parent corporation owns the other 50%. On the sale of CFC2, the consolidation exception applies, so the individual is allocated 50% of the Subpart F income from all the members' net used tested loss amounts. This is so despite the fact that the group members obtained all the benefit of those tested losses.

Moreover, if the individual shareholder owned 49% instead of 50% of CFC1, and an unrelated party held the other 1%, the special allocation rule would apply and all the additional Subpart F income would be allocated solely to the responsible members. There is no logical reason that the allocation of Subpart F income to the responsible members should depend upon the level of ownership of a non-group member, or why there should be such a benefit to the non-group member from selling one share of stock of CFC1 to an unrelated third party.

Fourth, by counting stock held outside the group, the consolidation exception treats a shareholder of a CFC that is a member of a consolidated group differently than a shareholder of a CFC that is not a member of a group. If a U.S. shareholder owns less than 100% of CFC1 under Section 958(a), but constructively owns all the remaining stock under Section 958(b), the special allocation rule will apply if the U.S. shareholder is not a member of a consolidated group, but will not apply if the U.S. shareholder is a member of a consolidated group.

For example, suppose US1 owns 50% of CFC1 under Section 958(a), and 50% of CFC1 under Section 958(b) through an individual shareholder of US1. If US1 is not a member of a group, the special allocation rule applies and there is a special allocation of 100% of the additional Subpart F income to US1. If US1 is a member of a group, even though no other member of the group owns any stock in CFC1, the consolidation exception applies, and there is a 50/50 allocation of the Subpart F income to US1 and to the individual shareholder of the CFC. This result is inconsistent with treating the group in the same manner as a single corporation, and the results seem quite illogical.

Fifth, the consolidation modification is presumably intended, at a minimum, to cause the special allocation rule not to apply if all the stock of CFC1 is held by group members. However, this result will not always be achieved, because the group member with the net used tested loss amount in CFC2 may not own, under Section 958(b), all the stock in CFC1 held by other group members. The reason is that the Section 1504(b)(4) disregards straight nonvoting preferred stock for purposes of the 80% vote and value test for consolidation, but the Section 318 attribution rules, incorporated by reference (with modifications) by Section 958(b), are based solely on the value of stock without any such exclusion for preferred stock.

For example, if M1 owns stock in CFC1, and more than half the value of M1 is in the form of preferred stock held outside the group, M1 will not own under Section 318(a)(2)(C), and therefore under Section 958(b), any stock in CFC1 owned by any other group member. As a result, to achieve single entity principles for the group, any test for the consolidation modification should be based on all CFC1 stock held by group members, without regard to Section 958(b).

Based on the foregoing, we believe that the consolidation modification should be either eliminated or substantially revised. If it is retained, its purpose should be stated in the preamble to the final regulations. We also believe that if it is retained, it should provide that any time the special allocation rule would apply to one or more members of a group, the total Subpart F income specially allocable to particular members under that rule will instead be allocated pro rata to group members based on their relative ownership in CFC1. However, even that rule, while logical on a stand-alone basis, is inconsistent with the result that arises when multiple members of a group own stock in a CFC and sell that stock simultaneously.

D. Proposed Regulation Section 1.1502-32: Upper Tier Basis Adjustments

1. *Summary of Proposed Regulations*

As background, if a member of a consolidated group has a subsidiary that is also a group member, the -32 consolidated return regulations generally adjust the basis of the member in the stock of the consolidated subsidiary to reflect income and loss of the subsidiary (and lower tier subsidiaries). For example, if P owns M and M has taxable income or loss, P’s basis in M increases or decreases, respectively, by M’s income or loss. If M has income, this avoids a second tax on the income if P sells the stock of M. If

M has a loss, this avoids the taxpayer receiving a second deduction for the loss when P sells the stock of M.

If M has tax exempt income (such as a dividend from a CFC exempt under Section 245A, or a domestic dividend entitled to the dividends received deduction), P's basis in M generally increases in the amount of the exempt income, to retain the exemption upon P's sale of the stock of M. Likewise, if M has a noncapital, nondeductible expense (e.g., a nondeductible fine or penalty), P's basis in M decreases by such amount to prevent the deduction in effect being allowed when P sells the stock of M.

The proposed amendments to the -32 regulations contain three new rules for adjustments to P's basis in the stock of M, to reflect M's ownership of stock in a CFC:

1. M has a noncapital, nondeductible expense (i.e., P's stock basis in M is reduced) for the net used tested loss amount of M's CFCs at the time the net used tested loss arises.[128] This rule is referred to herein as "**Rule 1**".

> **Example 25**. *Rule 1*. P owns M1 and M2, M1 owns CFC1 with $100 of tested loss, and M2 owns CFC2 with $100 of tested income. There is no GILTI inclusion. M1 has $100 of used tested loss. Under the CFC basis reduction rule, M1's basis in CFC1 goes down by $100 when M1 sells the CFC1 stock. But under Rule 1, P's basis in M1 goes down by $100 immediately.

Under this rule, so long as M1 continues to own the stock in CFC1, there is a mismatch between the lower outside basis of P in the M1 stock, and of the higher inside basis of M1 in the CFC1 stock. This mismatch is very unusual in the consolidated return context, since the -32 regulations are generally designed to cause a match between inside asset basis of M and the outside basis in the stock of M (except for purchased basis in M stock). The mismatch in the group ends when either P disposes of the M1 stock (in which case there is no longer a mismatch within the group) or when M1 disposes of the stock of CFC1 (in which case the basis in CFC1 goes down immediately before the disposition under the CFC basis reduction rule.

2. M has tax-exempt income (i.e., P's stock basis in M is increased) in the amount of M's offset tested income amount for a particular CFC, but the aggregate of such increases in basis cannot exceed the aggregate of the decreases in basis under Rule 1 for the used tested losses of the same CFC.[129] This rule is referred to herein as "**Rule 2**."

> **Example 26.** *Rule 2*. P owns M, which owns CFC1. In year 1, CFC1 has used tested loss of $100, and under Rule 1, P's basis in M goes down by

[128] Prop. Reg. § 1.1502-32(b)(3)(iii)(C).

[129] Prop. Reg. § 1.1502-32(b)(3)(ii)(E).

> $100 (although M's basis in CFC1 only goes down by $100 when CFC1 is sold). In year 2, CFC1 has offset tested income of $150. Under Rule 2, P's basis in M goes up by $100, the offset tested income not in excess of the prior basis reductions under Rule 1. Alternatively, if CFC1 had the offset tested income in year 1 and used tested loss in year 2, there would be no positive basis adjustment under Rule 2 in year 1 (because of the cap on positive adjustments) and no negative adjustment under Rule 1 in year 2 (because at that point there is no cumulative net offset tested loss).

3. M has tax-exempt income (i.e., stock basis in M is increased) immediately before the disposition of M stock by a group member to the extent that a CFC of M has net offset tested income that could be distributed to M immediately before the disposition and that would be eligible for Section 245A (and not subject to Section 1059).[130] This rule is referred to herein as "**Rule 3**".

The basis increase under Rule 3 is the basis increase that P would have in the M stock under the existing -32 regulations if the CFC had hypothetically distributed the stated amount to M. The theory for Rule 3 appears to be that P should be able to achieve the same increase in basis in the M stock (and reduced taxable gain) without the need for an actual distribution by the CFC to M.[131]

Note that unlike Rule 2, the basis increase in the M stock with respect to a CFC can exceed prior negative adjustments with respect to the same CFC. For example, a basis increase can apply even if the CFC has had offset tested income but has never had a used tested loss.

2. *Comments*

(a) *Rule 1 and the Timing for Basis Reduction*

As noted in the discussion of Rule 1 above, that rule creates a mismatch between P's basis in M1 and M1's basis in CFC1 until the sale of CFC1. The Preamble asks for comments on whether the timing of the outside basis adjustments in M1 stock under Rule 1 should be conformed to the timing of the inside basis adjustments in the CFC1 stock under the CFC basis reduction rule. This concept is referred to herein as "**modified Rule 1**". Of course, the basis reduction in modified Rule 1 is necessary to prevent the P group from obtaining a second benefit from the used tested loss of CFC1 at the time of the sale of the M stock, to conform the result to the denial of the second benefit under the CFC

[130] Prop. Reg. § 1.1502-32(b)(3)(ii)(F).

[131] The same rationale would support applying Rule 3 to tested income of a CFC that is not taxed to the U.S. shareholder because of QBAI (or income such as high-taxed Subpart F income that is neither Subpart F income nor tested income). There is no GILTI inclusion, and a distribution to M of such income would be eligible for Section 245A and would increase P's basis in M. Consideration should be given to extending Rule 3 to these cases.

basis reduction rule. As a result, the only difference in tax result between Rule 1 and modified Rule 1 is when P's basis in M is relevant before a sale of M.

We discuss in Part IV.B.3(c) in the context of the CFC basis reduction rule our view that for the purposes of several Code sections such as Section 382, M's basis in the CFC should be treated as reduced immediately because this better reflects the economics of M holding the stock in the CFC. Likewise, we discuss in Part IV.D.2 our view that the same should be true for certain purposes of the -36 consolidated return regulation. Since the purpose of modified Rule 1 is to achieve parity in the inside and outside basis of M, we believe that if modified Rule 1 is adopted, it should reduce P's basis in M immediately for purposes of the same Code provisions for which the CFC basis reduction rule would reduce M's basis in the CFC immediately.

If this approach is adopted, the difference between Rule 1 and modified Rule 1 would be the default rule that would apply in the absence of a specific rule reducing basis under modified Rule 1 (and under the CFC basis reduction rule itself) for purposes of applying a particular Code section. The default rule would be a reduced basis under Rule 1 and an unreduced basis under modified Rule 1. The scope of the default rule might be significant, since it would be impossible (and an inefficient use of resources) for the Treasury to attempt to identify all Code sections for which P's basis in M is relevant.

As noted above, we are aware of several Code sections where we believe that P's basis in M (and M's basis in the CFC) should be treated as reduced immediately. In fact, except in cases involving spinoffs where basis must be allocated, we are not aware of any Code sections where we believe that P should be treated as having an unreduced basis in M during the period before P sells the M stock. This reason for the latter statement is that references to tax basis in the Code are by definition references to the calculation of gain or loss that would arise on a sale of the underlying asset. Of course, the same is true for M's basis in the CFC, but as noted in the Preamble, there are significant problems with an immediate reduction in basis for all purposes outside the consolidated return context.

If modified Rule 1 were to be adopted, it would cause P to have an unreduced basis in M for purposes of all Code provisions unless the modified rule created a specific exception. However, we believe it would not be practicable to identify all cases where an exception would be appropriate. Moreover, as noted above, except in situations involving spinoffs, we are not aware of any Code sections for whose purpose an unreduced basis in M would be appropriate.

Finally, the immediate basis reduction in Rule 1 does not trigger immediate gain in a consolidated group even if the amount of the reduction exceeds P's basis in M. Rather, the excess reduction creates an excess loss account in the M stock that is generally taxed on the disposition of that stock. This is in contrast to the gain that could be triggered on a reduction in basis in the stock of a nonconsolidated subsidiary in excess of the initial tax basis.

As a result, we support the approach of the Proposed Regulations (Rule 1) rather than modified Rule 1. The latter rule would require exceptions, and any list of exceptions would likely not be complete.

(b) *Rule 1 Conformity to Basis Reduction Rule*

Rule 1 reduces P's basis in M by the net used tested loss amount that M has in a CFC. We suggest above that the CFC basis reduction rule should not apply in certain circumstances where the group has not achieved a double benefit from the used tested loss of the CFC. If final regulations create any exceptions to the deferred basis reduction under the CFC basis reduction rule, the same exceptions should apply to the immediate basis reduction provided in Rule 1.

As a policy matter, there is no justification to apply Rule 1 if the CFC basis reduction rule does not apply because the group has been determined not to have realized a double benefit from the used tested loss. For example, if the used tested loss has provided no benefit because of QBAI in the CFC with tested income, the group should be entitled to achieve a single benefit from the tested loss, either on the sale of the CFC with tested loss (as discussed in Part IV.B.2(a)), or on the sale of the stock of the member owning the CFC.

(c) *Rule 2 and Section 245A Dividend Payments*

Final regulations should modify Rule 2 to take account of Section 245A dividend payments made by the CFC in question.

> **Example 27**. *Rule 2 with Section 245A dividend*. Assume CFC1 has $100 of used tested loss in year 1 and $100 of offset tested income in year 2. P's basis in M decreases by $100 in year 1 under Rule 1, and increases by $100 in year 2 under Rule 2. Suppose that in addition, CFC1 pays a Section 245A dividend in year 2 out of its offset tested income (which generated current e&p to M).

The dividend in year 2 should create tax exempt income in M and increase P's basis in M.[132] The result is a duplicative increase in P's basis in M in year 2, once under Rule 2 because of the offset tested income in year 2, and again under existing -32 because of the dividend of that offset tested income. The final regulations should eliminate this duplication. Logically, all offset tested income would still count against the "cap" for basis increases under Rule 2. However, a basis increase under Rule 2 should not occur if it would result in duplication with basis increases from prior Section 245A distributions of the related tested income.

[132] We ask for clarification of this point in the Section 245A Report at 40.

We note that the issue raised by Example 27 does not arise from the fact that the dividend paid in year 2 is a nimble dividend, i.e., where the dividend is paid out of current earnings even though the accumulated earnings are negative or zero. The same issue would arise if the offset tested income and dividend were in year 1, and the used tested loss was in year 2. In that case, at least absent the dividend, there would be no basis adjustment under Rule 1 or Rule 2 in either year 1 or year 2. As in Example 27, the effect is that the dividend first increases P's basis in M in year 1, and the same earnings in year 1 then prevent a decrease in basis in year 2 that would otherwise arise from the year 2 tested loss.

We also note that, assuming conformity between e&p and tested income, a Section 245A dividend can result in a basis increase that is duplicative of a Rule 2 basis increase only if the dividend is paid by the CFC in the year the offset tested income arises, or in a later year before the year of the tested loss. Once the year with the tested income and the year with the tested loss have both passed, the tested income of the CFC in one year and the tested loss of the CFC in the other year will generally result in no net e&p and no ability to pay a Section 245A dividend out of the tested income. As a result, the rule proposed above would not in practice require a look-back period to determine whether Rule 2 and a Section 245A dividend had resulted in a duplicative basis increase.

It should also be noted that Rule 3 avoids this duplication issue for Section 245A dividends. It provides for a basis increase in M only for distributions that would be eligible for Section 245A. If earnings are actually distributed and are eligible for Section 245A, this reduces the remaining earnings that could be so eligible, and so the basis increase under Rule 3 is automatically decreased by the amount of the dividend.

(d) *Rule 2 and the "Same CFC" Limitation*

As noted above, Rule 2 allows an offset to the basis reduction for the net used tested loss amount of a CFC only on account of offset tested income of the same CFC. We have considered whether the offset should be expanded to apply to offset tested income of other CFCs owned by the same U.S. shareholder.

> **Example 28**. *Rule 2 and netting*. Suppose M owns CFC1 with $100 of tested income and CFC2 with $100 of tested loss. P's basis in M is reduced by $100 under Rule 1 because of the used tested loss in CFC2, without offset for the offset tested income in CFC1. There is no increase in the basis in M under Rule 2 on account of CFC1, because no net positive adjustments for a particular CFC are allowed under that rule.

If an offset was allowed, there would be no reduction in P's basis in M in that year. This would reduce the taxpayer-unfavorable mismatch that arises when the basis in M is reduced for used tested losses of one of its CFCs notwithstanding the existence of offset tested income in another of its CFCs.

On the other hand, the lack of netting in Rule 2 is in many cases not disadvantageous to the taxpayer. In the example, if M sells the stock of CFC1 and CFC2, M has no gain on the sale of CFC1 because of Sections 1248 and 245A, and M has no loss on the sale of CFC2 because of the CFC basis reduction rule. If P sells the stock of M, the same result would arise under netting, but it would also arise under the existing Proposed Regulations. P's basis had initially been decreased by $100 under Rule 1 on account of CFC2, but immediately before the sale of M, it would be increased by $100 under Rule 3 on account of CFC1.

Moreover, the lack of netting in the Proposed Regulations has the significant advantage of making irrelevant the location of different CFCs within the consolidated group for purposes of making the adjustments under -32. With netting, the overall tax basis in the group can be significantly higher if the same member own CFCs with both offset tested income and used tested loss. This is true notwithstanding the pro rata allocation of tested losses among members with tested income in the Proposed Regulations. In Example 28, netting would result in no basis decrease in the M stock, but if CFC1 and CFC2 were held by M1 and M2, respectively, there would be a basis decrease in the M2 stock and no adjustment in the M1 stock.

In addition, if netting was allowed, the effect is an increase in basis to reflect the offset tested income of CFC1 and a decrease in basis to reflect the used tested loss of CFC2. This would increase the complexity of Rule 2 and Rule 3, since if offset tested income of CFC1 arising from a tested loss in CFC2 is deemed to give rise to a basis increase in M, it cannot give rise to another basis increase under Rule 2 or Rule 3. For example, since Rule 3 is based on M's net offset tested income amount in the CFC being sold, this would depend not only on prior tested income and losses of the same CFC (as under the Proposed Regulations), but on tested income and losses of all other CFCs owned by M.

Netting would also require the adoption of prioritization rules for purposes of the CFC basis reduction rule. For example, suppose that in year 1, CFC1 had used tested loss of $100 and in year 2, CFC1 had tested income of $100 and CFC2 had tested loss of $100. Under Rule 1, there would be a basis reduction in M of $100 in year 1, and no basis increase or decrease in year 2. The issue would be whether, for purposes of the CFC basis reduction rule, the CFC1 tested income in year 2 is "matched" with the CFC1 tested loss in year 1 (reducing M's net used tested loss amount in CFC1) or whether it is matched with the CFC2 tested loss in year 2 (reducing M's net used tested loss amount in CFC2).

As a result, netting would not avoid the need to trace of the separate offset tested income and used tested loss amounts of all the CFCs owned by the particular U.S. shareholder. It would not promote simplification, and in fact would likely increase the complexity of the already-complex basis regime adopted in the Proposed Regulations.

On balance, we believe the most important factor is that the location of a CFC within the group should not matter, consistent with the other results in the Proposed Regulations. As a result, we support the lack of netting in Rule 2.

(e) *Rule 3 Following a Sale of M Stock*

The final regulations should clarify several aspects of Rule 3 that arise in connection with the sale of the M stock.

> **Example 29**. *Rule 3 upon sale of M stock.* M owns CFC1 with $100 of offset tested income and e&p. Assume Section 245A would apply, and Section 1059 would not apply, to a dividend of such income. The stock of M is sold, and under Rule 3, P's basis in M is increased by $100.

P gets the benefit of this basis increase on the sale of M, just as it would if CFC1 had paid a $100 Section 245A dividend before the sale, or if M had sold CFC1 and recognized $100 of Section 1248 gain eligible for Section 245A.

Assume now that the buyer (Buyer) of the stock of M is a member of a different consolidated group, the "Buyer group." Immediately before and after the purchase, M holds stock in CFC1, and immediately before the purchase, CFC1 had $100 of net offset tested income. Regulations should clarify whether the attribute of net offset tested income continues to reside with M after its purchase by Buyer, so that immediately before Buyer sells M in the Buyer group, Buyer's basis in M is increased by the amount of net offset tested income that arose in the P group.

This question on its face is similar to the question discussed in Part IV.C.2(b) of whether the net used tested loss amount of a CFC should carry over into a new group under Rule 1 to increase the gain when the CFC is sold. However, the considerations here are very different.

On the one hand, if CFC1 paid a dividend of the net offset tested income amount to M in the Buyer group, Buyer would increase its basis in the M stock by the same amount. To the extent the purpose of Rule 3 is to make such a dividend unnecessary, Rule 3 should apply to increase the basis of the Buyer's stock in M. To be sure, this might cause Buyer's basis in M to exceed its fair market value, since the cost basis is the fair market value of the M stock and this basis would be increased by the then-existing net offset tested income amount of CFC1. However, the -36 consolidated return regulations will potentially disallow any noneconomic or duplicated loss arising from this basis increase.

On the other hand, the P group got the benefit of Rule 3, and the purchase price for M already reflects the existing undistributed earnings in CFC1. Allowing a basis increase each time a new buyer acquires the M stock could result in an unlimited number of basis increases in the M stock in the hands of each buyer. While Treasury Regulation Section 1.1502-36(c) would generally disallow a loss to the buyer on the sale of the M stock to the extent the loss arose from this basis increase, the basis increase could still shelter post-sale appreciation in the M stock. This would be an ironic result for a rule designed to put P in the same position as if CFC1 had paid out all its earnings in the P group. After all, a CFC can only pay out the same earnings once, and a single amount of earnings of $100 cannot justify an unlimited number of $100 basis increases through the successive applications of Rule 3.

As a result, we recommend that the final regulations make clear that the basis increase in Rule 3 only applies to the consolidated group in which the net offset tested income amount arises.

Even this rule, though, would not be sufficient. In Example 29, P's basis in M is increased by $100 to reflect the fact that CFC1 could have paid a tax-free dividend of $100 before the sale. However, this is not treated as a real dividend and, in particular, does not reduce the e&p of CFC1. As a result, if P2 was the parent of another consolidated group and bought the M stock, CFC1 could pay an *actual* dividend of the same $100 to M after the purchase by P2. This would be tax-free to M under Section 245A and increase the basis of P2 in M. The double increase in tax basis would be unjustified for the reasons discussed in the second preceding paragraph.

Moreover, Treasury Regulation Section 1.1502-36(c) would not have any effect in this case. There would be no "disconformity amount" under that regulation as a result of the dividend because P2's increased basis in M from the dividend would match M's increase in inside tax basis from the receipt of the cash dividend. One possible way to avoid this result would be an amendment to the -32 regulations to prevent the tiering up of dividend income from a CFC if the dividend is paid from e&p that had resulted in a prior basis increase in a different group under Rule 3. Such a rule would, however, require a buyer of the stock of M to know the history of the Rule 3 basis increases in the selling group, and the rule would frequently cause buyers in acquisition transactions to require representations and/or indemnities from sellers concerning such basis increases in the selling group.

(f) *Sale of M Stock in Middle of Year*

We believe that final regulations should further clarify and illustrate certain aspects of the sale of stock of M in the middle of a tax year.

> **Example 30**. *Rule 3: Sale of stock mid-year*. P owns M, which owns CFC1. CFC1 has no attributes from prior years, but has $100 of tested income in 2019. P sells M to unrelated Buyer on June 30, 2019. M remains the sole shareholder of CFC1 for all of 2019, so CFC1 remains a CFC for all of 2019. All parties have a calendar year tax year.

First, since CFC1 remains a CFC through the end of 2019, and the tax year of M ends when it leaves the P group, we believe that the U.S. shareholder inclusion year is the tax year of the Buyer group that includes December 31, 2019. Assume first that the

Buyer group has no other CFCs. Then, the Buyer group has a GILTI inclusion of $100 for 2019, there is no offset tested income to M from CFC1 for any part of 2019, and Rule 3 has no application to the P group during 2019. Regulations should illustrate these conclusions.

Second, assume that for 2019, the Buyer group has $100 of tested income from CFC1 and $100 of tested loss from another of its CFCs. It therefore has no GILTI inclusion for 2019, and CFC1 has untaxed e&p of $100 for calendar year 2019. Rule 3 assumes a hypothetical distribution to M of the net offset tested income amount of the CFC allocable to the transferred shares immediately before the sale of the M stock, to the extent a dividend of such amount would be eligible for Section 245A.

A shareholder that is not a U.S. shareholder of the CFC on the U.S. shareholder inclusion date would not include in income any portion of the tested income for the year. Thus, there appears to be no net offset tested income amount allocable to the P group for the year. As a result, there is no hypothetical distribution to M under Rule 3. More generally, Rule 3 could never apply to any tested income that arises in the year of sale of a CFC, if the CFC remained a CFC after the sale. The result in this situation should be clarified in the final regulations, perhaps by an example.

Third, consider the same facts as Example 30, except that CFC1 pays a dividend of $50 to M on June 30, 2019, just before the sale of the M stock. The U.S. shareholder inclusion year is still the Buyer tax year that includes December 31, 2019. However, this fact pattern raises additional questions:

> (a) Assume the Buyer group has no tested losses. Then, the general GILTI inclusion amount would be $100. However, Section 951(a)(2)(B) reduces the GILTI inclusion to the U.S. shareholder on the last day of the year by the amount of distributions received by "any other person," subject to certain limitations. In form, M is the "person" that both received the dividend on June 30, 2019 and is the U.S. shareholder on December 31, 2019. Thus, arguably, the GILTI inclusion to the Buyer group should not be reduced by the amount of the dividend, and the distribution to M on June 30 would be PTI.
>
> However, this result would not make sense. In reality, the P group is the economic shareholder before the sale, and the Buyer group is the economic shareholder after the sale. Moreover, if "person" is defined without regard to treating consolidated groups as a single "person", then a transfer of CFC stock within a single group would be a transfer to a different "person." Regulations under Section 951(a)(2)(B) should clarify that the relevant "person" in respect of a member of a consolidated group is the common parent of the group.
>
> (b) Next, assume that the Buyer group has $100 of tested income and e&p from CFC1 and an equal tested loss from another CFC. Then,

> there is no GILTI inclusion to the Buyer group and Section 951(a)(2)(B) is irrelevant. It seems that a dividend of $50 (or even $100) paid to M before the sale would a dividend out of current e&p, would be eligible for Section 245A, and would increase P's basis in M under existing -32. There is not necessarily a policy objection to this result, since the Buyer group will have a used tested loss that corresponds to the offset tested income distributed to M. However, the Buyer group is then bearing the cost, through a basis reduction in M equal to the used tested loss, of providing exempt income and an increased tax basis in M to the P group. This would be a very surprising result, and, if intended, should be discussed explicitly in the final regulations.

(g) *Rule 3: Creating a Tax Loss on M Stock*

Regulations should explicitly state, or provide an example showing, that the basis increase provided in Rule 3 can create or increase a tax loss in the M stock. Arguably this is already clear, since the rule states that M is treated as having tax-exempt income immediately prior to a transaction in which P recognizes income, gain, deduction or loss with respect to M stock. If P recognized loss before taking Rule 3 into account, the only possible effect of Rule 3 would be to increase such loss, so this indicates that there is no limit on the basis increase under Rule 3.

However, to avoid the need to make such an inference on a very significant issue, an explicit statement or an example such as the following should make this point.[133]

> **Example 31**. *Tax loss on M stock*. P forms M with a cash contribution of $1000, and M forms CFC1 with a cash contribution of $1000. Thereafter, CFC1 has offset tested income of $100. Suppose P sells the M stock for $1060. Rule 3 will increase P's basis to $1100, and P will have a tax loss of $40 subject to the loss limitation rules in -36.

(h) *Avoiding the Loss Disallowance Rule*

An example to the final regulations should also illustrate the following fact pattern.

> **Example 32**. *Rule 3 avoiding loss disallowance*. M holds stock in a CFC with a tax basis and value of $200 at a time when the CFC has $100 of offset tested income. Suppose also that P's basis in M is $100, so that P would recognize a gain of $100 (before applying Rule 3) on the sale of the

[133] An example should also illustrate a discontinuity between Rule 3 and an actual dividend eligible for Section 245A. A basis increase in M under Rule 3 can result in a tax loss subject to -36 but not to Section 961(d), since the latter provision only applies when an actual dividend is subject to Section 245A. An actual dividend would give rise to the same basis increase, but in that case a loss in the stock would also be subject to Section 961(d).

> M stock for $200. In fact, if P sells the M stock, under Rule 3, P's basis in M increases by $100 to $200, and P has no gain on the sale.

If the CFC had actually paid a Section 245A dividend of $100 to M, M's basis in the CFC would not change, and M would have a loss of $100 on the sale of the CFC stock for $100. That loss would be disallowed under Section 961(d). However, Rule 3, like an actual dividend, increases the basis of P in the M stock and thereby avoids the loss disallowance rule and eliminates P's gain on the sale of the M stock. We believe this is the correct result, but it is not intuitive and an example would be helpful to confirm the result.

(i) *Rule 3 and Second Tier CFCs*

Under Rule 3, a hypothetical distribution that would be a dividend subject to Section 1059 does not create a basis increase in the M stock. This result makes sense, since an actual dividend subject to Section 1059 would not result in such a basis increase. In the case of offset tested income of a second tier CFC, it is not clear how the Section 1059 test in Rule 3 is to be applied. Similarly, it is not clear how the requirement that the distribution would be eligible for Section 245A is applied. For example, there might be intermediate entities with hybrid stock, with dividends on such stock not eligible for Section 245A.

Regulations should clarify whether these tests are applied solely to a dividend from the second tier CFC to the first tier CFC, whether they are based on whether the cash could be returned to the U.S. with Section 245A applying and without Section 1059 applying at either level, or whether they are based on whether, on the return of the cash to the U.S., there would in fact be a basis increase in the M stock taking Sections 245A and Section 1059 into account. The latter appears to be the most logical interpretation.

(j) *Rule 3 and PTI*

The test in Rule 3 is how much of a hypothetical distribution equal to the net offset tested income amount of the CFC would be a dividend eligible for Section 245A. However, if the CFC has any PTI, any distribution will first be out of PTI and will not be a dividend eligible for Section 245A. This will skew the calculation under Rule 3. For example, if the net offset tested income amount is $100, and there is also unrelated PTI of $90, the size of the deemed distribution is the net offset tested income amount of $100. On a hypothetical distribution of $100, $90 would be PTI and only $10 would be a dividend eligible for Section 245A, so the Rule 3 basis increase would only be $10.

This is clearly not the intent of Rule 3. As a result, the hypothetical distribution should either assume that the CFC has no PTI, or else the size of the deemed distribution should be the sum of the net offset tested income amount plus the PTI. We prefer the former formulation because it is more targeted. However, the latter formulation will be equivalent as long as the hypothetical PTI distribution is not counted towards the threshold tests for an extraordinary dividend under Section 1059, which we believe is the correct result.

(k) *Tiering Up of CFC Basis Reductions*

Regulations should confirm that if P owns M and M owns a CFC, a downward basis adjustment in the stock of the CFC under the CFC basis reduction rule does not tier up under -32 to reduce P's basis in M. P's basis in M has already been reduced for the net used tested loss amount under Rule 1, and another reduction would be duplicative.

(l) *E&P Adjustments*

Regulations should clarify whether a reduction of P's basis in M under Rule 1 decreases the e&p of P. Arguably there should not be a current decrease in e&p, since there is no current increase in P's e&p on account of offset tested income of a CFC held by M, unless the income is distributed. On the other hand, a decrease in P's e&p to reflect the Rule 1 basis decrease in the M stock would better match M's inside e&p with the outside tax basis in M.

When a CFC is sold, M's ending e&p balance should not generally be affected by whether the reduction in the basis of the CFC stock under the CFC basis reduction rule is a reduction in M's e&p. Any such reduction in e&p should reduce the tax basis of the stock for e&p purposes, and so the reduction in e&p would normally be offset by increased e&p to M arising from increased gain (or reduced loss) on the sale as a result of the basis reduction.

Correspondingly, on the disposition of the CFC, any increased gain to M as a result of the CFC basis reduction rule should not increase the e&p of P unless P's e&p has been reduced on account of Rule 1.

Regulations should clarify these results.

(m) *Predecessor/Successor Rule*

Regulations should confirm that the predecessor/successor rule in existing Treasury Regulation Section 1.1502-32(f) applies to a member's interest in a CFC's net used tested loss amount and net offset tested income amount, when a member of the group transfers the CFC to another member in a nonrecognition transaction.

(n) *Loss Duplication under -36(d)*

Treasury Regulation Section 1.1502-36(d) is designed to prevent "loss duplication." Loss duplication arises when M1 sells stock of M2 at a loss to the extent that such loss is also reflected in built-in loss in the assets M2. In that case, if M2 were to sell its assets immediately after the stock sale, a second tax loss would be allowed even though there is a single economic loss on the assets. The regulations prevent this result by reducing the basis of the assets in M2 to eliminate the duplication, with an election to instead reduce the basis in the stock to the extent of the loss duplication amount. The loss duplication amount is, simply stated, the lesser of the loss on the stock and the net loss that would arise if the assets were sold for the sale price of the stock (disregarding for simplicity liabilities of M2, NOLs and other factors).

The final regulations should state that in applying this rule on the sale of M, if a CFC has a net used tested loss amount, the tax basis of the CFC stock to M for this purpose is its basis after taking the CFC basis reduction rule into account. This is necessary to prevent -36(d) from disallowing tax losses that are not duplicated losses.

> **Example 33**. *The CFC basis reduction rule and loss duplication*. Suppose P buys M stock from a third party for $100, and M's only asset is stock of CFC1 with a tax basis of $60 and no prior history. Assume that CFC1 then has a net used tested loss amount of $40, reducing P's basis in M to $60 under Rule 1. The value of CFC2 goes down to $20, and P then sells the M stock for $20.

P has a real economic loss of $80 on the sale, and $40 of the corresponding tax loss was used to offset the tested income of other CFCs. However, if M is treated as having an unreduced tax basis of $60 in CFC1, P's remaining unused economic loss of $40 is duplicated by M's built-in loss of $40 in the stock of CFC1, which has a basis of $60 and value of $20. As a result, -36(d) would require either that P's loss be disallowed or that M's basis in CFC1 be reduced to $20 at the time of the sale of the M stock (in addition to a further reduction of $40 when M sells the CFC1 stock).

These results make no sense as an economic matter. Immediately after P sells the M stock, if M were to sell the CFC1 stock for $20, M's basis in CFC1 would be reduced from $60 to $20 and so M could not obtain a tax loss on the sale of the stock. There is simply no potential for a duplication of P's loss on the sale of the M stock, and there is no logical reason for -36(d) to apply in this case. The correct answer is reached only if M is treated as having a tax basis of $20 in the CFC, i.e., the basis that it would have immediately before a sale of the CFC stock, in testing for loss duplication under -36(d).[134]

We note that the problem is not solved by the election in -36(d) to allow P its $40 loss on the M stock at the cost of reducing the basis in the CFC stock by the duplicated loss of $40. This election would not prevent another reduction in the basis in the CFC

[134] This application of -36(d) when there is in reality no duplicated loss would also arise frequently if P bought the stock of M at a time when M already had a net used tested loss amount in a CFC that it owned. For example, assume P buys stock of M for $100 when M owns a CFC with a basis of $100 and net used tested loss amount of $100. If M's basis in the CFC is $100 for purposes of -36(d), any loss by P on the sale of M will be a duplicated loss. In reality, no such loss is a duplicated loss because M has a basis of $0 immediately before the sale of the CFC and so can never recognize a loss on the sale.

stock under the CFC basis reduction rule immediately before the sale of the CFC stock, resulting in a double reduction in basis for a single net used tested loss amount.

Moreover, it would not be adequate for a regulation to prevent this second reduction in basis. For example, regulations might say that to the extent that M's unreduced basis in the CFC causes a loss disallowance under -36(d) that would not otherwise arise, there is no additional basis reduction when M sells the stock of the CFC. In fact, P's tax loss of $40 should not be disallowed in the first place, there should be no reduction in M's $60 basis in the stock of the CFC under -36(d), and M should only be subject to the usual CFC basis reduction rule upon the sale of CFC1. The only way to achieve this result under -36(d) is to apply the CFC basis reduction rule in determining the tax basis of M's stock in a CFC for purposes of -36(d).

A similar issue arises under -36(d) if M owns a CFC with a net offset tested income amount. Under Rule 3, P's basis in M will increase by such amount immediately before the M stock is sold. This increased basis should be taken into account in determining whether there is loss duplication under -36(d).

> **Example 34**. *Rule 3 and loss duplication.* P buys the stock of M for $50. At that time, M's only asset is stock in CFC1 with a basis of $100. CFC1 has no prior tax history. CFC1 then generates a net offset tested income amount of $40. P then sells the stock of M for $50. Under Rule 3, P's basis in M increases from $50 to $90 immediately before the sale, resulting in a $40 loss to P on the sale before application of -36(d).

If P's basis in M is determined without regard to Rule 3, P has a basis of $50 in the stock, so it has no loss on the sale of the stock for $50 for purposes of -36(d). As a result, there could not be a duplicated loss under -36(d). Yet P in fact had a loss of $40 on the sale of M because of the basis increase from $50 to $90 under Rule 3.

Moreover, if M then sold the stock of CFC1 (basis $100) for $50, there would be a loss of $50 to M. This would result in a double loss of $40, to both P and M. The only way to carry out the purpose of -36(d) is to treat P as having a basis in M that is increased as it would be under Rule 3. In that case, P's loss for purposes of -36(d) would be $40, and this would duplicate $40 of the built in loss of $50 in the M assets.

As a result, to carry out the purposes of the loss duplication rule in -36(d), when P sells the stock of M and M is a U.S. shareholder of a CFC, we believe it is necessary to take account of both (1) the CFC basis reduction rule in determining M's tax basis in the CFC, and (2) Rule 3 in determining P's basis in M. We note that the former rule will reduce the amount of duplicated losses under -36(d) and the latter rule will increase the amount of such duplicated losses, but we believe both results are appropriate.[135]

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[135] In theory, the application of -36(d) should also depend upon whether an M loss on the sale of CFC1 would be disallowed under Section 961(d). If so, there is no loss duplication and no need to disallow

(o) *Loss Disallowance under -36(c)*[136]

Under -36(c), loss is disallowed on P's sale of stock of a consolidated subsidiary M to the extent of the lesser of (1) the "disconformity amount," which is the excess of P's outside basis in M stock over M's inside basis in its assets and its other tax attributes and (2) the net positive increase in P's basis in M under -32 (disregarding distributions) while M was held by P.

The purpose of -36(c) is to prevent a "son of mirror" transaction, where P buys the stock of M at a time when M has assets with unrealized gain. P's basis therefore already reflects the unrealized gain in the M assets. M then sells the assets at a taxable gain, increasing P's basis in M above fair market value of the stock. Absent -36(c), P could then sell the stock of M at a tax loss, with no economic loss, and that tax loss would offsets M's gain on the asset sale. The result is a tax free step up in the basis of the M assets in the hands of the buyer. To prevent this result, -36(c) would disallow P's loss on the sale of the M stock.

We believe that for purposes of determining the disconformity amount under -36(c), the basis of the stock of a CFC in the hands of M should take into account the CFC basis reduction rule as well as Rule 3.

> **Example 35**. *The CFC basis reduction rule and -36(c).* P buys the stock of M for $100 at a time when M's only asset is stock of a CFC with a basis of $100 and with a used tested loss amount of $100.

If the CFC basis reduction rule is disregarded under -36(c), the disconformity amount is $0, since the outside basis in M stock and inside basis in the M assets are both $100. As a result, -36(c) cannot apply. Then, M can sell the stock of the CFC for $100 and recognize $100 of gain, and this will increase P's basis in M to $200. P can sell the M stock for $100, recognizing a loss of $100 that offsets the $100 gain to M. The buyer of the CFC does not have any net used tested loss amount in the CFC. The result is that the detriment of the net used tested loss amount of $100 has been eliminated from the tax system at no cost to the P group or anyone else.

We believe this is inconsistent with the purposes of -36(c), and so the CFC basis reduction rule should be taken into account in determining the disconformity amount. Then, the disconformity amount is $100 and the net increase in basis to P is $100

P's loss on the sale of M stock. However, -36(d) currently determines loss duplication under a formula that is based solely on the tax basis of assets, not on whether a loss on a hypothetical sale assets held by M would be disallowed under any provision of the Code. If Section 961(d) were to be taken into account for purposes of -36(d), other loss disallowance provisions of the Code for all assets held by M should also be taken into account. This narrowing of -36(d) is beyond the scope of this Report, and we take no position on it.

[136] The issues arising under -36(c) are discussed further in the Section 245A Report, at 41-44.

resulting from the sale of the CFC. The lesser of these two numbers is $100 and so P's entire loss of $100 on the sale of the M stock is disallowed. We believe this is the correct result. In fact, if the net used tested loss amount in the CFC exceeds M's basis in the CFC, we believe that M's basis in the CFC should be treated as negative for purpose of computing the disconformity amount.

On the other hand, we do not believe that Rule 3 is relevant for purposes of -36(c). As discussed in Part IV.D.2(e), we believe that if a net offset income amount arises in one group, and P sells the stock of M to another group, it should not continue into the buying group. As noted above, -36(c) is aimed at the case where the purchase price of the M stock includes built in gain in the M assets, and the recognition of gain in those assets causes the basis in the M stock to be above fair market value. Assuming Rule 3 does not increase the basis of M stock when the new group sells the M stock, we do not believe that -36(c) requires any adjustment to take account of Rule 3.

However, if regulations were to apply Rule 3 to the net offset tested income in the buying group, additional issues would arise. Assume P buys the stock of M for $200, M has a basis of $100 in the CFC, and M has a net offset tested income amount of $100 in the CFC. If Rule 3 applies, when P sells the M stock for its purchase price of $200, M's basis would increase to $300 and it would have a loss on the sale. This is because M's purchase price already reflects the net offset tested income amount. The issue is in substance the same as the issue in the "son of mirror" transaction described above. Since Section 961(d) does not disallow a loss on the sale of the M stock, -36(c) should logically apply in this case.

(p) *Intra-group Sales of a CFC*

Regulations should confirm that the attribute redetermination rule of Treasury Regulation Section 1.1502-13(c)(1) applies to Rules 1-3. Under that rule, if M1 sells CFC1 to M2, and M2 later sells CFC1 to a third party, the attributes of M1 and M2 are redetermined if necessary to reach the same overall result for the group as if M1 and M2 were divisions of a single corporation.

For example, M1 might have increased deferred gain on the sale of the stock of CFC1 to M2 as a result of the CFC basis reduction rule. However, if CFC1 has offset tested income in the hands of M2, on an overall group basis the CFC basis reduction rule might be inapplicable when M2 sells the stock of CFC1 to a third party. In that case, the attribute redetermination rule should put the group as a whole in the same position as if the CFC basis reduction rule did not apply. As another example, if final regulations adopt our proposal that the CFC basis reduction rule does not apply in the absence of a double tax benefit from a used tested loss, this determination should be made at the time of the sale of CFC1 by M2 to a third party, and the treatment of M1 adjusted accordingly.

(q) *Rule 1 and Internal Spin-offs*

We believe that the final regulations should modify the rules for allocation of basis following an internal spin-off within a consolidated group, when the member receiving a spin-off distribution has had its basis in the distributing company reduced under Rule 1.

Suppose M1 has a CFC with a net used tested loss amount, and P has a reduced basis in M1 under Rule 1. M1 transfers some of its assets (which may or may not include the stock in the CFC) to newly formed M2, and spins off M2 to P in a divisive D reorganization. P's basis in M1 would be divided between its post-spin stock in M1 ("**New M1**") and M2 based on the relative fair market values of New M1 and M2.[137] Absent any special rule, P's original basis reduction in M1 becomes, in effect, partly a basis reduction in New M1, and partly a basis reduction in M2, in proportion to the relative values of New M1 and M2.

However, the prior reduction in P's basis in M1 was entirely attributable to the CFC, which is now held by either New M1 or by M2. We refer to the member owning the CFC as the "**CFC owner**" and to the other member as the "**non-CFC owner**". If P's reduced basis in M1 is allocated between New M1 and M2, it will result in a partial disassociation of the prior basis reduction in the M1 stock and the net used tested loss amount in the CFC stock that is now held by the CFC owner. This is inconsistent with the idea that Rule 1 and the CFC basis reduction rule are intended to result in merely a different timing for basis reduction, rather than shifting part of the consequences of the Rule 1 basis reduction to a party other than a direct or indirect shareholder of the CFC.

A closer match of the Rule 1 basis reduction with the net used tested loss amount in the CFC could be achieved if (1) the unreduced basis of P in M1 was initially allocated between New M1 and M2 under Section 358, and (2) the resulting basis in the CFC owner was then reduced by the Rule 1 amount (the "**alternative approach**").

> **Example 36**. *Rule 1 and internal spinoffs*. M has two assets, land with a basis of $100, and a CFC with a basis of $100 and net used tested loss amount of $100. P's basis in M is $200 minus the Rule 1 reduction of $100, or $100. Assume the land and CFC stock is each worth $100, and the value of the M stock is therefore $200. Disregarding the substantive spin-off requirements under Section 355, assume P transfers the land to M2 and spins M2 off to P.

After the spin-off, New M1's inside basis (after taking account of the CFC basis reduction rule) is $0 and M2's inside basis is $100. Under the Proposed Regulations, P's $100 basis in M is allocated $50 to New M1 and $50 to M2, creating a disparity in basis. The alternative approach eliminates this disparity: P would be viewed as having a $200

[137] Treas. Reg. § 1.358-2(a)(2)(iv).

basis in M that would be allocated $100 to New M1 and $100 to M2, and Rule 1 would then apply to P's basis in New M1, leaving P with a basis of $0 in New M1 and $100 in M2. The Rule 1 basis reduction in New M1 then exactly matches the future basis reduction that New M1 will have in the CFC under the CFC basis reduction rule.

It can be argued that the alternative approach should not be adopted because, as a general matter, no special adjustments under Section 358 are made for other deductions of M that are allocable to specific assets of M. For example, if M has a Section 168(k) expense deduction for a capital asset, P's basis in M is reduced by the amount of the expense, but there is no comparable adjustment under Section 358 to initially disregard that basis reduction in the M stock. More generally, because the allocation of the basis in M stock under Section 358 is based on the values of New M1 and M2 rather than their inside asset basis, the allocation inherently creates differences between the inside and outside basis of New M1 and M2.

On the other hand, the situation here is unique, because the Proposed Regulations themselves create the pre-spin disparity between higher inside tax basis of the CFC and the lower outside tax basis in M. Normally, any change to the inside basis of the M assets would result in an equal change to the outside basis of the M stock. It therefore seems reasonable to temporarily "undo" the disparity created by the Proposed Regulations in order to recalculate basis allocations following a spinoff.

A more significant problem with the alternative approach, however, is that it may make the disparity between inside and outside basis *worse* than under the normal application of Section 358. For example, assume the same facts as in Example 36, except the land is worth $900 so the M stock is worth $1000. Again, after the spin-off, New M1's inside basis (after taking account of the CFC basis reduction rule) is $0 and M2's inside basis is $100. Under the Proposed Regulations, P has a basis of $10 in New M1 and $90 in M2.[138]

Yet under the alternative approach, P has an excess loss account of $80 in New M1 and a basis of $180 in M2.[139] This result makes no sense. It arises because the increase in the M basis by the Rule 1 adjustment is mostly allocated to the M2 stock, which has 90% of the combined value, and yet the second step Rule 1 basis reduction is made entirely to the New M1 stock. To be sure, this is the result that would have arisen if Rule 1 only applied when the CFC stock is sold. However, the result would make no more sense if in fact the Rule 1 basis reduction was deferred in that manner.

These examples illustrate that the alternative approach appears to reach the "proper" result in some cases, retaining the match between the net used loss amount of

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[138] P's $100 basis in M is allocated 10% to New M1 ($10) and 90% to M2 ($90).

[139] P's $100 basis in M is initially considered $200, of which 10% ($20) is allocated to New M1 and 90% ($180) is allocated to M2, and the basis in New M1 is then be reduced by $100 to an excess loss account of $80.

the CFC and the outside tax basis of the CFC owner. However, in other cases it reaches results that are clearly incorrect. As a result, we do not recommend it in the form we have discussed so far.

However, we believe a variation of the alternative approach would be appropriate. Under that variation, initially, as in the alternative approach, the unreduced basis of P in M1 would be allocated between New M1 and M2 under Section 358. However, in the second step, the resulting basis in the CFC owner would then be reduced by the Rule 1 amount, but (unlike in the alternative approach) this basis reduction would be limited to an amount that would not reduce the basis in the stock of the CFC owner below the inside basis of the assets of the CFC owner (taking into account the CFC basis reduction rule). Any remaining basis reduction would be allocated to the non-CFC owner. We believe that this approach fairly balances the goals of undoing the new basis disparities created by the Proposed Regulations, and not having a revised basis allocation system create new basis disparities that would not otherwise exist.

Under this approach, in the variation of Example 36, since the inside basis of the New M assets is $0 (after taking account of the CFC basis reduction rule), the $20 of basis initially allocated to New M1 would not be reduced by $100 (as under the alternative approach), but would only be reduced by $20. The remaining $80 of basis reduction would apply to the stock in M2, reducing it from $180 to $100. As a result, the final basis in New M1 would be $0 and the final basis in M2 would be $100. On these facts, inside and outside basis match for both New M1 and M2. This approach would also not change the result in Example 36, since there the alternative approach already resulted in a match of inside and outside basis in both New M1 and M2.[140]

(r) *Rule 1 and External Spin-offs*

We believe that final regulations should provide rules for the application of Rule 1 when P spins off the stock of M to the shareholders of P in an external spin-off.

First, consider the case where P's unreduced basis in M is $100, but because of a net used tested loss amount of $150 in a CFC held by M, Rule 1 has reduced P's basis in M to an excess loss account (ELA) of $50. P then spins off M in a Section 355 spin-off or divisive D reorganization. Under Section 355(c) or Section 361(c), P would not recognize a gain on the distribution, but the ELA of $50 would be taxable under the consolidated return regulations. However, no such ELA would have existed, and no gain would have been taxable, in the absence of Rule 1.

We believe that except in the situations involving cash distributions described below, final regulations should provide that no gain is recognized on the spin-off of a

[140] Note that the various approaches to allocating basis may create discontinuities with the allocation of e&p, which is generally allocated in proportion to fair market value. See NYSBA Tax Section Report No. 1333, *Report on the Allocation of Earnings and Profits in Connection with Divisive Transactions* (Dec. 1, 2015).

member if the gain represents the triggering of an ELA that would not have existed absent the application of Rule 1. The reason for Rule 1 is that an unreduced basis in M allows P to obtain a second tax benefit from the single tested loss in the CFC. Here, even without the application of Rule 1, P is not obtaining any tax benefit from its basis in M, and it will never be able to in the future. In addition, except in the situations described below, P is not receiving any cash on account of its interest in M.

Of course, if it is assumed that the basis reduction is the "norm", and that the failure to reduce basis results in avoidance of tax on the ELA gain, it could be argued that this is a double benefit. However, this argument assumes the conclusion. In fact, the reason to reduce basis is to prevent a reduction in value of M resulting from the net used tested loss amount from allowing a taxable disposition of M at a reduced gain or increased loss to P. Here, no tax benefit or cash is being received by P on the spin-off of the M stock, so there is no reason to reduce the tax basis of M.

Next, consider the case where P's unreduced basis in M is $100, its reduced basis under Rule 1 is $20, and in a divisive D reorganization, P contributes M to a new Spinco in exchange for Spinco stock and $50 of cash, and then P spins off Spinco. P would not recognize gain under Section 361(b) if P distributed the cash to its shareholders or creditors. However, the cash would nevertheless reduce P's basis in Spinco, and any resulting ELA would be taxable to P.

The question here is whether P's unreduced or reduced basis in M should be used to determine whether (and to what extent) the cash distributed to P creates an ELA. We believe it is appropriate here to use the reduced basis, taking account of Rule 1. The reason is that when cash is actually received by P, P is obtaining the benefit of a tax-free receipt of cash to the extent of P's tax basis in M. Unless the Rule 1 basis is used for this purpose, a second benefit of tax-free cash is being received from the unreduced basis. This situation is similar to the issue involving Section 301(c)(2) and (c)(3) discussed in Part IV.B.3(e). However, here unlike there, P will no longer own the stock of M, so the time of the spin-off is the last opportunity for P to be taxed on the receipt of cash from M.

Finally, consider the case where the CFC basis reduction rule creates an ELA not on account of cash received as part of a reorganization transaction, but because of a debt financed distribution of cash, or debt financed losses that give rise to a tax benefit to P. By way of illustration, assume that P forms M with $100 and M forms CFC1 with $100. CFC1's assets then appreciate to $200. In a later year, M borrows $30 and distributes the $30 to P. CFC then has $100 of used tested loss (offset against tested income of another CFC in a different chain).

Under Rule 1, P's basis is reduced so that it has an ELA of $30 in the stock of M. P distributes M to its shareholders under Section 355. Arguably, if there is no ELA recapture, the P group has achieved two benefits from the tested loss and associated stock basis, once upon offset against the tested income and once to "shelter" the debt-financed distribution. The result is in substance no different than the result in the preceding paragraph. Arguably the same issue arises if M borrows the $30 and creates a tax loss that is used by the P group and reduces P's basis in M. (By contrast, if P had simply acquired M for $70 and there were no debt-financed distributions before the spin-off, there would be no "double benefit.") Regulations should clarify the result in this case.

E. Basis Issues in Intra-Group Reorganizations

1. *The Proposed Regulations*

Under Proposed Regulation Section 1.1502-51(c)(5), if M1 engages in a nonrecognition transaction with another group member M2 and receives stock in exchange for CFC stock held by M1, M1's basis in the stock received (which normally would be the basis in the CFC stock) is reduced by the net used tested loss amount of the CFC. This rule complements Rule 1. The purpose of the -51 rule is to mirror P's existing reduced basis in M1 with a new reduced basis by M1 in the member stock acquired in exchange for the CFC.

> **Example 37**. *Intercompany Section 351 transaction*. P's initial basis in M1 is $150, and M1's initial basis in the CFC is $150. The CFC has a used tested loss of $100, reducing P's basis in M1 to $50, but not changing M1's basis in CFC of $150. Then, M1 contributes the CFC to M2 in exchange for M2 stock. Under the general rules, M2 obtains a carryover basis of $150 in the CFC, and M1 obtains a substituted basis of $150 in the M2 stock. The Proposed Regulations require that the M1 basis in M2 be reduced by $100, to $50, to be the same as P's basis in M1.

2. *Comments on Proposed Regulation Section 1.1502-51*

The -51 Proposed Regulation makes sense in this example. However, it does not work if it is intended to apply to an intercompany asset reorganization.

> **Example 38**. *Intercompany asset reorganization*. P owns M1 and M2. P's initial basis in M1 is $150, and M1's initial basis in the CFC is $150. The CFC has a used tested loss of $100, reducing P's basis in M1 to $50, but not changing M1's basis in the CFC of $150. M1 merges directly into M2, with P deemed to receive additional M2 stock in exchange for its M1 stock. Absent the rule in -51, P's basis in the new M2 stock would be its old basis in M1, or $50. However, if the Proposed Regulation applies, it would reduce this basis again by another $100, the used tested loss of the CFC.

This double reduction of basis would not make sense. It is possible to interpret this Proposed Regulation so that it does not affect P's basis in M2. Under this interpretation, the basis of the new M2 stock deemed received by M1 in the reorganization would be reduced in the hands of M1, but this reduced basis would "wash out" on the deemed liquidation of M1 into P. Then, P's basis in the M1 assets (including M2 stock) would be a substituted basis from P's basis in the M1 stock under Section 358.

This Proposed Regulation could be modified to state that it does not apply to asset reorganizations. However, it is doubtful that this exclusion was intended, because Proposed Regulation Section 1.1502-51(c)(5) goes on to describe the application of the regulation to an intercompany transaction that is an all-cash D reorganization (as discussed below). It is possible that this Proposed Regulation is thought to be needed in case there is an asset reorganizations in which a basis reduction has not already occurred. To address this possibility, this Proposed Regulation could be modified so that the basis reduction for a used tested loss only applies to the extent that the used tested loss of the CFC has not already been reflected as a reduction in the basis of the stock received in the nonrecognition transaction involving the CFC.

Moreover, as noted, Proposed Regulation Section 1.1502-51(c)(5) goes on to say that in the case of an intercompany transaction that is an all-cash D reorganization, the basis reduction under (c)(5) is made prior to the application of the rule in the consolidated return regulations that an intra-group reorganization with boot is treated as an all-stock reorganization, followed by a separate distribution of cash.[141] If this rule is needed at all, it is not clear why it should only apply to an all-cash D reorganization, as opposed to any intra-group reorganization. In addition, it is not clear why this rule is necessary. It is especially difficult to see a situation involving an all-cash D reorganization in which the basis of the transferring member in the stock of the transferred member would not have already been reduced under Rule 1.

Finally, regulations should clarify the application of the -51 regulation to a net used tested loss amount that arises in the year that the stock of the CFC is transferred. Since a GILTI calculation is only made at the end of the tax year of the CFC, it appears that the -51 adjustments do not take account of a pro rata portion of the current-year net used tested loss amount. Rather, the CFC reduction rule and Rule 1 would apply at the end of the tax year, and to the shareholders at that time, on the basis of the net used tested loss amount for the entire year.

3. *Comments on Proposed Regulation Section 1.1502-13(f)(7)*

The Proposed Regulations modify Example 4 in Treasury Regulation Section 1.1502-13(f)(7) to reflect the modification to the -51 Proposed Regulation discussed immediately above.

Example 4 involves an "all-cash D" reorganization in which the transferor member S in the reorganization is deemed to receive stock in the transferee corporation B, followed by S's liquidation into its shareholder member M. In the example, M has a tax basis in S of $25, S has a value of $100, S's only asset is stock in a CFC, and the CFC has a net used tested loss amount of $15. B pays $100 to S for the stock in the CFC and S liquidates into M. Under the all cash D regulations, B is first treated as paying $100 worth of stock to S, with S then liquidating and M taking a basis in the B stock equal to

[141] Treas. Reg. § 1.1502-13(f)(3).

its old $25 basis in the S stock. The revised example states that M now owns stock in B and B owns the CFC, M's basis of $25 in the B stock must be reduced by $15, the used tested loss amount of B.

This last point does not appear to be correct. In the example, M's initial basis in S ($25) should already have been reduced under Rule 1 by the $15 of net used tested loss amount in the CFC. When S transfers the CFC to B and B issues its stock to S and S liquidates, M's basis in the B stock should be the same as its basis in the S stock (i.e., $25). That basis should not be reduced again by the CFC's used tested loss, since M's basis has already been reduced by that amount.[142] This is the same point concerning Proposed Regulation Section 1.1502-51(c)(5) discussed immediately above.

F. General Basis Issues Under the Proposed Regulations

1. *Aggregation of Shares*

The Proposed Regulations do not discuss specifically the question of whether all shares of a particular shareholder of a CFC are to be aggregated in making the calculations required by the Proposed Regulations. Alternatively, the calculations might be made on a share by share (equivalent to bloc by bloc), class by class, or shareholder by shareholder basis.

Under the Proposed Regulations, tested income and tested losses of a CFC are allocated to shareholders of the CFC based on the manner in which distributions of earnings would be made by the CFC.[143] An equal amount of tested income or loss is allocated to each share of the same class, although different amounts might be allocated to shares of different classes. On the other hand, the Proposed Regulations appear to contemplate that a U.S. shareholder of a CFC will have a single net used tested loss amount or net offset tested income amount for the CFC.[144]

However, a U.S. shareholder may have different shares in the same CFC that gave rise to different used tested loss amounts and/or offset tested income amounts while they were held by the U.S. shareholder. This could arise if the shares are of different classes, or if the shares are identical but were acquired at different times by the U.S. shareholder. Even if all of these amounts are aggregated in determining the U.S. shareholder's net

[142] The existing Example 4 also erroneously refers to S receiving B stock with a basis of $25 under Section 358 that it distributes to M in liquidation. In fact, M rather than S will have a basis of $25 in the B stock. This does not affect the conclusion of the example.

[143] Prop. Reg. §§ 1.951-1(e), 1.951A-1(d).

[144] *See, e.g.*, Prop Reg. § 1.951A-6(e)(2) (definition of net used tested loss amount); Prop Reg. § 1.951A-6(e) (definition of net offset tested income amount); Prop Reg. § 1.951A-6(e)(4)(i) (allocation of either of such items to particular shares); Prop Reg. § 1.951A-6(e)(1)(i) (basis on disposition of specified shares is reduced by the corporation's net used tested loss amount with respect to the CFC allocable under usual allocation rules to the specified shares).

used tested loss amount or net offset tested income amount at any time, it is not clear whether the underlying shares maintain their separate underlying attributes, for example if they are sold.

> **Example 39**. *Aggregation of shares*. In year 1, US1 owns 50 out of 100 shares of CFC1 (the "**year 1 shares**"), CFC1 has a tested loss of $100, and US1 uses its $50 share of the tested loss against other tested income. At the end of the year, US1 acquires the remaining 50 of the shares (the "**year 2 shares**"). In year 2, CFC1 has another tested loss of $100 that is used by US1 against other tested income. US1 sells the year 1 shares or the year 2 shares (but not both) at the end of year 2.

Under the Proposed Regulations, US1 has a net used tested loss amount in CFC1 of $150, $50 from year 1 and $100 from year 2. Under an aggregation approach, this represents $1.50 per share owned at the time of the sale, so the sale of the 50 year 1 shares or the 50 year 2 shares would result in a basis reduction of $75 in the shares sold. Under a tracing approach, the $150 of net used tested loss amount would be allocated $2 per share to the 50 year 1 shares and $1 per share to the 50 year 2 shares, so the basis reduction would be $100 if the year 1 shares were sold or $50 if the year 2 shares were sold.

The question is even more difficult if the CFC has offset tested income in some years.

> **Example 40**. *Aggregation of shares with offset tested income*. In year 1, US1 owns 50 out of 100 shares of CFC1 (again, the "**year 1 shares**"), CFC1 has a tested loss of $200, and US1 uses its $100 share of the tested loss against other tested income. At the end of the year, US1 acquires the remaining 50 of the shares (again, the "**year 2 shares**"). In year 2, CFC1 has tested income of $100 that is offset by other tested losses of US1. US1 sells the year 1 shares at the end of year 2.

US1 has a used tested loss amount of $100 from year 1, and an offset tested income amount of $100 in year 2. Therefore, on an aggregate basis, US1 has no net used tested loss amount, and there is no basis reduction when the year 1 shares are sold. However, under a share by share approach, the year 1 shares have a used tested loss amount of $100 from year 1 and a $50 offset tested income amount from year 2, while the year 2 shares have a $50 offset tested income amount from year 2. Under this approach, there is a $50 basis reduction when the year 1 shares are sold, and the year 2 shares have $50 of untaxed e&p.

The issue also arises if a U.S. shareholder holds different classes of stock, say common and preferred. Suppose first that the preferred stock is allocated tested income and the common is allocated tested loss in a single year, so that there is no GILTI inclusion. Presumably there is netting so that Rule 1 does not cause a reduction in the tax basis of the U.S. shareholder, and the CFC basis reduction rule does not apply if the U.S.

shareholder sells the common stock. However, the results under both rules is less clear if the only allocations from the CFC are of tested income on the preferred stock in year 1 that is offset tested income to the U.S. shareholder, and of tested loss on the common stock in year 2 that is used tested loss to the U.S. shareholder.

Another issue would arise if the U.S. shareholder held common stock with a used tested loss, and then purchased preferred stock of the same CFC. If part of the existing used tested loss was then reallocated to the preferred stock under an aggregation approach, it would be possible for the U.S. shareholder to use this technique to avoid part of the basis reduction that would arise on a sale of the common stock.

More generally, under a bloc by bloc approach, if a particular U.S. shareholder held shares of the same class acquired at different times, or shares of different classes, the results would be the same as if each bloc was held by a different shareholder. As illustrated above, the shareholder might have a separate net used tested loss amount or net offset tested income amount in each bloc, and might even have a net used tested loss amount in one bloc and net offset tested income amount in the other bloc.

As a result, the U.S. shareholder would be required to keep track of each bloc of shares separately. This would be a significant burden. Each bloc would have its own net used tested loss amount or net offset tested income amount in each CFC held by the shareholder. The CFC basis reduction rule, which is based on the cumulative net used tested loss amount, would apply separately to each bloc, and the shareholder could presumably designate the shares that it was selling even if the shares were otherwise identical.

The complexities of the bloc by bloc approach would be even greater in the consolidated return context, since Rules 1, 2 and 3 would apply on a bloc by bloc basis. If M held some shares in a single CFC with a net used tested loss amount and other shares with a net offset tested income amount, P's basis in M would decrease by the former without an offset for the latter. A rule would also be necessary to determine whether, under Rule 1, P's basis in M is reduced equally for each share that P owns in M, in an aggregate amount equal to the total net used tested loss amounts for blocs of stock in the particular CFC. Alternatively, P could be permitted to designate particular shares in M to obtain the reduced tax basis in different amounts, corresponding to the different shares that M holds in the CFC that might have different (or no) net used tested loss amount.

The same issue would arise for offsets under Rule 2 to basis reductions under Rule 1. If offset tested income arises in different shares than those that had the used tested loss, there would be no offset to the basis reduction that arose in the shares that had the used tested loss. Likewise, Rule 3 is limited to offset tested income, and the total of the net offset tested income amounts of the shares with offset tested income might be greater or less than the shareholder's net offset tested income amount for the CFC as a whole.

Moreover, in a consolidated group, it is very common for a member to contribute cash to a subsidiary member. Under a bloc by bloc approach, a rule would be needed as to whether such a contribution that is not in exchange for stock would be deemed to be a contribution for stock and a deemed recapitalization of the existing shares,[145] requiring separate tracking of the existing and "new" shares. Absent such a deemed recapitalization, the group could electively achieve bloc by bloc or aggregation results by choosing whether to issue additional stock in exchange for the cash.

On the other hand, aggregation of all shares held by a shareholder, even on a class by class basis, would raise its own issues. As in Example 40, suppose a shareholder holds a single bloc of stock in a CFC with a net used tested loss amount or net offset tested income amount. Suppose the shareholder then acquires additional shares of the CFC of the same class, either from a third party or from the CFC itself. Those new shares would immediately share in the preexisting attributes from the first bloc of shares, reducing the used tested loss amount or offset tested income amount for each original share.

This would encourage tax planning prior to a planned disposition of CFC stock. The result is also somewhat peculiar, since the tax basis of the shares in each bloc would remain separate. As a result, assuming a net used tested loss amount, so the tax basis taken into account on a sale of any share would be the "real" tax basis reduced by a pro rata portion of the aggregate net tested loss amount allocated to all the shares.

It should be noted that even if the regulations were to adopt a class by class or shareholder by shareholder approach, the members of a consolidated group would still need to be treated as separate shareholders. This is necessary under the Proposed Regulations in order to determine the correct amount of net offset tested income amount and net used tested loss amount for each member in each CFC, since those amounts determine the basis increases and decreases in the stock of each member under Rules 1-3.

As a result, if the regulations provided for an aggregation of all shares in a CFC held by a particular U.S. shareholder, a group that wished to have less aggregation of shares could easily have different members of the group own different shares in the CFC. This result would be inconsistent with the idea that a group should be treated as a single entity and that the location of CFCs in the group should not matter. The only way to avoid these results would be if all the calculations were made on a share by share approach, since then the allocations to each share would be the same regardless of where in the group a particular share was located.

It must be acknowledged that even today, shareholders of any corporation, including a CFC, are in principle required to keep track of the separate basis of each share. This is relevant for calculating gain or loss on the sale of individual shares, the holding period of shares for various Code provisions (including Section 245A), amounts

[145] Prop. Reg. § 1.358-2(g)(3) (2009).

taxable under Section 301(c)(3), and so on. In the case of a CFC, separate tracking is also required to determine whether a distribution is PTI, since shares owned during a period of a GILTI or Subpart F inclusion would have a basis increase and PTI allocation, while shares acquired afterwards would not. However, as a practical matter, separate tracking rarely makes a difference today, and so the calculation of basis for particular shares is often not made unless and until it becomes necessary. This is in contrast to separate tracking for GILTI purposes, which if required would be far more complex and far more difficult (if not impossible as a practical matter) to do retroactively.

To conclude, we believe that a share by share, or bloc by bloc, approach is the most theoretically correct approach, and avoids electivity in a consolidated group through nonproductive tax planning. However, this approach would be quite complex and could considerably increase the basis reductions arising under the CFC basis reduction rule and under Rule 1 in the consolidated return context. The Proposed Regulations already create an enormously complex basis regime, and, absent a compelling reason, it should not be made more complex.

On the other hand, an aggregation approach lends itself to tax planning because of the ability it creates to shift net used tested loss amounts and net offset tested income amounts from some shares in a CFC to other shares in the CFC owned by the same shareholder. On balance, we suggest aggregating all shares of the same class owned by a single U.S. shareholder in a CFC, with an anti-abuse rule for transactions undertaken with a principal purpose of taking advantage of the aggregation approach to achieve noneconomic tax results that would not be achieved on a share by share approach.[146] If a U.S. shareholder owns both common and preferred stock, the preferred should be treated separately because of the significantly different ongoing allocations to the two classes of stock and the resulting uneconomic effects that could arise from aggregation.

2. *Complexity*

We cannot submit this Report without an expression of concern about the enormous amount of complexity in basis calculations created by the Proposed Regulations. It is very common, both in the consolidated group context and otherwise, for a U.S. shareholder to sell stock of a one or more CFCs. It is not even unusual for dozens or even hundreds of CFCs to be sold at one time, often in multiple chains of ownership and including cross-ownership among CFCs.

In the past, the basis in the stock of the CFCs being sold has been relatively easy to determine. Now, in light of the CFC basis reduction rule, this will be enormously complicated. A U.S. shareholder will have to know the net used tested loss amount of

[146] Similarly, we suggested simplified rules allowing aggregation of basis in many cases where proposed regulations issued in 2009 would have required calculations be made on a share-by-share basis. NYSBA Tax Section Report No. 1316, *Report on Proposed Regulations Regarding Allocation of Consideration and Allocation and Recovery of Basis in Transactions Involving Corporate Stock or Securities* (February 6, 2015).

every CFC being sold. It will be impossible to make this calculation on a retroactive basis at the time a CFC is sold. As a result, it will be necessary for the U.S. shareholder to keep track, on an annual basis, of the tested income and loss of each CFC, and the allocation of the tested losses of tested loss CFCs to the tested income of tested income CFCs. For CFCs in the same chain, the interactions among members of the chain will add more complexity. Foreign tax credits, not discussed in this Report, will add yet another significant amount of complexity.

The complexity will increase further in the context of a consolidated group. It is very common for a group to sell stock of a member of the group that directly or indirectly owns numerous CFCs. A group will not only need to keep track of the data necessary to determine the net used tested loss amount of each CFC in case the CFCs are sold. It will also need to keep track of the data needed to determine the gain or loss that will arise on a future sale of stock of any member that owns any CFCs. Thus, a group will need to keep track, on a member by member basis, of all the data needed to determine the Rule 1, Rule 2, and Rule 3 adjustments to the basis of member stock. Again, it will not be possible as a practical matter to make these calculations retroactively, so this will be an annual exercise.

As discussed in Part III.F.2(b)(vii), the rules for partnerships holding stock in CFCs are also extraordinarily complicated. It is difficult to imagine partnerships making accurate tax reports to their partners, partners reporting accurately on the CFCs they hold directly and through partnerships, and IRS agents auditing these issues.

Some of the suggestions in this Report will make the basis adjustment rules even more complicated. We make some of the suggestions in order to make the rules work properly as a technical matter, such as the need to keep track of dividends paid by CFCs in order to make adjustments under Rule 2. Other suggestions are to grant taxpayers relief from rules that seem unfair, such as our proposal not to reduce basis under the CFC basis reduction rule for tested losses that do not give rise to an actual tax benefit.

It is possible that major accounting firms will develop computer software that will allow the input of the basic underlying information and will then, in seconds, generate data concerning all tax basis adjustments in the stock of all the CFCs and stock of all members of a group directly or indirectly owning CFCs. However, not all U.S. shareholders of CFCs will have access to such software, and the need for taxpayers to rely on the algorithms in such a “black box” is unfortunate. The resulting complexities and uncertainties could even have a chilling effect on transactions if the taxpayer is concerned that the gain on a sale might be unexpectedly large.

We understand that the purpose of the rules, as well as our suggestions, are to have basis results that reflect economic accuracy. We also understand that basis rules that err on the side of simplicity rather than economic accuracy give rise to the risk of potential manipulation by taxpayers. On the other hand, if manipulation is the concern, the rules are now so complex that it is difficult to imagine how IRS revenue agents are going to audit positions taken by taxpayers anyway.

The complexity and uncertainty of the basis rules will also cause enormous difficulties in the merger and acquisition context. Sellers may be reluctant to sell stock of CFCs, or stock of members owning CFCs, because of uncertainty about the amount of gain that might arise. A buyer might be reluctant to buy the stock of corporation holding a CFC because of concern about future basis reductions in the CFC under the CFC basis reduction rule. A buyer doing due diligence on a target might also be concerned about prior transactions engaged in by the target in which basis under the Proposed Regulations was relevant. The result of these various areas of uncertainty might be increased escrow amounts, longer indemnity periods, the purchase of tax insurance, a reduction in purchase price, or even a reduction in the level of transactions.

In any event, it is unlikely that Congress, when it passed the GILTI legislation, understood the new complexity in basis calculations that it was creating.

3. *The Broader Problem Concerning -32, Section 245A, and Section 961(d)*

As we have discussed in Part IV.D.2(e) and as is discussed further in the Section 245A Report, a noneconomic basis increase under -32 will often arise when buyer buys the stock of M, M owns a CFC, and the CFC pays a dividend of then-existing offset tested income that is eligible for Section 245A. The amount of the offset tested income is already included in the buyer's basis in M, and so the dividend results in a noneconomic basis increase in the M stock just as in a son of mirror transaction. In fact, such an uneconomic basis increase can arise from any untaxed income of a CFC, such as tested income offset by NDTIR. While beyond the scope of the Proposed Regulations and this Report, the Treasury should consider a broader reexamination of the -32 regulations to account for such income.

For example, suppose that M owns a single CFC with tested income of $100 that generates $100 of NDTIR to M. There is no GILTI inclusion, and the CFC can pay a tax free dividend of $100 to M. Under the usual -32 rules, this will increase P's basis in M by $100. This will be the correct economic answer if P's basis in M does not already reflect the $100 of earnings. However, it will be an uneconomic increase in stock basis if, say, P contributed $100 to newly formed M, M bought stock in a CFC for $200, the CFC at that time had $100 of untaxed income, and the CFC pays a $100 dividend to M eligible for Section 245A.[147] P will have a $300 basis in M and can sell it for its value of $200, resulting in a $100 tax loss without a corresponding economic loss.

While this is very similar to a son of mirror transaction, the loss disallowance rule in -36(c) will not apply because P's outside basis in M ($300) is the same as M's inside basis in its assets (cash of $100 and CFC stock with a basis of $200). However, under -36(d), there is a duplicated loss, since both the stock of M and the assets of M have a

[147] The same issue would arise if, when M bought the CFC, the CFC had an asset with unrealized appreciation of $100 and sold the asset after the acquisition, with the resulting tested income being sheltered by tested loss or NDTIR.

basis of $300 and value of $200. On P's sale of the M stock, the loss is allowed (absent an election otherwise), but M's basis in the stock of the CFC will be reduced from $200 to $100.

By contrast, if the CFC paid a dividend of $100 to M, and M then sold the stock in the CFC for $100, the $100 loss would be disallowed under Section 961(d). As a result, the group obtains a better tax result, in effect avoiding Section 961(d), if it buys the CFC through a special purpose member M, and, if there is a loss, sells the stock of M rather than having M sell the stock of the CFC.

Yet another result is achieved if M sells the stock of the CFC. Under Section 1248, the tax exempt deemed dividend is limited to the gain on the sale of the stock, and no loss on the stock is possible as a result of undistributed earnings in the CFC.

It will be difficult for regulations to reconcile and rationalize these different results. One possibility for consideration would be a rule that if P's loss on the sale of M stock would not be disallowed under -36(c) or (d), P's basis in M will be reduced by the amount that the CFC basis reduction rule would reduce the basis of M in the CFC stock if M were to sell that stock at the same time.[148]

G. Our Preferred Approaches to Avoid Loss Duplication

We discuss in this Part IV.G two different but related approaches to avoiding the double tax benefit that can arise from the use of a tested loss of CFC2 to offset the tested income of CFC1. These approaches, unlike the Proposed Regulations, are designed to reach results similar to those that would arise if all the CFCs owned by a single corporate U.S. shareholder were a single corporation. We believe these approaches will be simpler to implement than the Proposed Regulations, yet will generally carry out the goal of the Proposed Regulations in preventing loss duplication. We only provide an outline here of the issues that would arise under these proposals.[149]

We believe that either of these proposals would be preferable to the basis rules in the Proposed Regulations, although we prefer the first proposal below to the second. If

[148] See Section 245A Report, at 43.

[149] We also considered an alternative approach that would merely disallow a loss on the sale of stock of a CFC to the extent of the used tested loss amount, similar to Section 961(d) or Treas. Reg. § 1.1502-36(c). However, we do not believe such a rule would be adequate at the CFC level, since it would not prevent the used tested loss amount from reducing gain on the sale of CFC stock. Also, if the same rule was the only limitation that applied on the sale of stock of M, the rule would be almost meaningless at that level, since the group would always arrange, to the extent possible, to have its CFCs owned by group members whose stock was highly appreciated. On the other hand, the automatic denial of loss on a stock sale would also be unfair to taxpayers unless they had the ability to show that the loss was not a duplicated loss.

the Treasury is interested in pursuing either of these proposals, we would be happy to assist further in this process.

1. *The Primary Proposal*

Under the primary approach that we suggest (the "**Primary Proposal**"):

(1) the e&p of CFC1 would be reduced, with respect to a corporate U.S. shareholder, by the shareholder's offset tested income amount, so in effect the offset tested income would not create e&p for the shareholder,

(2) the e&p of CFC2 would be increased, with respect to a corporate U.S. shareholder, by the shareholder's used tested loss amount, so in effect the used tested loss would not reduce e&p for the shareholder,

(3) the shareholder's PTI account would not be changed on account of the adjustments in (1) or (2),

(4) the shareholder's basis in the stock of CFC2 would mandatorily shift to its stock in CFC1, to the extent of the shareholder's used tested loss in CFC2, but the amount of the shift would be limited to the shareholder's existing basis in CFC2 (this limitation, the "**cap**"),[150] and

(5) corresponding basis shifts would be made at the same time to the stock of members of a consolidated group owning stock in the tested loss and tested income CFCs, under Treasury Regulation Section 1.1502-32.[151]

2. *Discussion of Primary Proposal*

The Primary Proposal is analogous in some ways to the proposed regulations under Section 965. Those rules also result, in substance, in the elimination of e&p from the system when one CFC has positive e&p and another CFC has negative e&p.[152]

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[150] If the tested loss of a CFC was used to offset the tested income of more than one tested income CFC, and the cap applied, the basis in the tested loss CFC would be shifted to the tested income CFCs in proportion to the tested income of each such tested income CFC.

[151] Further consideration needs to be given to whether corresponding e&p adjustments should be made at the member level.

[152] More specifically, under the proposed Section 965 regulations, when e&p of a deferred foreign income corporation ("**DFIC**") is offset by an e&p deficit of another specified foreign corporation ("**SFC**"), the offset amount ("**Section 951(b) PTI**") is not included in the U.S. shareholder's income, does not increase the U.S. shareholder's basis in the DFIC, and becomes e&p described in Section 959(c)(2). The Section 951(b) PTI is generally excluded from the U.S. shareholder's income when distributed. Assuming the distribution reduces the shareholder's basis in the DFIC and results in gain to the extent it exceeds basis, the impact of creating Section 951(b) PTI is similar to the elimination of e&p from the system. Also, under the proposed Section 959 regulations, the SFC's deficit in e&p is reduced by the offset. A number of issues are raised by this Section 951(b) PTI system, some of which are discussed in recent reports of ours.

However, there the basis shift is elective, is not limited by the cap, and causes gain to be recognized to the extent of any basis that would otherwise become negative. Here, the basis shift would be mandatory, but only to the extent of existing basis, so no gain is recognized at the time of the shift in basis.

Under the Primary Proposal, assuming CFC1 had no unrelated e&p, a distribution by CFC1 in the amount of its offset tested income would not be tax free under Section 245A, because no e&p would be created by such income. Rather, the distribution would be tax free under Section 301(c)(2) to the extent of the basis in the stock of CFC1, which would include any available basis shifted from CFC2. Any additional distribution would be taxable under Section 301(c)(3).

The Primary Proposal prevents a double tax benefit from arising from a tested loss, because no e&p is generated that is eligible for Section 245A. It is also closer to a single entity approach than would arise under the Proposed Regulations, since it in effect aggregates the basis of CFC1 and CFC2 for purpose of determining the taxability of distributions of offset tested income. It would also allow, as do the existing Proposed Regulations, the avoidance of gain in the stock of CFC1 by selling gain assets in CFC1 and loss assets in CFC2, to the extent that there was basis in CFC2 that would be shifted to CFC1. However, this result is consistent with the result that could arise if CFC1 and CFC2 were divisions of a single corporation, so perhaps it is not objectionable. Nevertheless, given the existence of two corporations, this ability to shift basis could give rise to significant tax planning opportunities.

The Primary Proposal is more favorable to taxpayers than the Proposed Regulations in some cases. In particular, it will be more favorable if the basis reduction in CFC2 is limited by the cap, there is sufficient separate basis in CFC1 to allow a full distribution of the tested income of CFC1, and if the stock of CFC2 is then sold. In that case, the Proposed Regulations will result in more gain on the sale of CFC2 than will the proposal, but the distribution of the full amount of tested income can be made tax free from CFC1 under either the Proposed Regulations or the Primary Proposal.

For example, assume shareholder M has a basis of $100 in CFC1 and $0 in CFC2. CFC1 has $100 of tested income and CFC2 has $100 of tested loss. M then sells the CFC2 stock. Under the Proposed Regulations, CFC1 can distribute the $100 of tested income tax free without any basis reduction in CFC1. However, on the sale of the CFC2 stock, the gain is $100 plus the amount realized. Under the Primary Proposal, there is no shift of basis to CFC1, but CFC1 can take advantage of M's existing basis in CFC1 to distribute $100 tax-free, reducing M's basis in CFC1 to $0. On the sale of CFC2, the gain is the amount realized.

See NYSBA Tax Section Report No. 1402, *Report on Previously Taxed Income under Section 959* (October 11, 2018); NYSBA Tax Section Report No. 1401, *Report on Proposed Section 965 Regulations* (October 5, 2018).

In summary, under the Primary Proposal compared to the Proposed Regulations, there is $100 less gain on the sale of CFC2 stock, accompanied by a $100 reduction in the basis in CFC1. This is more favorable to the taxpayer than the approach under the Proposed Regulations, but again, it is consistent with single entity treatment. A single entity would have no e&p, an outside basis of $100, and outside basis reduced to $0 on the distribution from the CFC1 division, and gain on the sale of the CFC2 business.

If the cap is considered by the Treasury to give results that are too favorable to taxpayers as compared to the Proposed Regulations, a number of variations on the Primary Proposal would be possible. Each, however, would have its own shortcomings, complexities and potential authority issues that would need to be explored further.

For example, it would be possible to trigger gain on the disposition of CFC2 to the extent that a basis shift was prevented by the cap (at least to the extent that the tested loss in CFC2 that would give rise to the basis shift arose from built-in losses that existed when M purchased CFC2). However, the basis in CFC1 should then be increased by the amount of such gain, as if the basis shift had originally occurred, and the resulting rules would be complex.

Alternatively, the amount of tested loss of CFC2 that could be used to offset tested income of other CFCs of M could be limited to M's existing tax basis in CFC2. In the example, M would have a $100 GILTI inclusion from CFC1, and the CFC basis reduction rule would not apply to CFC2 because there is no used tested loss. This rule would be somewhat analogous to Section 704(d), which limits a partner's allocable share of partnership losses to the partner's tax basis in the partnership.

Finally, an anti-abuse rule could be adopted to cover the case where M buys CFC2 with built-in loss assets for the purpose of selling those assets at a loss, uses the tested loss to shelter tested income of CFC1, relies on the cap to limit the basis reduction in CFC2, and then sells the stock of CFC2 at a gain that does not reflect the full basis reduction because of the cap.

On the other hand, the Primary Proposal will give worse results for taxpayers than the Proposed Regulations in some cases. This will be true if there is less total basis in CFC1 and CFC2 than the amount of offset tested income in CFC1. The reason is that the offset tested income could be distributed tax-free under the Proposed Regulations, but not under the Primary Proposal. For example, suppose shareholder M has a $0 basis in both CFC1 and CFC2, CFC1 has $100 of tested income, and CFC2 has $100 of tested loss. Under the Proposed Regulations, CFC1 can distribute the $100 of income tax-free under Section 245A, at the price of additional gain of $100 when the stock of CFC2 is sold. Likewise, M can sell the stock of CFC1 at a gain of $100 that would be tax exempt under Section 1248.

Under the Primary Proposal, CFC1 would have no e&p, and M would have no basis in CFC1, so the $100 of tested income could not be distributed tax free and the $100 of gain would be taxable. To be sure, this result is consistent with the result that would arise if CFC1 and CFC2 were divisions of a single corporation that had no net e&p and where the shareholder had a $0 basis in the stock.

The Primary Proposal would also raise the issue of how to deal with the case where the offset tested income of CFC1 would not be taxed even without regard to the used tested loss of CFC2. For example, the U.S. shareholder might have NDTIR or foreign tax credits that would shelter the tested income even in the absence of the tested loss. This is similar to the question under the Proposed Regulations about whether there is really a duplicated loss that requires a basis reduction in CFC2. However, the issue will come up less often under the Primary Proposal because of the inapplicability of Sections 245A, 961(d), and 1059.

On the merits, under single entity principles there would be no net e&p in the single entity, no benefit from NDTIR, and no eligibility for FTCs for foreign taxes paid by the single entity. As a result, the usual basis adjustments for tested income and tested loss would logically apply without regard to NDTIR or FTCs. The loss of FTCs arises because the Primary Proposal is applying single entity principles to multiple CFCs, while foreign jurisdictions are (naturally) applying separate entity principles. There should also be less concern about the Primary Proposal applying even in the absence of loss duplication, since the result here is "only" a shift in basis as opposed to a permanent elimination of basis as under the Proposed Regulations.

Another question would arise if, say, M has a $100 basis in CFC1 and a $0 basis in CFC2, and in year 1, CFC1 has offset tested income of $100, and CFC2 has used tested loss of $100. Normally, $100 of basis would shift from CFC2 to CFC1, but there is no basis in CFC2 to shift. Suppose now that in year 2, CFC1 has $100 of used tested loss and CFC2 has $100 of offset tested income. While $100 of basis would normally shift from CFC1 to CFC2, as an economic matter that should not occur here since the two CFCs end up in the same economic position as they started. Rather, there should only be a "notional" shift of basis in year 2 from CFC1 to CFC2 that offsets the failure to make the reverse basis adjustments in year 1.

As a result, any time the cap on basis reduction applies, there would need to be created a notional account for unutilized basis reduction in the tested loss CFC, and unutilized basis increase in the tested income CFCs. Future basis adjustments would have to offset these accounts before being reflected in actual basis numbers.

As to the consolidated return regulations, the basis reduction in the stock of the member holding the CFC would match the basis reduction in the CFC stock. This would be similar to Rule 1, but with the cap on basis reduction in the CFC limiting the reduction to M's basis in the stock of the CFC. The discussion in the preceding paragraph is comparable to Rule 2, and only actual basis adjustments (not notional adjustments described therein) in the stock of the CFCs would tier up to M. Rule 3 would logically still apply, since a CFC with exempt e&p (such as arising from NDTIR without the existence of any tested losses) should not be required to distribute its e&p in order to reduce the gain on the sale of stock of the member holding the CFC.

Issues would also arise under the Primary Proposal from the failure to include the tested income of CFC1 in its e&p allocable to the U.S. shareholder, and the failure to reduce the e&p of CFC2 allocable to the U.S. shareholder by its tested loss. We note as background that under the basic GILTI regime, different U.S. shareholders of a CFC might have different GILTI inclusions because of different amounts of NDTIR or tested losses in other CFCs. As a result, different U.S. shareholders of a single CFC might have different amounts of PTI in the CFC. However, in general, each shareholder of a CFC should have, on a per share basis, the same total of e&p and PTI, representing their share of the total undistributed untaxed and taxed earnings of the CFC, respectively.[153]

This relationship would no longer be true under the Primary Proposal. If a CFC had tested income, (1) as before, some shareholders might have a full GILTI inclusion and an increase in PTI for their share of the income, (2) as before, shareholders with unrelated NDTIR might have no GILTI inclusion and an increase in e&p for their share of the income, and (3) under the Primary Proposal, shareholders with other CFCs with tested losses might have no increase in either PTI or e&p (although they might obtain a basis increase in the stock of the CFC). Likewise, as to a CFC with a tested loss, some shareholders would have their share of the e&p reduced by their share of the loss, and others shareholders would not. The Primary Proposal would also create new disparities between inside e&p and outside tax basis, since there is a cap on the shift of outside tax basis, but no cap on the shift of e&p.

We are not claiming that the Primary Proposal would be simple, and in fact no system of sharing attributes will be simple. Moreover, this proposal would no doubt create discontinuities by treating CFC1 and CFC2 as a single corporation for some purposes when there are in fact two corporations. However, we believe that the Primary Proposal would be significantly simpler than the existing Proposed Regulations, largely because (1) there is no tax-free e&p arising from the offset of tested income in one CFC and tested loss in another CFC, and therefore no effects from the applicability or nonapplicability of Sections 245A, 961(d), and 1059, and (2) there is no basis disparity between the stock of the CFC and the stock of a member of a consolidated group holding the CFC.

In addition, unlike the proposed regulations under Section 965, the Primary Proposal does not create upfront gain from the shift in basis of CFC2, although at the cost of less ability to distribute tax-free cash under Section 301(c)(2). The Primary Proposal could be further simplified if it only applied to U.S. shareholders with an ownership (including by related parties) of 50% or 80% of a CFC.

3. *Authority for Primary Proposal*

As to the authority of the Treasury to adopt the Primary Proposal by regulations, the Proposed Regulations already cause a reduction in basis of a CFC upon its sale. We

[153] This assumes all shares are of the same class and were issued at the same time.

do not believe that the reduction of basis at the time of a tested loss under the Primary Proposal is a materially greater use of existing authority, particularly because the cap prevents any gain recognition at that time.

The adjustments to e&p under the Primary Proposal also raise questions of authority. Section 964(a) provides that the e&p of a foreign corporation "shall be determined according to rules substantially similar to those applicable to domestic corporations, under regulations prescribed by the Secretary." Although the adjustments to e&p under the Primary Proposal would not be applicable to domestic corporations, Section 964(a) contemplates at least some disparity in the calculation of e&p for domestic and foreign corporations.

Moreover, such a disparity would only arise when a shareholder's tested income of one CFC offsets the shareholder's tested loss from another CFC. This is a unique situation created by Congress in the GILTI regime, and arguably a different rule for e&p in this situation would not prevent the overall regime for determining e&p of a CFC from being considered "substantially similar" to the overall regime for a domestic corporation. Moreover, the Treasury could continue to rely on *Ilfeld* to justify this method of preventing loss duplication. Nevertheless, as we suggest in connection with Proposed Regulation Section 1.961-6(e), we acknowledge that the Treasury might wish to obtain a statutory amendment to confirm its authority to adopt this approach.

4. *The Secondary Proposal*

If the Treasury does not wish to adopt the Primary Proposal, we would propose a simplified and modified version of that proposal (the "**Secondary Proposal**"). Under this proposal, the same adjustment for e&p would be made as in the Primary Proposal. However, there would be no adjustment to tax basis (or PTI). As a result, if CFC1 had tested income and CFC2 had tested loss, CFC1 would not have any e&p as a result of its tested income, and there would be no basis shift from CFC2 to CFC1.

The Secondary Proposal is obviously simpler than the Primary Proposal. Moreover, just as does the Primary Proposal, the Secondary Proposal would avoid loss duplication by eliminating any Section 245A benefit from offset tested income. However, because of the lack of a shift in basis, the Secondary Proposal creates results that are less similar than the Primary Proposal to the results that would arise if CFC1 and CFC2 were divisions of a single corporation.

For example, under the Primary Proposal, the basis shift would mean that CFC1 could make tax-free distributions under Section 301(c)(2) to the extent of the preexisting basis of both CFC1 and CFC2. This is the same result that would arise if CFC1 and CFC2 were divisions of a single corporation. Under the Secondary Proposal, CFC1 could make tax-free distributions under Section 301(c)(2) only to the extent of the preexisting basis of CFC1, a worse result than if CFC1 and CFC2 were divisions of a single corporation.

On the other hand, as a general matter, a basis shift can either help or hurt taxpayers. If the U.S. shareholder had sufficient basis in CFC1 to permit any desired distribution by CFC1 even without a basis shift from CFC2, the shareholder might prefer the Secondary Proposal to the Primary Proposal. The basis shift under the Primary Proposal would provide no benefit to the shareholder, and could even provide a detriment because of increased gain (or reduced loss) on the sale of the stock of CFC2.

By contrast, under the Secondary Proposal, the tested loss in CFC2 reduces the GILTI inclusion of the U.S. shareholder from the tested income of CFC1, without causing any basis reduction in the stock of CFC2. As a result, if the tested loss reduces the value of CFC2, the tested loss is both reducing a GILTI inclusion and allowing a reduction in gain (or increase in loss) on the sale of the stock of CFC2.

To be sure, under this approach, there is no "double tax benefit" from the tested loss because the offset tested income in CFC1 cannot be distributed tax-free under Section 245A. Nevertheless, there could be a significant timing benefit if the U.S. shareholder had sufficient basis in CFC1 to cover desired distributions from CFC1, and desired to sell the stock in CFC2. This approach could therefore give rise to significant tax benefits and significant tax planning, particularly since the unreduced tax basis in CFC2 might prevent the creation of gain on a stock sale that could otherwise be taxable at a 21% rate or might create loss that could shelter other gain otherwise taxable at a 21% rate.

The Secondary Proposal would also increase further the incentives of taxpayers to engage in the transactions involving the cap as described in connection with the Primary Proposal. Those techniques relied on the fact that under the Primary Proposal there is no basis reduction in CFC2 in excess of the preexisting basis in CFC2. Under the Secondary Proposal, there is no basis reduction in CFC2 at all. As a result, there is even more incentive under this proposal for M to buy a CFC with a built-in tested loss in order to have the CFC sell those assets to shelter tested income of CFC1, followed by a sale of the CFC stock.

If the Secondary Proposal is adopted, there should not be any consolidated return basis adjustments under -32. If M sells CFC1 at an amount that reflects the untaxed tested income, M would have a taxable gain. The reason is that the tested income does not give rise to e&p, and so Section 1248(j) does not convert the gain into a tax-free dividend under Section 245A. In order to match this result upon the sale of the stock of M, there should not be any basis increase in the stock of M (as there is under Rule 3) when M sells the stock in CFC1. Likewise, when CFC2 has a used tested loss, M's basis in CFC2 does not change either at that time or upon the sale of CFC2. There would be no reason to create a basis disconformity by reducing P's basis in M (as in Rule 1) at either such time.

The authority issues concerning a shift in e&p under the Secondary Proposal would be the same as those issues under the Primary Proposal.

Appendix

Report No. 1394

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON THE GILTI PROVISIONS OF THE CODE

May 4, 2018

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I. Introduction

This Report[1] discusses the so-called "GILTI" provisions of the Code added by the legislation informally known as the Tax Cuts and Jobs Act (the "**Act**").[2] The GILTI provisions are primarily in new Code Section 951A (income inclusion) and Section 250 (deduction), although the Act made conforming changes to other Code provisions.[3] In general, the GILTI provisions require a U.S. shareholder (a "**U.S. shareholder**")[4] of a controlled foreign corporation ("**CFC**")[5] to pay, on a current basis, a minimum aggregate U.S. and foreign tax on its share of the earnings of the CFC. The GILTI rules, along with other changes to the international tax rules made by the Act, are the most far-reaching changes made to these rules in many decades.

Part II of this Report is a summary of our recommendations. Part III is a summary of the GILTI rules. Part IV is a more detailed analysis of certain of the GILTI provisions and discussion of our recommendations. Appendix 1 contains diagrams and more detailed calculations concerning some of the Examples in the Report.

The Report discusses the issues under the GILTI rules that we have identified so far and that we consider most significant. As a consequence, there are many issues that are beyond the scope of the Report. In most cases we comment on the statute as written without proposing far-reaching revisions to it, although we make some specific suggestions for statutory changes to make the GILTI regime work better.

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[1] The principal authors of this report are Kara Mungovan and Michael Schler. Helpful comments were received from Neil Barr, Kimberly Blanchard, Nathan Boidman, Andy Braiterman, Peter Connors, Charles W. Cope, Michael Farber, Kevin Glenn, Peter Glicklich, David Hardy, David P. Hariton, Monte Jackel, Shane Kiggen, John Lutz, Jeffrey Maddrey, Alexey Manasuev, Teddy McGehee, David Miller, Michael Mollerus, Jose E. Murillo, John Narducci, Richard M. Nugent, Amanda H. Nussbaum, Cory John O'Neill, Paul Oosterhuis, Alexander Pettingell, Vasujith Hegde Rajaram, Yaron Z. Reich, Richard L. Reinhold, Robert Scarborough, Stephen Shay, David R Sicular, Eric B. Sloan, Andrew P. Solomon, Karen G Sowell, David Stauber, Chaim Stern, Ted Stotzer, Joe Sullivan, Jonathan Talansky, Marc D. Teitelbaum, Shun Tosaka, Richard R. Upton, Philip Wagman, Andrew Walker, Gordon E. Warnke and Robert H. Wilkerson. This report reflects solely the views of the Tax Section of the New York State Bar Association (***"NYSBA"***) and not those of the NYSBA Executive Committee or the House of Delegates.

[2] The Act is formally known as "*An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018*", P.L. 115-97.

[3] Unless otherwise stated, all "Code" and "Section" references are to the Internal Revenue Code of 1986, as amended.

[4] A U.S. shareholder is defined in Section 951(b) as a U.S. person that actually or constructively owns 10% or more of the vote or value of the stock in a foreign corporation. Prior to the Act, the test was based solely on voting power.

[5] A CFC is defined in Section 957(a) as a foreign corporation if stock with more than 50% of the total vote or value of its shares is actually or constructively owned by U.S. shareholders on any day during its taxable year.

II. Summary of Principal Recommendations

A. Purpose of the GILTI Regime

1. The GILTI regime contains elements of both a flat rate of tax on foreign income and the treatment of GILTI as an imperfect add-on to the existing rules for foreign source income. We believe that to the extent consistent with the statutory language, regulations should give significant weight to the theory that Congress intended to adopt the former approach. *See* Part IV.A.

B. Aggregation of Members of a Consolidated Group

2. Members of a group filing a consolidated U.S. Federal income tax return (a "**consolidated group**") should be treated as a single corporation for purposes of (a) the taxable income limitation under Section 250(a)(2), *see* Part IV.B.2, (b) the Section 904 foreign tax credit ("**FTC**") limit on the GILTI basket, *see* Part IV.B.3, and (c) the amount of the GILTI inclusion and the "inclusion percentage" (defined below), *see* Part IV.B.4.

3. We do not recommend applying aggregation principles to CFCs held by U.S. members of a controlled group that do not file a consolidated return, except perhaps as an anti-abuse rule if a principal purpose of having multiple owners of multiple CFCs is to avoid the purposes of the GILTI rules. *See* Part IV.B.4(b).

4. If this approach for the GILTI inclusion is adopted, Treasury and the Internal Revenue Service ("**IRS**") (Treasury and IRS referred to collectively as "**Treasury**") should consider whether the same rule should apply to CFCs held by a partnership where a specified percentage of the partnership is owned by group members. *See* Part IV.B.4(b).

C. Deductions Allowed in Calculating Tested Income

5. Regulations should clarify the method for calculating the tested income of a CFC. In general, we do not see a policy justification for deductions not allowed to a U.S. corporation to be allowed to a CFC in calculating tested income. We recommend that regulations adopt as a starting point either U.S. taxable income or the existing rules for Subpart F (which are largely based on GAAP income). In either case, Treasury should have the ability to make adjustments to bring the result closer to the other, and in the latter case the existing rule under Subpart F that the result should not be materially different than U.S. taxable income should be retained. *See* Part IV.C.2.

6. To the extent a U.S. corporation would be entitled to carry over a loss or deduction to a future year, we believe the same should be true of a GILTI loss. Therefore, if a CFC has a tested loss that is not utilized currently by its U.S. shareholders, regulations or a statutory amendment should permit the loss to be reattributed to the shareholders and carry over at the shareholder level to offset future GILTI inclusions, under rules similar to rules for domestic net operating losses ("**NOLs**"). Permitting carryovers of tested losses at the CFC level presents many complex issues and is likely not feasible. *See* Part IV.C.3(a).

7. If regulations apply Section 163(j) to CFCs, a CFC should be permitted to carry forward interest deductions disallowed under Section 163(j) in the same manner as a domestic corporation. *See* Part IV.C.3(b).

D. Other Computational Issues for GILTI Inclusions

8. Regulations should confirm that tested income of a CFC is determined before Section 956 inclusions. *See* Part IV.D.1.

9. When stock of a first tier or second tier CFC is sold, amendments made by the Act in some cases will cause the portion of the Subpart F income and Section 951A inclusions of the CFC for the taxable year of sale and attributable to the selling shareholder to permanently avoid inclusion in the U.S. tax base. We take no position on whether these results should be changed by legislation or regulations. However, we point out some possible approaches if a change is desired. *See* Part IV.D.2.

10. Regulations should clarify that under Section 951A(e)(3), while there is no minimum period of time that a CFC needs to qualify as a CFC in order for it to be a CFC during its qualification period, it is only a CFC during its qualification period rather than for the entire taxable year in which it is qualified for any period of time. *See* Part IV.D.2.

11. Regulations should address the order in which Section 163(j) and Section 250 are to be applied. The deduction in Section 250(a)(1) could come first, then the limits under Section 163(j) could apply, and then the taxable income limit for the Section 250 deduction under Section 250(a)(2) could apply. *See* Part IV.D.3.

12. Regulations should clarify that for purposes of the taxable income limit in Section 250(a)(2), taxable income includes all Section 951A, Subpart F, Section 78, and FDII inclusions, without regard to the Section 250(a)(1) deduction. In addition, regulations should clarify whether the Section 250(a)(2) carve-back applies to a Section 78 gross-up amount for a Section 951A inclusion. *See* Part IV.D.4.

13. Regulations should provide that typical nonconvertible preferred stock in a CFC is not allocated any tested income of the CFC in excess of accrued and unpaid dividends, and should clarify whether any allocation in excess of such dividends is made to convertible preferred stock. *See* Part IV.D.5.

14. Regulations should clarify whether the gross interest expense of a CFC with a tested loss reduces the NDTIR (defined below) of the U.S. shareholder without any adjustment for any notional QBAI return (defined below) of the CFC in question. *See* Part IV.D.6.

15. Regulations should address a number of issues involving tax basis and earnings and profits ("**e&p**") that arise from GILTI inclusions. *See* Part IV.D.7. The Tax Section will be submitting a separate Report discussing these issues in more depth.

E. Foreign Tax Credit Issues

16. Principles from Treas. Reg. § 1.904-6 should be applied to determine whether foreign taxes paid by a CFC are "properly attributable" to tested income of the CFC. Once such a connection is made, the foreign taxes should not need to be traced to particular dollars of tested income in order to be considered properly attributable to tested income. *See* Part IV.E.1(a).

17. When income accrues in a different year for U.S. and foreign tax purposes, foreign taxes on that income should still be treated as tested foreign income taxes eligible for FTCs. In addition, regulations should confirm that Section 905(c)(2)(B) applies to audit adjustments relating to tested income, and clarify the application of that provision. Finally, the principles of Section 905(c)(2)(B) should be extended so that, in as many situations as possible, the foreign tax will be deemed to arise in the same year as the U.S. inclusion rather than in the taxable year in which the tax is paid or accrued. *See* Part IV.E.1(b).

18. Regulations should confirm that withholding tax on a distribution of tested income that is previously taxed income ("**PTI**") is not subject to the 20% cutback on GILTI FTCs or to cutback by the inclusion percentage (defined below). *See* Part IV.E.1(c).

19. If Treasury determines that no expenses of the U.S. shareholder are "properly allocable" to income in the GILTI basket, Treasury could issue regulations that no allocation of expenses to that basket should be made. However, arguments can be made that such an interpretation would be inconsistent with the structure and purpose of the statute.

In any event, as a policy matter, we do not believe that no shareholder expenses should be allocated to the GILTI basket. Rather, we believe the existing regulatory framework for allocating expenses should not be applied wholesale to GILTI, and consideration should be given to modifying certain of the existing allocation rules to minimize allocations to GILTI inclusions that are not economically justified.

In particular, certain aspects of the allocation rules for research and development expenses should be reconsidered, and regulations should clarify that Section 864(e)(3) does not apply to stock giving rise to dividends eligible for the Section 245A deduction. In addition, regulations should determine whether expenses should be allocated to a CFC based on the exempt CFC return of the CFC for the year or based on the Section 245A dividends actually paid by the CFC during the year. Moreover, when allocations of expenses are now based on gross income rather than assets, possibly these allocations should be based on net GILTI rather than gross GILTI. *See* Part IV.E.2(a).

20. Regulations should clarify the application of new Section 904(b)(4), and in particular whether it results in the calculation of FTC baskets by disregarding all exempt income from a CFC and shareholder expenses related to such exempt income, without any reallocation of such expense to other income or assets. *See* Part IV.E.2(b).

21. Regulations should confirm that the portion of the Section 250 deduction that is allocable to the GILTI inclusion is allocated to the GILTI basket. *See* Part IV.E.2(c).

22. Regulations should specify that the Section 78 gross-up for foreign taxes deemed paid under Section 960(d) is in the GILTI basket. If this position is rejected, so the gross-up is in the general basket, regulations should provide that the portion of the foreign tax allocable to the gross-up is also in the general basket. *See* Part IV.E.2(d).

23. Regulations should confirm that interest, rent and royalties received by a U.S. shareholder of a CFC from the CFC should be treated as non-GILTI inclusions for Section 904(d) purposes. *See* Part IV.E.2(e).

24. Legislation should be adopted to treat foreign taxes on items that are not in the U.S. tax base as being in a basket determined on the basis of the facts and circumstances, rather than always being in the general basket as in the past. If this recommendation is rejected, a statutory amendment should be adopted to correct a drafting error that now puts these residual taxes in the branch basket. *See* Part IV.E.2(f).

25. Regulations should provide that withholding tax on distributions of tested income that is previously taxed income is in the GILTI basket. In addition, regulations or legislation should extend the principles of Section 960(c)(1)(A) to such withholding tax, so that excess limitation in the year of the inclusion of the underlying tested income would be available to allow FTCs for such withholding tax in the year the tax is imposed. *See* Part IV.E.2(g).

26. Regulations should clarify issues that arise in 2018 and later years from an overall foreign loss or overall domestic loss under Sections 904(f) and (g) in 2017, in light of the fact that the Section 904(d) baskets have changed in 2018. *See* Part IV.E.2(h).

27. Regulations should clarify issues involving FTCs that arise because the concept of tested income did not exist before 2018. Part IV.E.2(i).

F. U.S. Partnership as a U.S. Shareholder in a CFC

28. If a CFC is held through a U.S. partnership, the GILTI inclusion and the Section 250 deduction should be determined at the partner level. However, Section 163(j) should not apply at the partnership level in a manner that allows a greater interest deduction than if Section 250 and Section 163(j) applied at the same level. We propose two methods to achieve the latter result. *See* Parts IV.F.1 through IV.F.3.

29. If regulations determine instead that the GILTI inclusion and deduction should be made at the partnership level, they should clarify how the rule applies to certain ownership situations, whether the Section 250(a)(2) limit is determined at the partner or partnership level, and how the Section 250 deduction is to be modified at the partnership level to reflect partners (such as individuals) that are not eligible for such deduction, in order to calculate the Section 163(j) limit at the partnership level. *See* Part IV.F.4.

G. Other Issues

30. Regulations or legislation should allow a Section 250 deduction based on the deemed GILTI inclusion under Section 962, and should clarify whether a dividend from

the CFC is to be treated as qualified dividend income **("QDI")**. We also support the positions on Section 962 taken in Notice 2018-26.[6] *See* Part IV.G.1.

31. We take no position on whether Treasury should adopt anti-abuse rules to deal with fiscal year 2017-2018 transition issues under GILTI. If Treasury determines to do so, we suggest various standards it might consider. If it believes anti-abuse rules are necessary but that the statutory grant of authority is too limited, it should request legislation to conform the statute to the scope of anti-abuse authority referred to in the Conference Report. *See* Part IV.G.2.

32. The consequences of the repeal of Section 958(b)(4) should be limited, by regulations or a statutory amendment, to the intended scope of repeal as reflected in a colloquy on the floor of the Senate. However, any such regulations or amendment should only be adopted after taking into account its effect on other Code provisions. *See* Part IV.G.3.

33. Regulations should address the overlap between Section 250(a)(2) (limiting the Section 250 deduction to a percentage of taxable income) and Section 172(d)(9) (stating that the deduction cannot be used to create an NOL). *See* Part IV.G.4.

34. Regulations should clarify whether GILTI inclusions are investment income under Section 1411 (*see* Part IV.G.5), clarify the extent to which GILTI inclusions are qualified income for REIT purposes (*see* Part IV.G.6), clarify the rules for a RIC having a GILTI inclusion (Part IV.G.7), and confirm that GILTI inclusions are not UBTI to a tax-exempt U.S. shareholder (*see* Part IV.G.8).

35. Legislation should be enacted to treat all CFCs related to a particular U.S. shareholder as a single corporation for purposes of the GILTI calculations for that shareholder. The existing rules that treat each CFC separately are unjustified as a policy matter, are very unfair to taxpayers, and invite restructurings solely for tax purposes. *See* Part IV.H.

III. Summary of GILTI Rules

A. Income Inclusion

Section 951A requires each U.S. shareholder of a CFC to include in its gross income each year its share of "global intangible low-taxed income" or "**GILTI**" for the year.[7]

[6] 2018-16 IRB (April 2, 2018).

[7] Section 951A(a).

GILTI is calculated on a U.S. shareholder-by-U.S. shareholder basis. It is the excess, if any, of the U.S. shareholder's "net CFC tested income" for the year over its "net deemed tangible income return" ("**NDTIR**") for the year.[8] GILTI cannot be negative.

In addition, if the U.S. shareholder is a domestic corporation that elects to receive the benefit of FTCs for a taxable year, 100% of the foreign taxes attributable to the Section 951A inclusion are included in gross income under Section 78.

References herein to the "**GILTI inclusion**" mean the inclusion under Section 951A and, where applicable when a CFC pays foreign taxes, the Section 78 gross-up of such inclusion for such foreign taxes.

1. Net CFC Tested Income

A U.S. shareholder's "net CFC tested income" for a taxable year is based on the "tested income" or "tested loss" for the year of each CFC of which it is a U.S. shareholder. (With respect to any U.S. shareholder, each such CFC is referred to herein as a "**Related CFC**"). The U.S. shareholder's net CFC tested income is the excess (if any) of the aggregate of the U.S. shareholder's *pro rata* share of the tested income of each Related CFC with positive tested income, over the U.S. shareholder's *pro rata* share of the tested loss of each Related CFC with a tested loss.[9] Net CFC tested income cannot be negative.

"Tested income" of a CFC for a taxable year is the excess (if any) of the CFC's gross income, with certain specified exceptions, over the "deductions (including tax) properly allocable to such gross income under rules similar to the rules of section 954(b)(5) (or to which such deductions would be allocable if there were such gross income)".[10] The specified exceptions are:

(1) effectively connected income described in Section 952(b),

(2) gross income taken into account in determining the Subpart F income of the CFC,

(3) gross income excluded from foreign base company or insurance company Subpart F income by reason of the high-tax exception in Section 954(b)(4),[11]

[8] Section 951A(b)(1).

[9] Section 951A(c)(1).

[10] Section 951(c)(2)(A).

[11] This exclusion means that high-taxed Subpart F income is excluded from GILTI, but other high-taxed operating income is included. It can be helpful to taxpayers to allow the averaging of high- and low-taxed tested income for FTC purposes, but it can also be harmful because it can "waste" high GILTI FTCs that cannot be carried over as GILTI credits (*see* the discussion in Part III.D) but might be usable currently or as future carryovers in the general basket or passive basket. Note that Treas. Reg. § 1.954-1(d)(1) allows the high-tax exception from Subpart F income to be elected on a CFC by CFC basis, but the exclusion from

(4) dividends received from a related person (as defined in Section 954(d)(3)), and

(5) foreign oil and gas extraction income (as defined in Section 907(c)(1)).[12]

Tested loss is the excess (if any) of the deductions described above over the income, calculated as described above.[13] Accordingly, a CFC can have tested income or tested loss, but not both. A CFC that breaks even has neither tested income nor tested loss.

2. NDTIR

A U.S. shareholder's NDTIR for a year is determined by a multi-step process. First, for each Related CFC with positive tested income for the year, its "specified tangible property" is its tangible property used in the production of tested income,[14] and its "qualified business asset investment" ("**QBAI**") is the aggregate adjusted tax basis of its specified tangible property that is used in a trade or business and subject to an allowance for depreciation.[15] If a CFC does not have positive tested income for a year, none of its tangible property for the year is taken into account and it has no QBAI.

Second, the U.S. shareholder aggregates its *pro rata* share of the QBAI for all of the Related CFCs. Third, this aggregate QBAI amount is multiplied by ten percent, which is considered a deemed return on the tangible assets that should not be subject to U.S. tax.[16] Fourth, this deemed return is reduced by any interest expense taken into account in calculating the shareholder's net CFC tested income for the year, except to the extent interest income attributable to that interest expense was also taken into account in determining the shareholder's net CFC tested income.[17] The reduction applies even if the interest expense is not in the same Related CFC as is the QBAI. The result is the U.S. shareholder's NDTIR.[18] Note that gross interest expense of a CFC (unless paid to a Related

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GILTI will apply to a CFC whether or not such an election is made (under the Subpart F exclusion if no election is made or under the exclusion for high-taxed Subpart F income for which the election is made).

[12] Section 951A(c)(2)(A).

[13] Section 951A(c)(2)(B)(i).

[14] Section 951A(d)(2)(A). If property is used in the production of tested income and other income, then it is treated as specified tangible property in the same proportion as the tested income bears to the total income. Section 951A(d)(2)(B).

[15] Section 951A(d)(1). The adjusted tax basis is determined at the end of each quarter of the taxable year and then averaged.

[16] Section 951A(b)(2)(A).

[17] Section 951A(b)(2)(B).

[18] Section 951A(b)(2).

CFC of the same U.S. shareholder) reduces the U.S. shareholder's NDTIR to the extent thereof, even if the CFC has offsetting interest income from an unrelated party.

It is important to distinguish calculations that are done at the CFC level and calculations that are done at the U.S. shareholder level. Tested income is purely a CFC level concept, and NDTIR is purely a shareholder level concept. Each CFC with positive tested income has its own QBAI, but the calculation of the exempt return on QBAI is done at the shareholder level by aggregating QBAI of all Related CFCs and multiplying the total by 10%. Likewise, each CFC has its own interest expense allocable to its own tested income, but the total of such interest expenses of all Related CFCs of a U.S. shareholder (except if paid to another Related CFC of the same U.S. shareholder) is aggregated at the shareholder level in calculating the reduction to NDTIR.

Stated simply, the GILTI gross income inclusion is essentially the U.S. shareholder's share of (1) the aggregate net tested income, if positive, of all Related CFCs, with limited exceptions such as Subpart F income, minus (2) 10% of the tax basis of the tangible depreciable assets of those Related CFCs with positive tested income. However, any gross interest expense (not paid to a Related CFC of the same U.S. shareholder) will reduce the size of item (1) and automatically also reduce the size of (2), so such interest expense does not reduce the GILTI gross income inclusion except to the extent it exceeds the size of item (2).

For convenience, we use the term "**QBAI return**" of a particular CFC with tested income to refer to 10% of the QBAI of the CFC, without reduction for any interest expense. In practice, this is the amount of exempt income generated by the CFC for the U.S. shareholder, before reduction for interest expense. If a particular CFC does not have positive tested income, we use the term "**notional QBAI return**" to refer to the QBAI return the CFC would have if it had positive tested income. Unless indicated otherwise, we assume throughout that there is no interest expense that reduces QBAI return.

B. Section 250 Deduction

1. Initial Calculation

A domestic corporation is entitled to a deduction equal to the sum of (A) 37.5% of its "foreign-derived intangible income", or "**FDII**", (B) 50% of the Section 951A inclusion and (C) 50% of the Section 78 amount included in its income and attributable to GILTI (together, the "**Section 250 deduction**").[19]

> Example 1. U.S. shareholder with no FDII has $100 of Section 951A inclusion solely from a CFC with no foreign taxes. The Section 250 deduction

[19] Section 250(a)(1). The percentages are lowered from 37.5% and 50% to 21.875% and 37.5%, respectively, for taxable years beginning after December 31, 2025. A discussion of the Section 78 amount is included below. FDII is calculated pursuant to Section 250(b), but a detailed discussion of FDII is beyond the scope of this report.

> is \$50, resulting in \$50 of taxable income. The income is taxed at 21% to a corporate U.S. shareholder, for an effective tax rate of 10.5% on GILTI.

2. Carve-Back to Deduction

Under Section 250(a)(2), if the sum of the U.S. shareholder's FDII and Section 951A (and possibly Section 78) inclusions exceeds its taxable income (not taking into account the Section 250 deduction), then, solely for purposes of calculating the Section 250 deduction, those inclusions are reduced *pro rata* by the excess (the "**carve-back**").[20] In addition, the Section 250 deduction is disallowed in calculating a net operating loss.[21]

The carve-back comes into effect if the U.S. shareholder has current losses or loss carryovers to the year in question, and those losses exceed the non-GILTI, non-FDII income of the corporation. In that case, the carve-back requires that these losses be used to offset FDII and GILTI eligible for the Section 250 deduction, and the deduction is calculated by reference to the FDII and GILTI that remain (if any) after the losses have been used. As a result, the excess losses might be absorbed in the year but provide the U.S. shareholder with a tax benefit of only a fraction of the usual tax benefit of a loss.

> <u>Example 2(a)</u>. U.S. shareholder has \$100 of operating income and \$100 of Section 951A inclusion. If the shareholder has no other income or loss, the Section 250 deduction is \$50, taxable income is \$150, and the tax is \$31.50. If the shareholder instead has a \$100 NOL carryforward to the year, the pre-Section 250 taxable income and Section 951A inclusion for the year are both \$100, so there is no carve-back. The Section 250(a)(1) deduction is \$50, the taxable income is \$50, and the tax is \$10.50. The tax savings from the NOL is \$21, as would be expected.

> <u>Example 2(b)</u>. Same facts as Example 2(a), except the NOL is \$150. Now, the taxable income before Section 250 is \$50, and the carve-back limits the Section 250 deduction to 50% of that, or \$25. Taxable income is \$25, and tax liability is \$5.25.

[20] Section 250(a)(2). It is not clear if the carve-back applies to Section 78 inclusions. *See* the discussion in Part IV.D.4. The reductions in GILTI and FDII are not completely symmetrical, because expenses of the U.S. shareholder allocable to its FDII income reduce its FDII, while expenses of the U.S. shareholder allocable to its Section 951A inclusion do not reduce that inclusion.

[21] Section 172(d)(9).

> The tax savings from the extra $50 of NOL is $10.50 minus $5.25, or $5.25, a rate of savings of 10.5% rather than 21%.

In fact, every $100 of NOL that exceeds non-GILTI, non-FDII income reduces the GILTI and FDII inclusion in taxable income by $100, and therefore reduces the Section 250 deduction by $50. This results in a net decrease in taxable income of $50, for a net tax saving of $10.50, half the usual benefit from an NOL.[22]

C. Foreign Tax Credits

1. Calculation of the FTC

If a domestic corporation includes GILTI in income, and elects to credit foreign taxes, it is treated as having a "deemed paid" FTC equal to the product of (1) 80% of the aggregate "tested foreign income taxes" paid or accrued by the Related CFCs, and (2) the domestic corporation's "inclusion percentage".[23]

"Tested foreign income taxes" are foreign income taxes paid or accrued by a Related CFC that are "properly attributable" to the tested income of the CFC taken into account by the U.S. shareholder in calculating GILTI.[24] Accordingly, foreign taxes include taxes attributable to QBAI return, since tested income is not reduced by QBAI return. However, if a particular CFC does not have positive tested income for a year, foreign taxes paid by that CFC for that year do not give rise to tested foreign income taxes for the year.[25]

A domestic corporation's "inclusion percentage" is a fraction, the numerator of which is its Section 951A inclusion and the denominator of which is the aggregate of its share of the tested incomes of all Related CFCs with positive tested income.[26]

Note that the corporation's Section 951A inclusion is the tested income of Related CFCs with positive tested income, reduced by (1) tested loss of Related CFCs with tested loss, and (2) NDTIR based on QBAI of Related CFCs with positive tested income. As a

[22] Under the rules for FTCs discussed below, the tax saving from the NOL is further reduced if the Section 951A inclusion carried with it a foreign tax credit, since in that case the U.S. residual tax rate on the inclusion is less than 10.5%. As a general matter, subject to various complications discussed herein, the higher the foreign tax rate (up to a point), the lower the U.S. residual tax and the smaller the benefit from the carryforward.

[23] Section 960(d)(1).

[24] Section 960(d)(3).

[25] Section 960(d)(3); Conference Report, at 643 n. 1538, describing the Senate Bill ("Tested foreign income taxes do not include any foreign income tax paid or accrued by a CFC that is properly attributable to the CFC's tested loss (if any).)"

[26] Section 960(d)(2).

result, these two items reduce the numerator but not the denominator of the inclusion percentage, and so they reduce the percentage.

> Example 3. U.S. shareholder owns (1) CFC1 with tested income of $100 after foreign taxes, foreign taxes of $15, and QBAI return of $20, and (2) CFC2 with tested loss of $30 after foreign taxes and foreign taxes of $10. The Section 951A inclusion is $100 (tested income of CFC1)) minus $20 (NDTIR) minus $30 (tested loss of CFC2), or $50, and the tested foreign income taxes are $15. The inclusion percentage is $50 (the Section 951A inclusion) divided by $100 (the positive tested income of CFC1), or 50%. The allowed FTC is therefore 80% times 50% times $15, or $6.

2. GILTI Basket

For FTC purposes, GILTI is a separate basket, with no carrybacks or carryforwards.[27] Any income that is GILTI is not general category income.[28]

3. Section 78 Amount

As noted above, if a domestic corporation elects to receive the benefit of FTCs for a taxable year, 100% of the foreign taxes deemed paid by the domestic corporation are counted in the deemed dividend, or "Section 78 amount".[29] The Section 250 deduction is allowed against the full grossed-up amount.[30]

> Example 4(a). In Example 3, the U.S. shareholder would have a Section 78 amount of $7.50, for total GILTI inclusion of $50 plus $7.50, or $57.50.[31] We assume hereafter that the gross-up goes in the GILTI FTC basket.[32]

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[27] Section 904(c) and (d)(1)(A).

[28] Section 904(d)(1)(A) and (2)(A)(ii).

[29] Section 78.

[30] Section 250(a)(1)(B)(ii).

[31] The U.S. shareholder's allowed FTC was 80% times 50% times $15, or $6. Its inclusion under Section 78 is the same as the allowed FTC, but without the 20% cutback, so it is 50% times $15, or $7.50.

[32] *See* Part IV.E.2(d).

> Example 4(b). Consider the simple case where the U.S. shareholder owns a single CFC with $100 of pre-tax tested income, no QBAI return, and $13.125 of foreign taxes. The tested income and Section 951A inclusion are $86.875. The inclusion percentage is 100% (86.875/86.875), so it does not reduce the foreign tax credit of $13.125. The credit results in a Section 78 inclusion of $13.125. The GILTI inclusion is $100 and the allowed foreign tax credit is 80% of $13.125, or $10.50. If the full Section 250 deduction of $50 is allowed, taxable income will be $50 and the tentative U.S. tax liability is $10.50. If no expenses are allocated to GILTI income (*see* Part III.D) the FTC will exactly offset the U.S. tax.

D. Limitations on Use of FTCs

In general, a taxpayer's FTC for a year is limited to (1) the taxpayer's foreign source taxable income for the year, multiplied by (2) the effective U.S. tax rate on the taxpayer's worldwide taxable income for the year.[33] This determination is made separately for each FTC basket, including the GILTI basket.[34] The U.S. shareholder must therefore determine which items of gross income belong in the GILTI basket, and then allocate and apportion its deductions to determine net income in the GILTI basket.[35]

Under preexisting law, deductions that are "definitely related" to gross income are generally allocated and apportioned to that gross income, and other deductions are generally ratably allocated and apportioned.[36] Following the Act, interest deductions are generally allocated and apportioned on the basis of the tax basis of assets, rather than the value of assets or income.[37]

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[33] Section 904(a). The formula in the text assumes no U.S. source losses. The statutory formula is that the allowed FTC cannot exceed the same proportion of total U.S. tax liability (before FTCs) that foreign source taxable income bears to worldwide taxable income. Mathematically, this is equivalent to the rule that the allowed FTC cannot exceed (1) total U.S. tax liability, multiplied by (2) foreign source taxable income, with the product divided by (3) worldwide taxable income. Since (1) divided by (3) is the effective U.S. tax rate on worldwide taxable income, the formula is equivalent to that in the text. New Section 904(b)(4), discussed below, modifies this formula in certain cases.

[34] Section 904(d).

[35] Various re-sourcing rules under Section 904 must be taken into account but are beyond the scope of this discussion.

[36] *See generally,* Sections 861(b), 862(b), 863(a) and Treasury Regulations thereunder.

[37] Section 864(e)(2), Temp. Treas. Reg. § 1.861-9T(a). Prior to the Act, Section 864(e)(2) allowed an allocation based on the basis or value of assets, but now basis is required. There are exceptions to this general rule, including that (i) interest expense is directly allocated to income generated by certain property

> Example 5(a). Same facts as Example 4(b). U.S. source income is $0, foreign source income (after Section 250 deduction) is $50, U.S. tax before FTC is $10.50, and effective U.S. tax rate is 21% ($10.50/$50). The Section 904 limit is $50 (foreign source income) multiplied by 21% (effective U.S. tax rate), or $10.50, so the full credit is allowable.
>
> Example 5(b). Same facts as Examples 4(b) and 5(a), except that U.S. shareholder also has U.S. source business income of $10 (before interest deductions) and $10 of interest deductions. Assume the interest deductions are all treated as U.S. source deductions. The result is the same as in Example 5(a).
>
> Example 5(c). Same facts as Example 5(b), except $5 of the interest deductions are allocable to the foreign source GILTI inclusion. Then, nothing changes except the FTC limit under Section 904(a). That limit is now $45 (foreign source GILTI inclusion of $50 minus interest expense of $5) times the effective U.S. tax rate of 21%, or $9.45. Thus, only $9.45 of FTC is allowed, and there is U.S. tax of $10.50 minus $9.45, or $1.05. Note that this loss of credits has the same tax cost ($1.05) as would the allowance of the full FTC and the disallowance of the $5 of foreign source interest deductions. The same result would arise for any other deductions allocable to the GILTI inclusion.

Members of an affiliated group, whether or not they file a consolidated return, must allocate and apportion interest expense of each member as if all members of the group were a single corporation.[38] A similar rule applies for purposes of allocating and apportioning certain other expenses that are not directly allocable or apportioned to any specific income producing activity.[39] For affiliated groups filing a consolidated return, all foreign taxes

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acquired, constructed or improved with proceeds of qualified nonrecourse indebtedness, (ii) interest expense is directly allocated to certain investments funded with amounts borrowed in connection with certain integrated financial transactions and (iii) third party interest expense must be directly allocated to certain separate foreign tax credit limit categories in certain circumstances where the U.S. shareholder's debt is much greater than its CFCs' debt. Temp. Treas. Reg. § 1.861-10T(a), (b), (c), Treas. Reg. § 1.861-10(e).

[38] Section 864(e)(1), Temp. Treas. Reg. § 1.861-11T. Foreign corporations are excluded from an affiliated group for this purpose. Treas. Reg. § 1.861-11(d)(1).

[39] Section 864(e)(6), Temp. Treas. Reg. § 1.861-14T.

paid by group members are aggregated, and a single Section 904 limit is calculated for the group.[40]

IV. Discussion and Recommendations

A. Purpose of the GILTI Regime

As can be seen from the description above, the GILTI regime creates a tax system for the United States that is a hybrid between a territorial system and a world-wide system. Like a world-wide system, a significant amount of income of a U.S. shareholder that is earned through CFCs is subject to immediate U.S. tax if the foreign tax rate is insufficient. Moreover, gains on a sale of CFC stock are taxable if they exceed previously taxed income in the CFC. While the territorial system in most countries does not tax foreign operating income at all, the GILTI regime taxes GILTI income at a significantly lower rate than domestic income. Moreover, NDTIR is permanently exempt from U.S. tax, and dividends from foreign subsidiaries are exempt from U.S. tax.[41]

In addition, to the extent that GILTI is a world-wide tax system, it results in yet another hybrid between (1) a flat minimum domestic and foreign tax rate on a U.S. shareholder's non-NDTIR GILTI inclusions earned through CFCs[42] (the "**flat-rate theory**"), and (2) the imperfect adding of the GILTI regime onto the existing tax regime for foreign source income, particularly Subpart F income (the "**add-on theory**").

The strongest evidence that Congress intended the flat-rate theory is that the Conference Report arguably contemplates no GILTI tax if the foreign tax rate is at least 13.125%,[43] although this may have merely been intended as an illustrative rate.[44] Other factors that are consistent with this theory (although with the add-on theory also) are the ability to offset tested income of some CFCs with tested losses of other CFCs, and the fact

[40] Treas. Reg. § 1.1502-4(d).

[41] In the case of a U.S. shareholder that is not a domestic corporation (and assuming no Section 962 election), the GILTI regime creates a system that is even closer to a worldwide tax system. GILTI inclusions are subject to tax at the same rate as other ordinary income because neither the Section 250 deduction nor foreign tax credits are available. The discussion in this Part IV.A assumes the applicable U.S. shareholder is a domestic corporation.

[42] This approach is similar to the approach taken for pass-through income in Section 199A, where a deduction of a fixed percentage of specified categories of pass-through income results in a reduced tax rate on that type of income.

[43] Conference Report at 626-7 ("Since only a portion (80 percent) of foreign tax credits are allowed to offset U.S. tax on GILTI, the minimum foreign tax rate, with respect to GILTI, at which no U.S. residual tax is owed by a domestic corporation is 13.125 percent....Therefore, as foreign tax rates on GILTI range between zero percent and 13.125 percent, the total combined foreign and U.S. tax rate on GILTI ranges between 10.5 percent and 13.125 percent.").

[44] The quoted language is under the heading "Illustration of effective tax rates on FDII and GILTI". *Id.* at 626.

that the GILTI FTC limitation is determined on a world-wide basis rather than a country-by-country basis.

Moreover, the flat rate theory is arguably more consistent with the tax rate on FDII. Aside from the deemed return on QBAI, which is fully taxable under FDII and exempt under GILTI, the FDII rules are designed to lower the U.S. tax rate on FDII export income to a rate that is approximately the rate the taxpayer could achieve by engaging in activities through a CFC. FDII income would not normally generate significant foreign tax credits except for withholding taxes on royalties from non-treaty jurisdictions. As a result, Congress could have considered the statutory FDII rate to be close to the final worldwide rate.

Thus, if Congress had not believed it was adopting the flat-rate theory, it arguably should have realized that the effective world-wide tax rate on GILTI will often be much higher than the rate on FDII, and it would not have been necessary to lower the rate on FDII as much. The fact that Congress did reduce the rate on FDII as much as it did arguably indicates that it believed the rate on GILTI inclusions would usually be 13.125% or not much higher. On the other hand, FDII is also reduced by allocable deductions such as interest and research and development,[45] so arguably Congress intended both the FDII rate and the GILTI rate to be higher than 13.125%.

Other elements of the GILTI regime support the add-on theory because they can cause a much higher tax rate on the net world-wide income of the CFCs owned by a U.S. shareholder. Under this view, the add-on theory is in effect a “minimum tax theory”, namely that Congress intended the world-wide effective tax rate on GILTI to be no less than 10.5%, but U.S. tax could apply even if the foreign rate is more than 13.125%. For example, a tested loss in a CFC can cause a loss of FTCs and NDTIR exclusion, and neither unused tested losses nor unused FTCs can be carried over.[46] All interest expense of a shareholder’s CFCs not reflected in tested income of a Related CFC is in substance first allocated to tax-exempt NDTIR, rather than being allocated between taxable income and exempt NDTIR. The Section 250 deduction of the U.S. shareholder is limited to its taxable income. All of these restrictions would have to be reconsidered as a legislative matter if the flat-rate theory was to be implemented.

As to the placement of GILTI FTCs in a separate FTC basket, on its face this is a neutral factor, since even a system for taxing GILTI at a fixed tax rate might prohibit cross-crediting of FTCs arising on non-GILTI income. On the other hand, by placing the FTC limitation in Section 904, Congress intentionally or unintentionally adopted the add-on theory, because it thereby incorporated numerous limitations on GILTI FTCs that can give rise to a combined U.S. and foreign tax rate on CFC income that is well in excess of 13.125%.

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[45] Section 250(b)(3)(A)(ii).

[46] We propose in Part IV.C.3(a) that unused tested losses should be allowed to carry over.

In many cases the statute is clear and Treasury would not have discretion to change a specific rule even if it wished to. However, regulations will be needed to resolve many ambiguities and unanswered questions under the statute. The resolution of many issues depends upon whether one believes that the intent of Congress was, as much as possible, to create a uniform maximum tax rate of 13.125% on foreign income, or, alternatively, to (imperfectly) lay the GILTI rules on top of the existing rules for foreign income.

There is no definitive way to resolve this dual nature of the GILTI regime. To the extent the statute provides flexibility for interpretation, we believe that regulations should give significant weight to the theory that Congress intended to create a flat tax at a 13.125% rate, even if the statute itself does so imperfectly. Many of our suggestions for regulations in this Report, such as allowing carryovers of CFC losses and modifying the existing rules for allocating expenses to FTCs, reflect this view. We also suggest some legislative changes to further achieve this result.

B. Aggregation of Members of a Consolidated Group

This section discusses the extent to which members of a consolidated group should be treated as a single corporation for purposes of the various GILTI calculations.

1. In General

Under Sections 951A and 78, each U.S. corporation must calculate its own GILTI inclusion based on its own Related CFCs. However, a consolidated group is treated as a single entity for many purposes of the Code, and in a typical group there will be more than one, and perhaps many, members that are U.S. shareholders of CFCs. It is important for guidance to state the extent to which a consolidated group is to be treated as a single corporation for purposes of the various GILTI calculations.

The statute itself provides no specific guidance. The statute[47] and the legislative history suggest similarity between Subpart F income and GILTI,[48] and consolidation principles do not apply to calculating Subpart F inclusions. However, the GILTI rules are different from Subpart F in many critical respects, and we discuss below the extent to which we believe that consolidation principles should apply to GILTI.

2. The Section 250(a) Deduction

Consider a consolidated group where a single member (M1) has a single Related CFC with tested income. Because consolidation principles do not change the location of items of income and deduction, the GILTI inclusion would be income of M1, and the Section 250 deduction would be a deduction of M1. However, Section 250(a)(2) limits the

[47] Section 951A(f)(1)(A) lists the Code sections for which GILTI is to be treated in the same manner as Subpart F income.

[48] For example, in describing the Senate Amendment, the Conference Report at 641 says: "a U.S. shareholder of any CFC must include in gross income for a taxable year its global intangible low-taxed income ("GILTI") in a manner generally similar to inclusions of subpart F income".

deduction to the taxable income "of the domestic corporation". The question is whether this refers to M1's separate taxable income or to the taxable income of the group as a whole. If more than one member of the group had a Related CFC, the issue would be whether to count the entire taxable income of the group and the entire Section 250(a)(1) deduction of the group. There is no relevant analogy to Subpart F, since income inclusions under Subpart F do not depend in any way on taxable income of the U.S. shareholder.

We believe that regulations should provide that the Section 250(a)(2) limitation is determined on the basis of the taxable income of the group as a whole. We have several reasons for this conclusion.

First, placing such importance on a particular member's taxable income would require the IRS to police the allocation of income among group members, such as intercompany pricing for transactions between group members. Separately determined taxable income of a member is rarely relevant from a nontax point of view, and so taxpayers would be incentivized to take aggressive positions with few (if any) nontax economic consequences. These issues rarely arise today.

Second, looking at the single member's taxable income would be a trap for unwary taxpayers, who would not expect this result. Well-advised taxpayers could easily avoid it, as discussed below.

Third, if the separate taxable income of the member-shareholder is the relevant test, it will be trivial for taxpayers to avoid ever having the carve-back apply. No matter how big the overall loss of the consolidated group, the CFC could be held by a member with no other items of income or deduction. In that case, the GILTI inclusion would by itself create sufficient taxable income to support the full Section 250(a)(1) deduction without the carve-back. Even in the unusual case where this was not practicable, it would not generally be difficult to locate a CFC in a corporation that was not expected to have a taxable loss without regard to the GILTI inclusion.

Fourth, in a consolidated group, losses of one member can freely be used against income of another member, and (as long as the members remain in the group), the location of losses is generally irrelevant. Consistent with this policy, it is difficult to see why the carve-back should apply if the group as a whole has positive taxable income, solely because the member that is the U.S. shareholder has a tax loss on a stand-alone basis. Likewise, if the group as a whole has a tax loss, it is difficult to see why the carve-back should *not* apply merely because the particular member that is the U.S. shareholder has positive taxable income.

Note that if the member has a loss but the group as a whole has positive taxable income, even if a Section 250 deduction is allowed, the carve-back would prevent the deduction from creating a loss in the member that could not be used by the group on a current basis. Therefore, even aside from Section 172(d)(9), the loss created by the deduction could not be carried forward outside the group even if the stock of the member was sold.

Finally, consolidated groups determine their income on a group-wide basis, and it is rarely relevant to determine taxable income on a member-by-member annual basis. It could be a considerable administrative burden for a group to have to separately calculate the taxable income of every member that had a Related CFC solely for purposes of GILTI and FDII.

We believe that Treasury has regulatory authority under Section 1502 to reach the result we propose. That section specifically authorizes consolidated return regulations "that are different from the provisions of chapter 1 that would apply if such corporations filed separate returns." This provision was adopted in 2004, and the legislative history makes clear that it authorizes regulations to treat members of a group as a single taxpayer or as separate taxpayers, or a combination of the two approaches.[49]

We note that Section 5 of Notice 2018-28[50] applies the interest deduction limits of Section 163(j) on a consolidated basis. Those limits are based on the adjusted taxable income of the taxpayer and are analogous to the limits on the deduction under Section 250(a)(2). To be sure, the Notice relies in part on the legislative history of Section 163(j) that specifically supports the conclusion of the Notice. While there is no similar legislative history concerning Section 250, we believe the implicit logic of the Section 163(j) legislative history applies equally to Section 250.

3. Section 904 Limit on the Deemed Paid Foreign Tax Credit

Under the existing consolidated return regulations,[51] the Section 904(a) limit on foreign tax credits is determined on a consolidated basis. This is consistent with the calculation of taxable income on a consolidated basis, as discussed above. We believe that regulations should confirm that this principle continues to apply to the calculation of the limitation on the GILTI basket under Sections 904(a) and (d).

The foregoing discussion applies equally here. A separate company limitation for the GILTI basket would necessarily require a company-by-company calculation of notional taxable income and U.S. tax liability, neither of which is relevant today. In fact, for purposes of allocating research expenses, as well as most other expenses (other than interest) that are not directly allocated or apportioned to any specific income producing activity, an affiliated group is treated as a single corporation,[52] and a member-by-member allocation would be necessary solely for purposes of GILTI.

These special rules for GILTI calculations would result in enormous administrative complexity, a trap for the unwary taxpayer, and a very large tax planning opportunity for

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[49] *See* Staff of the Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress*, JCS-5-05 (2005) at 415.

[50] 2018-16 IRB (April 2, 2018).

[51] Treas. Reg. § 1.1502-4(d).

[52] Section 864(e)(6); Treas. Reg. §§ 1.861-14T and 1.861-17(a)(3)(i).

taxpayers. In fact, no matter how large the overall group losses or how many deductions the group had that might be allocated to GILTI inclusions, a group could avoid a Section 904 limitation by having a CFC be held by a member with no losses and with no expenses that might be allocated to foreign source income.

4. The Amount of the GILTI Inclusion

A more complex question is whether all members of a consolidated group should be considered a single U.S. shareholder for purposes of calculating a single GILTI inclusion for the group. If the answer is yes, then, since each Section 951A inclusion creates its own FTC inclusion percentage, the group would also have a single inclusion percentage. The result would generally be the same as if all the Related CFCs of all members of the group were owned by a single group member.

For the reasons stated below, we believe that regulations should adopt this approach. As discussed above, we believe that Section 1502 provides clear authority for such regulations. Treating all group members as a single member is referred to below as the "**aggregation approach**", while treating each member as having its own separately computed GILTI is referred to as the "**nonaggregation approach**".

(a) Why it matters

The aggregation approach can be either beneficial or harmful to taxpayers, depending on the situation. The reason is that aggregating or not aggregating particular CFCs with other CFCs in calculating GILTI can have a significant effect in determining the benefits that the group will receive from tested losses, QBAI return, and FTCs.

There are at least six distinct ways in which aggregation can be better or worse for taxpayers. The examples that follow illustrate these situations. In the examples, CFC1 is owned by group member M1, and CFC2 is owned by group member M2. If aggregation applies, M1 and M2 are together referred to as M. Unless otherwise indicated, there is no FTC or QBAI return. Charts and more detailed calculations for certain of these Examples are provided in Appendix 1.

(i) *Tested income can be offset by tested loss of another CFC*

Absent FTCs or QBAI return, aggregation is generally better for taxpayers when CFC1 has tested income and CFC2 has a tested loss. This is because tested income and tested loss can offset each other when they are included in a single GILTI calculation.

> <u>Example 6(a) (tested income and tested loss; aggregation is taxpayer-favorable)</u>. Assume CFC1 has $100 of tested income, and CFC2 has $100 of tested loss. Under aggregation, M has a $0 Section 951A inclusion. Under nonaggregation, M1 has $100 of tested income and Section 951A inclusion,

> and M2 obtains no benefit from the tested loss of CFC2. The group is better off under aggregation.

However, if there is interest expense in a CFC with tested losses and QBAI return in a CFC with tested income, nonaggregation may be better for the taxpayer.[53]

> Example 6(b) (tested income and tested loss, interest expense offsets QBAI return; nonaggregation is taxpayer-favorable). CFC1 has \$100 of tested income and \$100 of QBAI return. CFC2 has \$100 of interest expense and \$50 of tested loss. Under nonaggregation, neither M1 nor M2 has any Section 951A inclusion. Under aggregation, the CFC2 interest expense of \$100 offsets M's NDTIR from CFC1, so M has a Section 951A inclusion of \$50.

(ii) *Tested income can be offset by excess QBAI return of another CFC*

If a Related CFC has QBAI return in excess of its tested income, such excess will reduce the Section 951A inclusion of its shareholder arising from other Related CFCs. This provides a benefit of aggregation.

> Example 7 (excess QBAI return of one CFC offsets tested income of another CFC; aggregation is taxpayer-favorable). Assume CFC1 has \$100 of tested income and no QBAI return, and CFC2 has \$10 of tested income and \$100 of QBAI return. Absent aggregation, M1 has a Section 951A inclusion of \$100, and M2 has no inclusion. With aggregation, M has a Section 951A inclusion of \$10.

(iii) *Tested loss offsets tested income but also reduces the inclusion percentage*

As illustrated in Example 6(a), a tested loss of one CFC has the benefit of offsetting tested income of other CFCs in the same aggregation group. However, a tested loss also reduces the inclusion percentage for FTCs paid by other CFCs in the same aggregation group. Aggregation can help or hurt the taxpayer depending on whether the tested loss offsets tested income of a high-taxed or low-taxed CFC.

> Example 8(a) (base case with aggregation: tested loss offsets high- and low-taxed tested income).

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[53] This example assumes that interest expense in a Related CFC with tested losses reduces the U.S. shareholder's NDTIR from other CFCs with QBAI return. *See* discussion in Part IV.D.6.

> Assume (1) CFC1 has $100 of tested income net of foreign taxes and a foreign tax rate of 13.125%, (2) CFC2 has $100 of tested income and foreign tax of $0, and (3) the group also owns CFC3 with a $100 tested loss. With aggregation, the Section 951A inclusion is $100 and the inclusion percentage is 50%, regardless of who owns CFC3.[54]
>
> Example 8(b) (no aggregation, tested loss only offsets high-taxed income; result is worse for taxpayers than aggregation). Same facts as Example 8(a), but assume CFC3 is owned by M1. Absent aggregation of M1 and M2, M1 has no Section 951A inclusion and an inclusion percentage of 0%. M2 has a Section 951A inclusion of $100 and no FTC. The result is worse than under aggregation because the tested loss of CFC3 is "wasted" when used against high-taxed income in CFC1.[55]
>
> Example 8(c) (no aggregation, tested loss only offsets low-taxed income; result is better for taxpayers than under aggregation). Same facts as Example 8(a), but assume CFC3 is owned by M2. Then, M1 has a Section 951A inclusion of $100 and a 100% inclusion percentage, so no tax is due. M2 has no inclusion, and no tax. Full use has been obtained for both the tested loss in one GILTI group, and the FTC in a different GILTI group.

(iv) *NDTIR reduces the Section 951A inclusion, which then reduces the FTC inclusion percentage*

When NDTIR reduces the Section 951A inclusion, the result is a *pro rata* cutback of FTCs based on the reduction of the Section 951A inclusion, without regard to which CFC had QBAI return. If one CFC has QBAI return and the other does not, and tax rates on the CFCs are different, the single calculation of the inclusion percentage under

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[54] The Section 951A inclusion is equal to CFC1's $100 of tested income, plus CFC2's $100 of tested income, minus CFC3's $100 of tested loss, or $100. The inclusion percentage is the $100 Section 951A inclusion, divided by the sum of CFC1's $100 of tested income and CFC2's $100 of tested income, or 50%. A portion of CFC1's foreign taxes is available to M for use as a FTC because the inclusion percentage is 50%.

[55] None of CFC1's foreign taxes is available as an FTC because M1 has no inclusion under Section 951A. M2 has an inclusion under Section 951A but no FTCs because CFC2 paid no foreign taxes.

aggregation can be better or worse for taxpayers than the separate calculations of the inclusion percentage under nonaggregation.

In the three examples below, the FTCs are half utilized under aggregation (Example 9(a)), fully utilized under one fact pattern involving nonaggregation (Example 9(b)), and not utilized at all under another fact pattern involving nonaggregation (Example 9(c)).

> <u>Example 9(a) (base case with aggregation; NDTIR reduces inclusion percentage).</u> Assume (1) CFC1 has $100 of tested income net of foreign taxes, and no QBAI return, and (2) CFC2 has $100 of tested income net of foreign taxes, and $100 of QBAI return. Also assume that either CFC1 or CFC2 has a foreign tax rate of 13.125%, and the other has a 0% rate. Under aggregation, M has $200 of tested income, a Section 951A inclusion of $100 ($200 minus $100 of NDTIR), and an inclusion percentage of 50%.
>
> <u>Example 9(b) (no aggregation; lower foreign tax on QBAI return; result is taxpayer-favorable compared to aggregation).</u> Assume the same facts as Example 9(a), but with the foreign taxes being imposed on CFC1. Under nonaggregation, M1 has a Section 951A inclusion of $100 and an inclusion percentage of 100%, while M2 has a Section 951A inclusion of $0. This allows for full usage of FTC on the non-exempt income in CFC1, while aggregation "wastes" half of the FTC on the QBAI return in CFC2.
>
> <u>Example 9(c) (no aggregation; higher foreign tax on QBAI return; result is taxpayer-unfavorable compared to aggregation)</u>. Same facts as in Example 9(a), but the foreign taxes are imposed on CFC2. Under nonaggregation, M1 has a $100 Section 951A inclusion, with no FTC offset, and M2 has no Section 951A inclusion. This is worse for taxpayers than the aggregation case because the FTC in CFC2 is totally "wasted".

(v) *Interest expense reduces NDTIR of the U.S. shareholder unless paid to a Related CFC of the same U.S. Shareholder*

Gross interest expense of a CFC reduces NDTIR of the U.S. shareholder unless the corresponding interest income is taken into account in determining the U.S. shareholder's net CFC tested income. This can make aggregation or nonaggregation more favorable depending on the facts.

Suppose CFC1 has interest expense to a third party and no QBAI return, and CFC2 has no interest expense but has QBAI return. Under aggregation, the interest expense of CFC1 will reduce M's NDTIR. Without aggregation, there will be no reduction in M2's NDTIR, so aggregation is worse for the group.

Alternatively, suppose CFC1 has QBAI return and pays interest to CFC2. With aggregation, the interest will have no effect on the group's net CFC tested income or NDTIR. Without aggregation, the interest will reduce M1's NDTIR and net CFC tested income, and increase M2's net CFC tested income. Total net CFC tested income is the same in both cases, but aggregation avoids the reduction in NDTIR and is better for the group in this fact pattern.

(vi) *Investment adjustments in stock of M1 and M2 will differ depending on aggregation or nonaggregation*

Part IV.D.7 discusses issues that arise in making stock basis adjustments to M1 and M2 under the consolidated return regulations. Aggregation or nonaggregation may have different effects on allocating the GILTI inclusions to M1 and M2, even if the total inclusion is the same in both cases. These differences in stock basis could be favorable or unfavorable to the group depending on its future plans to dispose of stock of M1 or M2.

(b) Discussion

These examples illustrate some of the ways in which aggregation of members of a group in calculating GILTI helps taxpayers in certain circumstances and hurts taxpayers in others. As a policy matter, we do not believe the substantive tax results in these examples should differ so dramatically depending on where in a group a particular CFC is held. The statute already provides for a single calculation of the GILTI inclusion for all Related CFCs held by a single group member. Logically, the rule should also apply to all Related CFCs held by all members of a group.

It is often quite arbitrary where in a group a particular CFC is held, and it would be quite unusual for significant tax consequences to depend upon the location of the CFCs within a group. At a minimum, this would create an enormous trap for the unwary taxpayer who simply assumes that it would not make a difference where a particular CFC is held within a group.

Moreover, if regulations do not provide for mandatory aggregation for all Related CFCs held by members of a group, the result will be an effectively elective regime. In many if not most cases, it will make little or no business difference to taxpayers where in a group any particular CFC is held.[56] As a result, in the absence of mandatory aggregation,

[56] An exception might be CFCs that are regulated entities, which may be required by law to be held within or outside of specified structures.

taxpayers can be expected to obtain aggregation for whichever CFCs it is desirable, by having the relevant CFCs held by a single group member, and to avoid aggregation for whichever CFCs it is desirable, by having individual CFCs each held by a separate group member.

Elaborate computer programs would likely be designed to determine, on an annual basis, the groupings and non-groupings of CFCs that will minimize the overall tax liability of the group for the following year. Likely the only reason a well-advised group would not reach the optimal structure every single year would be if their predictions for the following year were inaccurate. Query whether the use of such a computer program would even violate any anti-abuse rule, given the rather arbitrary nature and murky purpose of some of these rules.

For example, a group could restructure today to cause every member with a Related CFC that it directly holds to transfer it to a single newly-formed U.S. group member ("**CFC Master Holding**") in a series of transfers that qualify for non-recognition of gain and loss under Section 351. Aggregation of all the Related CFCs would therefore apply absent further action.

At the end of this year, the group would determine whether separate treatment of any CFC (along with its CFC subsidiaries) would likely be favorable for next year. If so, CFC Master Holding would transfer each of those CFCs to a new separate wholly owned U.S. subsidiary of CFC Master Holding (each, a "**CFC Subsidiary Holding**"). If a separate grouping of two or more CFCs was desirable, those could be contributed together to a separate CFC Subsidiary Holding.

At the end of each year thereafter, the group would make a new determination for the following year. Depending on the results, any CFC Subsidiary Holding can either be retained as such or else liquidated into CFC Master Holding in a transaction that qualifies for nonrecognition of gain and loss under Section 332. Any CFC already held by CFC Master Holding could either be retained there, or transferred to a new CFC Subsidiary Holding or to an existing CFC Subsidiary Holding. The result is a practical election on an annual basis whether each CFC (along with its own CFC subsidiaries) will be treated on a separate or aggregated basis for GILTI purposes, and what the aggregation groups will be for the year.

In reality, this type of structuring would often have little or no business purpose. While existing or newly created anti-abuse doctrines or rules might be employed to attempt to stop the most blatant structuring, such doctrines or rules will be extremely difficult to enforce for a multinational corporation with hundreds if not thousands of CFCs.[57] A lot of pressure will also be put on the ability to make retroactive check the box elections, in order to retroactively combine or separate out companies based on results that are different than the expected results.

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[57] None of this restructuring would be affected by Section 367, since the stock of the CFCs remains within the U.S. consolidated group.

As a policy matter, these transactions do not carry out the purposes of the statute and we are not aware of any other reason why they should be permitted. Thus, the statute should not be allowed to distort taxpayer behavior and incentivize these transactions. Moreover, we are not aware of any policy reason why taxpayers should have adverse tax consequences solely because they hold CFCs through multiple members for good business reasons.

More broadly, there is no reason that consolidated groups should obtain significantly different tax results under GILTI depending on where CFCs are held within the group. Indeed, given the statutory aggregation among CFCs owned by a single group member, the single entity principle of consolidated returns supports aggregation among CFCs owned by different group members.

We acknowledge that Section 951A reflects a general similarity between GILTI and Subpart F, and that there is no aggregation of group members in Subpart F. Each U.S. group member calculates its own Subpart F inclusion solely by reference to the CFCs for which it itself is a U.S. shareholder. However, under Subpart F, the U.S. shareholder takes account of each CFC separately, without regard to any other CFCs of which it is a U.S. shareholder. As a result, it would not make a difference whether all group members were aggregated.

On the other hand, the GILTI calculation for a single member of the group already involves considerable aggregation of the tax attributes of the Related CFCs of that member, and it is a logical extension of that procedure to extend the aggregation to CFCs owned by all group members. As a result, we do not find the Subpart F analogy persuasive.

The administrative aspects of aggregation do not appear to add undue complexity. It is true that the group would often have a different Section 951A inclusion than the sum of the separate Section 951A inclusions in the absence of aggregation, but this is the proper result. The overall inclusion would logically first be allocated to members in proportion to the net CFC tested income that each member would have from its own Related CFCs in the absence of aggregation. This method would disregard members' NDTIR that would reduce their respective Section 951A inclusions on a stand-alone basis. However, it is consistent with the second step of the process based on Section 951A(f)(2), which allocates a member's own Section 951A inclusion (as determined in the first step) among its own Related CFCs with positive tested income in proportion to such income.

Alternatively, the overall inclusion could be allocated to members in proportion to the separate Section 951A inclusions or GILTI inclusions they would have had in the absence of aggregation, although the second step would still be on the basis of tested income. A number of issues under the basis adjustment rules of Treas. Reg. § 1.1502-32 would also arise and are discussed in Part IV.D.7.

In principle, aggregation could be applied to CFCs held by U.S. members of a controlled group that do not file a consolidated return. We do not recommend the expansion of aggregation in this manner, except perhaps as an anti-abuse rule if a principal purpose of having multiple owners of multiple CFCs is to avoid the purposes of the GILTI rules. We note in this regard that Section 5 of Notice 2018-28 states that Treasury does not anticipate that affiliated groups not filing a consolidated return would be aggregated for purposes of Section 163(j).

Even setting aside the question of the government's authority to aggregate more broadly, we think aggregation among consolidated group members is correct because these members are already treated as a single entity for most tax purposes. This is not true for each member of a controlled group that does not file a consolidated return. As a result, there is less policy justification for aggregation. Moreover, mandatory aggregation would be difficult to justify, and elective aggregation does not seem justified. The mechanics of aggregation would also be very difficult to apply, since each U.S. shareholder would have its own taxable income and other tax attributes.

If aggregation among consolidated group members is required, consideration should also be given to whether the same rule should apply to CFCs held by a partnership where a specified percentage of the partnership is owned by group members. For example, if a CFC is held by a partnership and two group members are each a 50% partner, the issue is whether the group's overall GILTI calculation should be made as if the CFC were held directly by group members, or whether the partnership should be respected and the usual rules for partnerships holding CFCs (discussed below) should apply.

In the absence of a look-through rule, it would be possible for a group to take particular CFCs out of its aggregation groups by putting them into a partnership that is wholly or largely owned by group members. Treasury could either adopt an automatic look-through rule, or it might conclude that existing anti-abuse rules such as economic substance and partnership anti-abuse are adequate to police this structure.[58]

C. Deductions Allowed in Calculating Tested Income

1. The Issue

Assume that all the gross income of a CFC is included in tested income. The threshold question is which expenses of a CFC should be allowed as a deduction in calculating tested income.

The statute provides that tested income is "gross income" determined without regard to certain specified items,[59] less deductions (including taxes) "properly allocable to such gross income under rules similar to the rules of section 954(b)(5) (or to which such

[58] In our recent report on Section 163(j), we recommended that a partnership among members of a consolidated group be respected as such, although a minority supported the view that aggregate principles should apply. *See* NYSBA Tax Section, "Report on Section 163(j)", Report No. 1393, March 28, 2018 (the "**Report on Section 163(j)**"), Part III.G.5. Arguably Section 951A presents a better case for aggregation because, as noted in that Report, Section 163(j)(4)(A)(i) specifically says that Section 163(j) is to be determined at the partnership level and does not distinguish a partnership among group members.

[59] Section 951A(c)(2)(A)(i).

deductions would be allocable if there were such gross income)".[60] Section 954(b)(5) contains the same reference to deductions "properly allocable" to Subpart F income. However, it refers to the method to allocate known deductions to different categories of income, not the method to determine whether an expense is properly counted as a deduction.[61]

In the absence of guidance from either the statute or the legislative history, we consider three possible methods for determining which expenses of a CFC should be allowed as a deduction from its gross income:

(1) The "**modified taxable income method**". All costs that would be allowable as a deduction to a U.S. corporation would be allowed, except as specifically identified otherwise by Treasury. The CFC must in effect file a hypothetical U.S. tax return reporting taxable income and loss, with any specified adjustments, but only for gross income that is tested income and deductions allocable to tested income.

(2) The "**Subpart F method**". All costs of the type deductible for Subpart F purposes would be allowed. Allowed deductions are generally amounts deductible under U.S. generally accepted accounting principles ("**GAAP**") for a domestic corporation, unless the use of those principles would have a "material effect" as compared to a calculation under U.S. tax principles.[62] This calculation incorporates by reference the rules for determining e&p of the CFC.[63]

(3) The "**modified Subpart F method**". The Subpart F method would apply, but with the disallowance of particular deductions specified in regulations that are disallowed for U.S. tax purposes.

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[60] Section 951A(c)(2)(A)(ii).

[61] Treas. Reg. § 1.954-1(c)(1)(i)(B) refers to allocating expenses under the principles of Sections 861, 864, and 904(d). It appears the drafters of the Act intended Section 954(b)(5) principles to apply for purposes for allocating deductions, rather than determining deductibility: "For purposes of computing deductions (including taxes) properly allocable to gross income included in tested income or tested loss with respect to a CFC, the deductions are allocated to such gross income following rules similar to the rules of section 954(b)(5) (or to which such deductions would be allocable if there were such gross income)." Conference Report at 644.

[62] Treas. Reg. § 1.952-2(b)(1), (c)(2).

[63] *Id.* These rules are in Treas. Reg. § 1.964-1. *See also* Proposed Treas. Reg. § 1.163(j)-8, which provides rules for applying Section 163(j) to a foreign corporation that has "effectively connected income", or "ECI". Arguably this regulation contains a negative inference that Section 163(j) must not apply to a foreign corporation unless it has ECI.

Under any of these methods, foreign taxes are permitted as deductions in calculating tested income if they are "properly allocable" to gross Section 951A inclusions.[64] The question of what taxes are properly allocable to Section 951A inclusions is discussed in Part IV.E.1(a).

2. Choice of Method

Each of these methods could produce very different outcomes, depending on the particular facts. For example, a nondeductible fine or penalty,[65] a payment under a hybrid instrument,[66] a loss on a sale to a related party,[67] an interest deduction that exceeded the limits under Section 163(j), and a nondeductible business entertainment or meal expense[68] would likely be allowed under the Subpart F method and the modified Subpart F method absent a regulatory exception, but not under the modified taxable income method. "Interest" expense on an instrument treated as debt for GAAP purposes but not for U.S. tax purposes because of its riskiness might even be allowed under the same circumstances.[69]

(a) The modified taxable income method

We believe that the modified taxable income method is the preferable method as a theoretical matter. Under either of the theories of GILTI discussed above, GILTI is in substance a partial world-wide tax system, with nonexempt income of a CFC effectively taxed at a reduced rate of U.S. tax (in the case of a corporate U.S. shareholder) or at the regular rate of U.S. tax (in the case of all other U.S. shareholders in the absence of a Section 962 election and Section 250 deduction).

Moreover, "gross income", the initial component of tested income, is based on U.S. tax principles.[70] It would be most logical for the second step, namely the calculation of deductions allocable to gross income, to be calculated in the same manner so that taxable income for GILTI purposes is the same as for U.S. tax purposes generally. We note that

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[64] Section 951A(c)(2)(A)(ii).

[65] Section 162(f).

[66] Section 267A.

[67] Section 267.

[68] Section 274.

[69] Under the modified taxable income method, if the CFC makes a locally deductible payment under a hybrid instrument to the U.S. shareholder, there would not be a deduction from tested income, but the payment would be a dividend payment out of previously taxed GILTI inclusion and not taxable in the U.S. As a result, both the local tax deduction and the reduced GILTI rate would apply to the income underlying the hybrid payment.

[70] Section 951A(c)(2)(A)(i) refers to "gross income", which is necessarily used in the tax rather than accounting sense.

the Subpart F rules use a consistent method for calculating gross income and deductions, because it is taxable income (not merely deductions) that is determined on a GAAP basis unless the result has a material effect as compared to the use of U.S. tax principles.[71]

We also do not see a policy justification for deductions not allowed to a U.S. corporation to be allowed to a CFC in calculating tested income. Such a rule would invite “deduction shifting”, since a U.S. corporation could shift nondeductible expenses to a CFC and in effect obtain a deduction at the GILTI tax rate. For example, if Section 163(j) did not apply to a CFC, the U.S. shareholder could avoid the limitations of that section (at the cost of a reduced 10.5% tax benefit) by having its existing debt assumed by the CFC or new borrowings incurred by the CFC. To be sure, such shifting of debt could have significant business consequences, and the application of Section 163(j) might not eliminate the incentive for shifting debt to CFCs.[72] Nevertheless, we do not believe taxpayers should have an incentive to make such shifts.

We acknowledge that Section 6 of Notice 2018-28 states that Section 163(j) does not prevent the application of disallowed deductions to reduce e&p, and arguably the same reasoning would disregard Section 163(j) in calculating GILTI. However, we do not think the situations are analogous. Earnings and profits is a measure of economic income or loss, many disallowed deductions reduce e&p, and in particular interest is a true cost regardless of its deductibility. As a result, the position in the Notice makes sense. On the other hand, Section 163(j) is specifically designed to prevent income stripping, and the fact that interest deductions disallowed under Section 163(j) reduce e&p is not a justification for allowing excessive interest expense to strip income out of CFCs with tested income.

Under this method, Treasury would be given the authority to specify particular variances from U.S. taxable income that would apply. This might be done for administrative convenience, such as not requiring an add-back to tested income for disallowed travel and entertainment expenses.

A disadvantage of the modified taxable income method is that it would require a corporate group to create a separate hypothetical U.S. Federal income tax return for each CFC in the group. This could be extremely difficult, since local finance officials in the CFCs are likely unfamiliar with U.S. tax principles.[73] Moreover, even minor variances from U.S. taxable income (as adjusted) could result in audit adjustments.

This difficulty in calculation might be reduced under the Subpart F method or the modified Subpart F method. Those methods begin with U.S. GAAP income, and a U.S.

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[71] Treas. Reg. § 1.952-2(b)(1), (c)(2).

[72] Since there is no aggregation of CFCs for Section 163(j) purposes, debt could be incurred by particular CFCs with high levels of tested income, even if the Related CFCs in the aggregate had little tested income.

[73] We also note that if U.S. tax principles are to be used in calculating the tested income of CFCs, logically other U.S. tax principles should also apply, such as allowing aggregation of Related CFCs of a U.S. shareholder as if they filed a U.S. consolidated tax return.

group with CFCs is likely already computing its GAAP income by taking into account the income of its CFCs. On the other hand, these methods would require a determination in each case that the result was not materially different than the result under the modified taxable income method, so some knowledge of U.S. tax principles would be required in any event. In reality, the difficulties in calculation are inherent in the decision by Congress to impose a current U.S. tax on the income of CFCs.

Another disadvantage of the modified taxable income method is that it would result in tested income being calculated on a different basis than Subpart F income. This is literally consistent with Section 951A(c)(2)(A), which defines tested income as gross income not taken into account in determining Subpart F income, minus deductions allocable to such gross income under rules similar to the rules for allocating deductions under Subpart F. This language should prevent a double inclusion of gross income, or a double deduction of the same item. However, Congress may not have contemplated Subpart F and tested income being calculated on a different basis. Moreover, if deductions were allowed for one purpose but not the other, both taxpayers and the IRS would have incentives to shift deductions between the categories.

(b) The Subpart F method

The Subpart F method imports Subpart F principles into the GILTI calculations. This is consistent with the general similarity between GILTI and Subpart F. Moreover, tested income is defined in substance as total taxable income reduced by Subpart F income,[74] and it would be peculiar to determine the total on a different basis than the subtraction.[75]

However, we believe that the differences between these two regimes are sufficiently great that the existing application of the Subpart F method does not strongly support the extension of that method to GILTI. GILTI is not based on or limited to e&p, so arguably consistency between Subpart F income and GILTI was not viewed by Congress as important. Moreover, GILTI involves a vastly greater amount of potential income inclusions than Subpart F.[76] Thus, the rule for Subpart F should not be applied to GILTI without an independent policy justification.

In considering whether such policy justification exists, we note that under pre-2018 law, tax on the earnings of CFCs was deferred until e&p generated by the CFC was repatriated in the form of dividends (or deemed dividends under Section 1248 upon a sale

[74] Section 951A(c)(2)(A).

[75] The Tax Section recently asked Treasury to allow items arising under Section 987 to be determined on a basis similar to GAAP profit and loss rather than U.S. taxable income. NYSBA Tax Section Report No. 1386, *Report on Notice 2017-57: Alternative Rules for Determining Section 987 Gain or Loss*, Jan. 22, 2018.

[76] On the other hand, the prevalence of Subpart F income may increase if taxpayers create it to avoid unfavorable aspects of GILTI. This would make disparities between Subpart F income and GILTI more meaningful than at present, and planning opportunities would arise to take advantages of such disparities.

of the stock of the CFC). Subpart F represented an exception to deferral for particular categories of income,[77] and it was logically limited to the same e&p that would eventually be taxed on payment of a dividend. Moreover, the calculation of e&p is relatively similar to the calculation of GAAP income, so it made sense to use GAAP income (which would already be known) as a surrogate for e&p as long as the differences were not too great. To the extent that the GAAP calculation resulted in less Subpart F income than the e&p calculation, the difference was a timing difference for income inclusion.

By contrast, tested income and GILTI are not based on e&p. If tested income of a CFC is understated under U.S. tax principles, there is a permanent exemption of income of the CFC (calculated under U.S. tax principles) from the U.S. GILTI tax. This result does not seem consistent with the intent of Congress in imposing a tax on GILTI without regard to the e&p of the CFC.

As between the modified taxable income method and the Subpart F method, the former will usually be less favorable to taxpayers because of deductions disallowed for U.S. tax purposes but allowed for GAAP purposes. However, it will sometimes be more favorable to taxpayers. For example, in cases where U.S. tax depreciation is faster than GAAP depreciation, there will be less tested income in earlier years.

We do not believe the Subpart F method should be adopted, because we believe that it is inferior to the modified Subpart F method for the reasons described below.

(c) The modified Subpart F method

In light of the practical concerns raised by general adherence to U.S. tax principles under the modified taxable income method, and the policy concerns raised by disregarding U.S. tax principles under the Subpart F method, we believe the modified Subpart F method is superior to the Subpart F method and is a realistic alternative to the modified taxable income method. The modified Subpart F method would give Treasury the flexibility, for example, to apply the Section 163(j) limits on interest deductions. Permitting departures

[77] The Senate Finance Committee made the following comment regarding the 1962 bill that enacted Subpart F: "Under [then] present law foreign corporations, even though they may be American controlled, are not subject to U.S. tax laws on foreign source income. As a result no U.S. tax is imposed with respect to the foreign source earnings of these corporations where they are controlled by Americans until dividends paid by the foreign corporations are received by their American parent corporations or their other American shareholders. The tax at that time is imposed on the American shareholder with respect to the dividend income received, and if this shareholder is a corporation it is eligible for a foreign tax credit with respect to the taxes paid by the foreign subsidiary. In the case of foreign subsidiaries, therefore, this means that foreign income taxes are paid currently, to the extent of the applicable foreign income tax, and not until distributions are made will an additional U.S. tax be imposed, to the extent the U.S. rate is above that applicable in the foreign country. This latter tax effect has been referred to as 'tax deferral.'" The committee went on to describe the ways in which the House bill had sought to eliminate deferral only for "tax haven" devices, and the committee's amendments were "designed to end tax deferral on 'tax haven' operations by U.S. controlled corporations". S. Rep. No. 1881, 87th Cong., 2d Sess., *reprinted at* 1962-3 C.B. 703, 784-785.

from the Subpart F method in certain circumstances is also consistent with our position below that carryovers of losses of a CFC should be allowed.

Under the modified Subpart F method, taxpayers would begin with the same type of analysis with respect to each CFC that is already conducted for Subpart F purposes. They would then refer to a list formulated by Treasury of specific deductions that are disallowed to U.S. corporations and would also be disallowed in calculating GILTI regardless of their treatment for GAAP purposes

This method would limit adjustments to GAAP income to the elimination of those deductions that Treasury believes are most important to disallow for GILTI purposes. In particular, it would minimize the need to make minor add-backs such as (if Treasury agreed) for disallowed travel and entertainment expenses.

Under this method, we propose to continue the rule in the existing Subpart F regulations that the result could not be materially different than the calculation of taxable income for U.S. tax purposes. This would prevent abuse of the modified Subpart F method for GILTI purposes, just as for Subpart F purposes today.

Ultimately, a significant disadvantage of this method is that it involves dealing with three different tax systems. First, GAAP income must be determined as in the Subpart F method. Then, adjustments to GAAP income as required by Treasury guidance must be made. Finally, the result must be compared to U.S. taxable income with specified adjustments (the modified taxable income method) to see if the differences are material. On top of this, the statute specifically requires that the tax basis of assets for purposes of the QBAI calculation be determined quarterly under the alternative depreciation system of Section 168(g).[78] It is not clear that this process is any simpler than beginning with the modified taxable income method in the first place. It would also be peculiar for an asset to have a GAAP basis for calculating tested income and a Code-based tax basis for calculating QBAI.

(d) Conclusion

We recommend that Treasury adopt either the modified taxable income method or the modified Subpart F method. These methods are similar. The former starts with taxable income and allows Treasury to make adjustments to bring the result closer to GAAP income. The latter starts with GAAP income and allows Treasury to make adjustments to bring the result closer to taxable income. The choice of method depends upon whether, in the end, the desired result is closer to GAAP income or closer to taxable income. We do not take a position on this issue.

3. Loss and Interest Carryovers

(a) Carryover of operating losses

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[78] Sections 951A(d)(1), (d)(3)(A).

(i) In general

Under any of the foregoing methods of determining tested income, the question arises as to whether losses can be carried forward. Consider a U.S. shareholder with a single CFC that has no QBAI return, a tested loss in year 1, an equal amount of tested income in year 2, and no foreign tax liability. Absent a loss carryover, the shareholder would have a net GILTI inclusion and resulting tax liability in year 2, in the absence of any economic income over the two year period. This result is unfair, and inconsistent with the flat-rate theory of GILTI, assuming the flat-rate theory is intended to apply over time as opposed to only in years with profits.

As a result, to the extent a U.S. corporation would be entitled to carry over a loss or deduction to a future year, we believe the same should be true under GILTI. Moreover, we believe that rules similar to the existing rules for NOL carryovers should apply. We believe this should be true under any of the methods for determining tested income described above that might be adopted for GILTI purposes.[79]

The Subpart F regulations provide that net operating losses are not taken into account in calculating taxable income for Subpart F purposes.[80] However, Subpart F income is limited to current year e&p of the applicable CFC[81] and is reduced for certain prior year e&p deficits of the same CFC from Subpart F activities.[82] In some cases, e&p deficits of other CFCs in the same ownership chain may also be used.[83] As a result, in at least some cases, an NOL carryover under such a system is not needed to prevent net Subpart F income from arising in year 2 if there is a loss in year 1 and income in year 2. Moreover, Subpart F losses are not likely to arise very often, so the rule for Subpart F should not as a policy matter determine the rule for GILTI, where tested losses are likely to arise much more frequently.

We also acknowledge that under any method of allowing carryovers, the amount of the carryover is based in part on the tested loss of a CFC. Under any of the methods of determining tested loss, the tested loss might be greater than the NOL that would arise for a domestic corporation. However, because of the restrictions on those methods, the tested loss could not be materially greater. Moreover, given that the full amount of the tested loss

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[79] We do not recommend that rules similar to the e&p deficit rules apply in calculating tested income (as an alternative to loss carryovers). Many of the complexities described below relating to loss carryovers arise because of the aggregation principles inherent in the GILTI calculations, and many of the same complexities would arise in this alternative system.

[80] Treas. Reg. § 1.952-2(c)(5)(ii).

[81] Section 952(c)(1)(A), Treas. Reg. § 1.952-1(e).

[82] Section 952(c)(1)(B).

[83] Section 952(c)(1)(C).

is respected as an offset to current year tested income of other CFCs, it should logically be available in full to determine the carryover to future years.

We describe below two alternative methods to implement a system to allow the carryover of unused tested losses, one at the CFC level and the other at the shareholder level. The first method would allow a tested loss of a CFC to carry over at the CFC level to offset future tested income of the CFC, similar to an NOL carryforward of a domestic corporation. As discussed below, this gives rise to extremely complex issues because the income inclusion occurs at the shareholder rather than the CFC level, and the amount of the inclusion is affected by factors arising from other CFCs. As a result, while this approach may be the more theoretically correct one, the resulting complexities make it questionable as a practical matter.

The alternative approach is to "push out" an unused tested loss of a CFC to the shareholder and permit the shareholder to use it to reduce its GILTI inclusions in future years. We prefer this approach because it avoids many, but far from all, of the complexities of loss carryovers at the CFC level.

Both approaches raise the question of whether they could be implemented by regulation, or if legislation would be required. We take no position on this issue,[84] but we urge that Treasury either adopt our preferred method by regulation, or if it does not believe it has the authority, that legislation be adopted to implement this method.

(ii) Carryover at the CFC level

Under the existing rules, if a Related CFC has a tested loss, all or part of that tested loss is available to shelter tested income of the U.S. shareholder from Related CFCs.[85] To the extent the loss is in fact utilized in this manner, it obviously should not carry over to future years of the CFC.

We would apply this rule even if the U.S. shareholder did not obtain any tax benefit from the use of the tested loss to shelter tested income, either because the tested income had high FTCs or because the shareholder had NDTIR. For example, suppose CFC1 has a tested loss of $100, and CFC2 has tested income of $100. In addition, either CFC2's income is non-NDTIR income taxed at a high foreign tax rate, or else all of CFC2's income is NDTIR.

In either case, the shareholder has no GILTI tax even without regard to the tested loss of CFC1. However, both NDTIR and foreign tax credits are determined at the

[84] One issue under the existing statute for allowing losses to carry over at the CFC level is the rule that tested income of a CFC for a taxable year is gross income of the CFC for that year less deductions properly allocable to that gross income. The question is whether a tested loss carried over from a prior year, representing expenses in prior years that were allocable to gross income in prior years, can be considered properly allocable to gross income of the current year.

[85] Section 951A(c)(1) states that the U.S. shareholder's *pro rata* shares of tested income and tested losses of all Related CFCs for the current year are aggregated to determine net CFC tested income.

shareholder level, and in fact can arise from CFCs other than CFC1. Moreover, the application of a tax benefit principle would not be consistent with the normal rule that a loss is absorbed when it offsets taxable income, even if the taxpayer would not have been taxed on the taxable income for a reason such as high FTCs. Application of tax benefit principles would also be enormously complex and require a CFC to obtain far more information from its shareholder. As a result, we believe that a tested loss should be treated as "used" by the shareholder, and unavailable for carry forward by the CFC, whenever it offsets tested income of the shareholder, without regard to a "tax benefit" analysis at the shareholder level.

So far, this approach appears to be fairly straightforward. However, considerable complexity quickly arises.

First, rules would need to address how to determine which tested losses allocable to a particular U.S. shareholder are used to offset tested income of that shareholder. The shareholder might have multiple Related CFCs with tested income and tested loss.

The issue would only arise if the shareholder has a net tested loss, since only in that case are some tested losses from Related CFCs not utilized to offset tested income of other Related CFCs. In that case, the net tested loss at the shareholder level should logically be allocated to the various Related CFCs with tested losses in proportion to the tested loss of each Related CFC. A carryover of tested loss by each Related CFC would then be allowed to the extent of such allocation. This calculation would be done separately for each U.S. shareholder of a CFC with a tested loss.

Second, if there are multiple unrelated U.S. shareholders of a CFC, it would be necessary for the CFC to determine the extent to which its tested losses were actually used to offset the tested income of each U.S. shareholder. Perhaps a rule could be adopted that unless the CFC could provide proof that its loss was not utilized by a U.S. shareholder, the loss would be deemed to have been so utilized and could not carry over.

Third, suppose some but not all U.S. shareholders of a CFC can use their share of a tested loss in year 1.[86] The non-users would include, for example, all U.S. persons that are not U.S. shareholders of the CFC, all U.S. shareholders that do not have tested income from other CFCs, and all non-U.S. individual and corporate shareholders that directly hold stock in the CFC. The unused portion of the tested loss is the portion allocable to the shareholders in the non-user group.

It would be extraordinarily complicated to allocate the losses carried over to year 2 solely to the non-users in year 1. As a result, whatever portion of the loss is carried over will potentially benefit all U.S. shareholders in future years on a *pro rata* basis, not only the non-users in year 1. This will result in a partial double benefit to the shareholders that

[86] For simplicity, disregard shareholders who can use part but not all of their share of the tested loss.

used their share of the loss in year 1, at the expense of the non-users in year 1 who can use the loss in a later year.[87]

For example, suppose a CFC has a tested loss of $100 in year 1, and the CFC is owned 50% by a U.S. corporation and 50% by a non-U.S. corporation.[88] If the U.S. corporation can use $50 of tested losses in year 1, then $50 of tested losses would carry over to year 2. The U.S. corporation would obtain 50% of the benefit of this $50 carryover if either (i) the CFC had $50 of tested income in year 2, or (ii) the CFC had no tested income in year 2 but the U.S. corporation had $25 of unrelated tested income in year 2.

In either case, the U.S. corporation obtains 75% of the benefit of the $100 tested loss in year 1. This result might be considered particularly surprising, if, say, the non-U.S. corporate shareholder owned 100% of the U.S. corporate shareholder. In that case, 75% of the tax benefits would be shifted to the 50% U.S. shareholder. The same allocation of 75% of the tax benefits to a related U.S. party would arise if a U.S. individual owned a U.S. corporation, each owned 50% of the CFC, the CFC had a tested loss of $100 in year 1, and either the U.S. individual or the U.S. corporation, but not both, could use $50 of tested losses in year 1.

The results can be even more extreme. In the example, assume the U.S. corporation can use unlimited tested losses, the other shareholder cannot use any tested losses, and the CFC has $0 tested income in each year after year 1. As above, the U.S. shareholder uses $50 of tested losses in year 1. Then, of the $50 that carries over to year 2, the U.S. shareholder uses its $25 share. Then, the remaining $25 of tested loss carries over to year 3, the U.S. shareholder uses $12.50 of that loss, and so on literally forever.

One possible way to avoid these results in some cases would be to limit the carryover of tested losses of a CFC to losses allocable to U.S. corporate shareholders that could not use their share of the tested losses, or to U.S. individuals that could not use their share and were not related to a U.S. corporate shareholder. This would prevent the shifting of the benefit of tested losses from non-U.S. persons to U.S. persons, or among individuals and related U.S. corporations.

However, this approach could give uneconomic results for U.S. shareholders that could not use their share of the loss in year 1. They would obtain no benefit in year 1 and might receive only a *pro rata* share of a reduced tested loss in year 2.

Consider the example above with a 50% U.S. corporate shareholder and 50% non-U.S. corporate shareholder. If the U.S. corporate shareholder could use $50 of the $100 tested loss in year 1, no tested loss would carry over and the result seems correct. However,

[87] The shifting of tested losses among possibly unrelated shareholders would also raise complex basis and e&p issues similar to those discussed in Part IV.D.7 where the shareholders are related.

[88] Fifty percent U.S. ownership is used for simplicity. The CFC might be a CFC because the non-U.S. corporation has a U.S. subsidiary, or because the U.S. corporation owns 50.01% of the stock or holds stock with over 50% of the vote.

if the U.S. corporate shareholder could not use any of the tested loss in year 1, only its $50 share of tested loss would carry over, and the U.S. corporate shareholder could obtain the benefit of only $25 of that amount in year 2.

This result seems unfair. However, arguably it is justifiable on the ground that the U.S. corporate shareholder is in no worse a position than if the other shareholder was another U.S. corporate shareholder that could use its $50 share of the tested loss in year 1.

Fourth, under current law, NOL carryforwards to a taxable year can offset only 80% of taxable income for the year.[89] Tested loss carryforwards should likewise be limited to offsetting only 80% of tested income in future years. However, consider the case where in the future year the CFC has QBAI return:

> Example 10(a): Carryover of tested loss to year with QBAI return. A U.S. shareholder owns 100% of a single CFC, and the CFC has a tested loss of $100 in year 1. In year 2, the CFC has $100 of tested income, of which $20 is QBAI return. Absent the loss carryover, the shareholder would have a Section 951A inclusion of $80.

If the loss carryover is allowed in the amount of 80% of the year 2 tested income, the shareholder's net CFC tested income will be $100 minus $80, or $20, and its Section 951A inclusion will be $20 of net CFC tested income minus $20 of NDTIR, or $0. Thus, the loss carryover eliminates 100% of the Section 951A inclusion.

The elimination of 100% of the Section 951A inclusion for year 2 is arguably inconsistent with the purpose of the 80% limitation for domestic corporations. That rule does not allow a carryover to year 2 to eliminate 100% of the taxable income in year 2. Under this theory, the carryover should be limited to 80% of the Section 951A inclusion in year 2.

On the other hand, allowing a carryover of $80 only reduces tested income in year 2 by 80%, consistent with Section 172(a). Moreover, tested income is determined on a completely separate basis than are NDTIR and Section 951A inclusions. As a result, if the goal is to reduce the Section 951A inclusion to the U.S. shareholder by no more than 80%, it is impossible even in theory to determine at the CFC level how much of a carryover should be allowed. For example, another CFC held by the same U.S. shareholder might have QBAI return that offsets the tested income of this CFC, or might have interest expense that offsets the QBAI return of this CFC. If the CFC has more than one U.S. shareholder, then any loss carryover allowed at the CFC level will likely result in different percentage reductions to each U.S. shareholder's Section 951A inclusion.

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[89] Section 172(a).

The allowance of the loss carryover equal to 80% of tested income in year 2, without regard to QBAI return, is helpful to the taxpayer in Example 10(a). However, it can also be very adverse to taxpayers.

> Example 10(b): Carryover of tested loss to year with QBAI return. Same facts as Example 10(a), but in year 2, the CFC has \$100 of tested income, of which all \$100 is QBAI return. Even without the loss carryover, the Section 951A inclusion is \$0. If \$80 of the loss carryover is allowed in year 2, it has been absorbed with no tax benefit to the U.S. shareholder.

The avoidance of the 80% limitation in Example 10(a), and the wasting of loss carryovers in Example 10(b), would not arise if the loss carryover is limited to 80% of the excess of tested income over QBAI return in the carryover year. In that case (i) the carryover utilized in Example 10(a) will be 80% of (\$100 minus \$20), or \$64, (ii) tested income and net CFC tested income will be \$36, (iii) the Section 951A inclusion will be \$36 minus \$20, or \$16, and (iv) \$36 of the \$100 of tested loss from year 1 will be carried forward to year 3. The Section 951A inclusion is reduced by 80%, arguably the correct result. No carryover would be utilized in Example 10(b), and the entire \$100 carryover would be available in future years.

However, as discussed above, this limitation on carryovers could reduce the Section 951A inclusion by either more or less than 80% if the U.S. shareholder had other CFCs whose attributes were included in the Section 951A calculation. Moreover, the structure of the statute seems to contemplate that tested losses will be absorbed with no tax benefit in a situation such as Example 10(b) where they shelter QBAI return. It would be peculiar (and an opportunity for tax planning) if loss carryovers gave a more favorable result.

Finally, a rule for carryovers would normally treat a carryover in the same manner as a loss realized in the subsequent year.[90] However, this principle does not resolve the present issue. The ability to use carryovers to offset only 80% of current-year income necessarily means that a carryover is not as beneficial as a current year loss. Rather, the issue here is 80% *of what*, *i.e.*, tested income or tested income reduced by QBAI return.

Fifth, even in the absence of QBAI return, the 80% limit on carryovers raises uncertainties if the U.S. shareholder has more than one Related CFC. For example, as illustrated in Examples 6 and 7 above, the shareholder's Section 951A inclusion is determined by reference to net CFC tested income and NDTIR, which take into account

[90] *See, e.g.*, the discussion of Example 12 in Part IV.3.C(2) below, where we state that carryovers of disallowed interest under Section 163(j) to a year with QBAI return should not be treated more favorably than interest expense actually incurred in the later year. The distinction is that Section 163(j) treats current and carryover interest the same in limiting the deduction to a percentage of adjusted taxable income of any taxable year, while Section 172(a) only limits NOL carryovers to a percentage of taxable income in the carryover year.

not only the tested income and QBAI return of a particular Related CFC, but also the tested income and losses, QBAI return or interest expense of other Related CFCs.

> Example 11. NOL carryover to year in which tested income is offset by tested loss of another CFC. In year 1, CFC1 has a tested loss of $100 that is not used by its 100% U.S. shareholder. In year 2, CFC1 has tested income of $100, and the U.S. shareholder also owns CFC2 that has a tested loss of $20. Assume there is no NDTIR. The Section 951A inclusion aside from the loss carryover is $80.

If the loss carryover to year 2 is allowed to offset 80% of the $100 of tested income of CFC1, then CFC1 will have tested income of $20 in year 2 and the Section 951A inclusion will be reduced from $80 to $0 as a result of the carryover. Arguably this is inconsistent with the 80% limitation on loss carryovers, although it can be argued that the carryover is at the CFC1 level and any attributes of CFC2 are irrelevant. Allowing this result would also put a premium on shifting tested income from CFC2 to CFC1 in year 2 (and, depending on the rule adopted in Example 10, shifting QBAI return from CFC1 to CFC2 in year 2), in order to maximize the utilization of the loss carryover.

Alternatively, a rule could be considered that all loss carryovers from all Related CFCs of a particular U.S. shareholder should only be allowed to offset 80% of the net Section 951A inclusion of the particular U.S. shareholder, taking into account all tested income, tested loss, and NDTIR of that shareholder. This rule would be simple when there was a single U.S. shareholder.

However, this rule would not work when there were multiple U.S. shareholders with different Section 951A inclusions from different CFCs. The reason is that only a single specified amount of the carryover can be used to offset tested income of CFC1 in year 2, and that reduction in tested income would flow through *pro rata* to all shareholders. That *pro rata* amount would normally cause a different percentage reduction of the Section 951A inclusion for different U.S. shareholders with different holdings in other CFCs.

Sixth, if carryovers of tested loss are allowed, presumably Section 382 would apply to limit loss trafficking just as it does to domestic losses. This would introduce another layer of complexity, particularly among CFCs with multiple non-affiliated owners.

Finally, the allowance of carryover of tested losses at the CFC level might be quite disadvantageous to taxpayers in some situations, especially if the law is changed in the future so that NOL carryovers can offset 100% of taxable income. If this rule was applied to allow tested losses of a CFC to offset 100% of tested income of the CFC in future years, the benefits of FTCs and QBAI return of the CFC in the future year would be eliminated, just as they are today for a CFC with no positive tested income. Such a result could be much worse for taxpayers than the disallowance of the loss carryover, since the FTCs and

QBAI return in a particular CFC could be more valuable than the tax cost of the tested income in the CFC.[91]

This issue would not arise or would be less significant under the current rule limiting the reduction in tested income by 80%, to 20% of tested income. This would always leave *some* positive tested income, which would allow full retention of FTCs and QBAI return of the CFC. However, the FTC inclusion percentage could be reduced because of the reduction in positive tested income, *e.g.*, because the QBAI return would be a greater percentage of the total positive tested income.

(iii) Carryover at the US shareholder level

We consider now the alternative approach of having tested losses arising from a CFC carry over at the shareholder level. As a reminder, tested losses of a CFC are taken into account in reducing the U.S. shareholder's income inclusion under Section 951A(a). A U.S. shareholder's Section 951A inclusion is the excess (if any) of the shareholder's net CFC tested income for the year over its NDTIR for the year.[92] Net CFC tested income is the excess (if any) of the aggregate of its *pro rata* shares of its Related CFCs' tested income over the aggregate of its *pro rata* shares of its Related CFCs' tested losses.[93]

We propose that in the first instance, all tested losses of a CFC move up to the U.S. shareholder and be taken into account by the U.S. shareholder, whether or not this gives the shareholder a net negative tested loss. These tested losses then become tax attributes of the U.S. shareholder, and are treated just like other tax attributes for all purposes, such as Section 381. The possible consequences to the U.S. shareholder's tax basis in the CFC are briefly discussed in Part IV.D.7.

Then, the question is how the tested losses that move up to the shareholder are "absorbed" in the current year and affect the amount of the carryover to future years (or are absorbed in future years and unavailable for further carryover).

The following example illustrates two methods for calculating carryovers. Assume a U.S. shareholder has two CFCs ("**CFC1**" and "**CFC2**"), CFC1 has $100 of tested income and $150 of QBAI return. CFC2 has $100 of tested loss. Under the statute, the U.S. shareholder has $0 tested income and $150 of NDTIR. As will be seen below, the two approaches give carryovers from year 1 of $0 and $150.

Under one approach (the "**tested loss carryover approach**"), $100 of tested losses would be absorbed by the $100 of tested income, and there would be no carryover of tested loss. More generally, the carryover amount would be the "**net CFC tested loss**", which

[91] Presumably losses from pre-2018 years would not carry over into 2018 because the expenses giving rise to the losses were not attributable to tested income in those years.

[92] Section 951A(b)(1).

[93] Section 951A(c)(1).

would be defined in the same manner as net CFC tested income, except tested losses of some CFCs could exceed tested income of other CFCs. Likewise, in future years, the carryover would reduce, and be reduced by, the net CFC tested income, subject to the 80% limit. This approach is consistent with carrying over tested losses at the CFC level, since as discussed above tested losses would logically offset future tested income of the CFC without any adjustment for QBAI return in the future year.

The alternative approach (the "**shareholder calculation carryover approach**") applies the entire calculation at the shareholder level. If the Section 951A formula for inclusion would result in a negative number, aside from the prohibition of a negative result, that amount could be carried over, just like any excess of taxable expenses over taxable income. In the example, the Section 951A formula would result in minus $150 in year 1 (net tested income of $0 and NDTIR of $150), and this could be carried over.

This approach allows NDTIR not only to offset net CFC tested income, but also allows NDTIR to create its own carryover if it exceeds net CFC tested income. Specifically, the carryover of the negative amount in the GILTI formula is equal to net CFC tested income minus NDTIR, to the extent this number is negative and without regard to whether it exceeds aggregate tested losses of loss CFCs for the year. This approach, like the tested loss carryover approach, does not provide any benefit from shifting income and deduction among CFCs, since only net CFC tested income (or loss) is relevant.

This approach in effect treats NDTIR as exempt income earned on tangible assets, whether or not that is true in fact. It assumes that, say, a CFC with $100 of tested income and $150 of QBAI return *really* had a $50 tested loss on intangible assets and $150 of income on tangible assets, whether or not that is true as a factual matter. The shareholder obtains "credit" for the deemed $50 loss on intangible assets by being allowed a loss carryover of $50.

On the other hand, even aside from carryovers, the statute does a poor job of treating NDTIR as exempt income, such as by not providing any current year tax benefit for NDTIR when tested loss equals tested income. Moreover, this discussion began with the idea that tested losses of a CFC should be allowed to carry over if they are not utilized currently by the shareholder. It is a considerable leap from that position to the idea that the Section 951A calculation should be allowed to become negative and result in a loss carryover even in the absence of a net CFC tested loss. As a result, this approach would be a more significant conceptual change from the existing statute.[94]

[94] We considered a third, intermediate, approach under which NDTIR would offset tested income from CFCs with positive tested income, freeing up such amount of tested losses from CFCs with tested losses to be used currently against remaining tested income or to carry over. Only tested losses could carry over. However, this approach would allow the benefit of NDTIR to increase through the shifting of income and deduction within the group. In fact, if income and deduction items were shifted so that CFCs with positive tested income had total tested income equal to NDTIR, the group would achieve the result of the shareholder calculation carryover approach.

We turn now to a separate issue. Either of the approaches for allowing a loss carryover at the U.S. shareholder level would raise a number of questions.

First, a U.S. shareholder could have a regular NOL carryover and a GILTI NOL carryover (aside from any Section 163(j) carryover from its own activities). GILTI NOLs would not offset non-GILTI income, just like a negative GILTI inclusion for the current year cannot offset non-GILTI income of the shareholder. However, non-GILTI loss carryovers should be available to offset GILTI inclusions, just like current non-GILTI losses can offset GILTI inclusions.

As a result, an ordering principle would be needed to establish which losses are used first. For example, current year losses are typically used before loss carryforwards. However, if the current year has a GILTI inclusion and a non-GILTI loss, and there is a GILTI loss carryforward, arguably the carryforward should be used first since it is of more limited use. Likewise, loss carryovers are usually utilized earliest year first. However, if there is a GILTI inclusion in the current year, arguably all GILTI carryovers should be used before any non-GILTI carryovers, for the same reason.

Second, the GILTI loss carryover (however defined) would presumably be subject to the same 80% limit for use against future GILTI income as are regular NOLs. There is no reason that these carryovers should be exempt from the rule. Suppose that there is both a GILTI inclusion and non-GILTI income in the year, and sufficient carryovers of both types. The question is whether each type of carryover should be limited to offsetting 80% of its respective income type.

The alternative would be an aggregate limitation on carryovers equal to 80% of total income, with a preference given to the GILTI carryovers. For example, if there was $100 of GILTI inclusion and $100 of non-GILTI income and sufficient carryovers of both types, the net result could be either (1) $20 of GILTI inclusion and $20 of non-GILTI income, or (2) $0 of GILTI inclusion and $40 of non-GILTI income.

Third, having GILTI and non-GILTI carryovers would raise issues under Section 382. Suppose a corporation had $100 of each type of carryover, and a Section 382 event occurred that limited annual use of NOLs to $20. There are at least three possibilities:

- The aggregate limit of $20 would be available for any $20 of carryovers, and if the usual priority was for GILTI carryovers, that priority would continue to apply until the entire $20 was used up.

- The annual limit of $20 would be divided up *pro rata* between GILTI and non-GILTI carryovers based on their relative size.

- The annual limit of $20 would be divided between GILTI and non-GILTI carryovers based on the relative value of the assets generating GILTI inclusions and other assets.

The third alternative is supported by the fact that the Section 382 limit is equal to a percentage of the value of the stock of the shareholder at the time of the change in ownership.[95]

Yet another issue arises because under Notice 2003-65,[96] the Section 382 limit is adjusted by "recognized built in gain and loss". The question arises if the second or third alternative in the preceding paragraph is used. In those cases, the Notice 2003-65 amount could be calculated separately to adjust the GILTI and non-GILTI carryovers, or it could be done for the corporation as a whole and then allocated between the two carryovers in the same manner as the rest of the NOL limitation.

We note that while these issues appear to be complicated, in reality they are primarily design choices. Once the choice is made by regulations or legislation, the rules appear to operate relatively simply, in contrast to the operational effects of carrying over losses at the CFC level.

(b) Section 163(j) carryovers

We discuss in Part IV.C.2 the method for determining the taxable income of a CFC. Under our proposal, Treasury would have the authority to determine whether Section 163(j) applies to a CFC. If the limitations of Section 163(j) apply, we believe that all of Section 163(j) should apply, including the carryover of unused interest deductions in the same manner as for a domestic corporation. As in the case of tested loss carryovers, we urge that either regulations or legislation provide for Section 163(j) carryovers.

We have the following reasons for this conclusion. The interest deductions that are disallowed currently under Section 163(j) are for interest that would reduce tested income if it was allowed. A taxpayer should not be in a worse position if an interest deduction is disallowed under Section 163(j) than if the interest deduction was allowed and created a tested loss that was permitted to be carried over. Moreover, absent a carryover rule, a CFC could have plenty of tested income over a period of two or more years, but because the income is bunched into a few of the years, interest deductions would be permanently disallowed. This result is unfair to taxpayers, a trap for the unwary, and an incentive to engage in nonproductive activities to equalize income over a period of years.

In addition, a carryover is necessary to mitigate the consequences of "phantom income" or "phantom tested income" that can arise from a Section 163(j) disallowance for interest paid between related parties. Suppose a CFC ("**CFC1**") pays interest to a related CFC ("**CFC2**") and the interest deduction is disallowed under Section 163(j). Then, CFC2 has an increase in tested income from the receipt of the interest payment, but CFC1 does not have a reduction in tested income. The group has net positive tested income, which

[95] Section 382(b)(1).

[96] 2003-2 C.B. 747.

may result in a Section 951A inclusion, without any cash profit.[97] Similarly, if a CFC pays interest to its U.S. shareholder and the interest deduction is disallowed under Section 163(j), the U.S. shareholder has taxable interest income but the CFC does not have a reduction in tested income.[98]

Of course, this result could also arise for an interest payment between two related but nonconsolidated U.S. corporations. In that case, however, the interest disallowed under Section 163(j) can be carried forward to reduce future tax liability. A carryover at the CFC level would ameliorate the same risk in the GILTI regime.

Although we recommend applying loss carryovers at the U.S. shareholder level, we recommend applying Section 163(j) carryovers at the CFC level. This is most consistent with the language of Section 163(j)(2), which treats the carried over amount as paid or accrued in the succeeding taxable year.

Moreover, many of the difficulties that arise in the context of a carryover of tested losses at the CFC level do not arise in the context of Section 163(j) carryovers. The reason is that tested loss is determined at the CFC level but used at the U.S. shareholder level, while both Section 163(j) limitations and carryovers of disallowed interest deductions are determined and used at the CFC level. As a result, there is no need to reduce carryovers that have been used by shareholders, and no possibility of some shareholders receiving a double benefit from a carryover. Attempting to apply Section 163(j) carryovers at the U.S. shareholder level would introduce unnecessary complexity.

We note that the Code already applies Section 382 to Section 163(j) carryovers,[99] so this limitation is already built into the system and should apply equally to domestic and foreign corporations. In contrast to tested losses, no regulations or statutory amendment would be required to achieve this result.

As in the case of the 80% limit for NOL carryovers, there is a question as to how the 30% limit on Section 163(j) carryovers should apply to the tested income of the CFC that also has QBAI return in the carryover year. Consider the following variation on Example 10(a) above.

> <u>Example 12: Carryover of Section 163(j) deduction to year with QBAI return</u>. A U.S. shareholder owns 100% of a single CFC, and the CFC has an excess Section 163(j) deduction of $100 in year 1. In year

[97] Alternatively, the interest income might be foreign personal holding company income to CFC2, which could give rise to a better or worse result depending on the group's FTC position. *See* L.G. "Chip" Harter and Rebecca E. Lee, *A Brave New World—The Application of code Sec. 267(a)(3)(B) to Expenses Accrued by Controlled Foreign Corporations*, CCH Int'l Tax. J. May-June 2008, at 5.

[98] In the absence of a rule allowing carryovers in these cases, relief could only be provided by a rule treating non-consolidated affiliates as a single corporation.

[99] Section 382(d)(3), added by the Act.

2, the CFC has $100 of tested income, of which $30 is QBAI return. Absent the loss carryover, the shareholder would have a Section 951A inclusion of $70.

If the carryover is limited to 30% of tested income, or $30, then tested income is reduced to $70. Then, the U.S. shareholder's NDTIR is reduced by the $30 of allowed interest, namely to $0, since interest expense first reduces NDTIR until NDTIR is reduced to $0.[100] As a result, the U.S. shareholder's Section 951A inclusion is still $70, and the $30 interest carryover is absorbed but provides no tax benefit.

Arguably the allowed carryover should be increased by $21, to $51, to reduce the Section 951A inclusion by 30%, to $49. However, if the interest expense of $100 had actually been incurred in year 2, $30 would be allowed under Section 163(j), tested income would be $70, NDTIR would be $0, and the Section 951A inclusion would be $70. Under Section 163(j)(2), a carryover is to be treated the same as, not better than, interest actually incurred in year 2. Moreover, interest expense and QBAI return in another related CFC of the same U.S. shareholder can affect the Section 951A inclusion of the U.S. shareholder. As a result, any Section 163(j) limitation based on QBAI return of the particular CFC with carryovers will have varying effects on the Section 951A inclusion depending on the attributes of the other CFCs and, in the case of a CFC with more than one U.S. shareholder, will have varying effects for different U.S. shareholders.

The combined effect of (1) limiting current or carryover interest expense to 30% of tested income, and (2) disallowing any benefit of the interest expense to the extent of NDTIR, is a rather extreme result. However, this clearly is the result under the statute if the interest expense was incurred in the current year. It would not even help materially if regulations limited the Section 163(j) current or carryover amount to 30% of the excess of tested income over QBAI return of the particular CFC, since the allowed deduction would still reduce NDTIR before providing any tax benefit.

The Section 163(j) carryover also raises the question of how to deal with a situation similar to that raised in Example 11.

> Example 13: Section 163(j) carryover to year in which tested income is offset by tested loss of another CFC. In year 1, CFC1 has a Section 163(j) carryover of $100 to year 2. In year 2, CFC1 has tested income of $100, and the U.S. shareholder also owns CFC2 that has a tested loss of $70. The Section 951A inclusion aside from the carryover is $30.

If the carryover to year 2 is allowed to the extent of 30% of the $100 of tested income of CFC1 in year 2, then tested income of CFC1 will be $70 and the Section 951A

[100] Section 951A(b)(2)(B).

inclusion will be $0. The reduction in Section 951A inclusion from $30 to $0 is arguably not consistent with the intent of the 30% limitation in Section 163(j).[101]

On the other hand, it can be argued that the result is correct, since the Section 163(j) limit is properly determined at the level of the particular CFC. Moreover, attempting to limit the carryover that is used by CFC1 to 30% of the Section 951A inclusion for year 2 would raise the same issues discussed in the previous examples if the U.S. shareholder had other CFCs with interest expense, QBAI return, etc., or if CFC1 had more than one U.S. shareholder.

D. Other Computational Issues for GILTI Inclusions

1. Order of GILTI versus Section 956 Inclusions

Regulations should confirm that tested income of a CFC is determined before Section 956 inclusions.

It is clear from the Code that Subpart F income is determined before Section 956 inclusions.[102] Treasury Regulations confirm this result.[103] Moreover, the definition of tested income specifically excludes Subpart F income,[104] so Subpart F income must be determined before tested income can be determined.

Section 951A(f)(1)(A) states that Section 951A inclusions are to be treated as Subpart F inclusions for purposes of Section 959. Therefore, since Subpart F inclusions come before Section 956, tested income should also come before Section 956. Under this interpretation, which we refer to as "**GILTI First**", the U.S. shareholder would first report a GILTI inclusion, and this inclusion would create a PTI account.[105] Investment by the CFC in U.S. property under Section 956 would give rise to incremental income inclusions only to the extent it exceeded the PTI account and there was additional e&p available. This

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[101] Under this theory, the carryover is limited to 30% of the Section 951A inclusion of $30, so the allowed carryover is $9, net tested income of CFC1 is $91, and the Section 951A inclusion is $91 less $70, or $21.

[102] Subpart F income is included under Section 951(a)(1)(A) and Section 956 amounts are included under Section 951(a)(1)(B). Section 956 inclusions under Section 951(a)(1)(B) are specifically limited by Section 959(a)(2), which states that e&p attributable to PTI is not included in income again either as a Subpart F inclusion or a Section 956 inclusion. Section 959(f)(1) says that amounts that would be Section 956 inclusions are attributable to PTI to the extent of prior Subpart F inclusions. By contrast, Section 951(a)(1)(A) includes no similar PTI-based limitation for Subpart F inclusions. As a result, Subpart F income causes a Subpart F inclusion, which creates PTI and (assuming the income is not distributed) thereby limits Section 956 inclusions to the extent of that PTI.

[103] Treas. Reg. § 1.959-1(a).

[104] Section 951A(c)(2)(A)(i)(II).

[105] Sections 951A(f)(1)(A), 959. We assume for simplicity that the CFC has a single U.S. shareholder and that there is no Subpart F income.

result avoids any double inclusion of income of the CFC into the income of the U.S. shareholder.

By contrast, if Section 956 inclusions were determined before tested income is calculated ("**Section 956 First**"), any Section 956 income inclusion (up to e&p) would first create a PTI account. Then, since tested income is not reduced by Section 956 inclusions and (crucially) is not limited to e&p, tested income would be determined completely without regard to the Section 956 inclusion. This would result in a double inclusion of the income of the CFC into the income of the U.S. shareholder.

To be sure, each inclusion would create its own PTI account and basis increase.[106] As a result, the second inclusion in income might provide a tax benefit to the U.S. shareholder on a future distribution from the CFC or on sale of the CFC stock. However, this benefit might be far in the future, and the benefit could be in the form of a future capital loss with a tax benefit of less than the current cost of ordinary income. In any event it would be quite anomalous for $1 of earnings to create $2 of PTI and $2 of basis increase.

We do not believe Congress intended these results. Consequently, we believe that GILTI First is more consistent with both the plain meaning of the statute and the intent of Congress.

In principle, it would be possible for "Section 956 First" to apply, with tested income being reduced for Section 956 inclusions. However, actual distributions do not reduce tested income, so it would be inconsistent for deemed distributions from Section 956 inclusions to do so.

Moreover, in some cases taxpayers will prefer Section 956 inclusions and in other cases they will prefer tested income, in part because of very different FTC rules. This modified version of "Section 956 First" would effectively create an elective regime where well-advised taxpayers could choose between Section 956 and tested income by having CFCs making (or not making) loans to U.S. shareholders or otherwise investing in U.S. property. On the other hand, the same rule would create a trap for the unwary for less well advised taxpayers.

We observe that in applying GILTI First, a U.S. shareholder's income inclusion is based first on the CFC's Subpart F income (which is limited to e&p), then on its tested income and NDTIR (which are not based on e&p), and finally by Section 956 (which is limited to e&p). This ordering is not intuitive, but for the reasons described above, it seems most consistent with the language and purpose of the statute.

2. GILTI and Subpart F Inclusions in a Year When CFC Stock is Sold

When stock of a CFC is sold in the middle of a taxable year, in some cases the Subpart F income and GILTI inclusions allocable to the selling shareholder for the pre-sale portion of the year of the sale are permanently eliminated from the U.S. tax base. These

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[106] Sections 951A(f)(1)(A), 959 and 961(a).

results arise because of the enactment of Section 245A.[107] We discuss ways in which legislation or regulations could prevent these results. However, we do not take a position on whether any such legislation or regulations should be adopted.

(a) Background

The Section 951A inclusion applies only to a U.S. shareholder of a CFC that owns (directly or indirectly through a foreign entity) stock in the CFC on the last day of the taxable year of the CFC that it is a CFC (the "**last CFC date**").[108] The same rule applies to a Subpart F inclusion.[109] The U.S. shareholder's Section 951A inclusion is based on its *pro rata* share of the CFC's tested income for the CFC's taxable year.[110] The U.S. shareholder's *pro rata* share of tested income, tested loss, and QBAI is determined "under the rules of section 951(a)(2) in the same manner as such section applies to subpart F income".[111]

Assume that a U.S. shareholder owns X% of the CFC stock on the last CFC date, and the CFC is a CFC for Y% of the year. Under Section 951(a)(2), the U.S. shareholder's *pro rata* share of the Subpart F income for the year is equal to:

- X% times Y% times the Subpart F income for the entire year, including periods after the last CFC date, *see* Section 951(a)(2)(A), *minus*

- actual dividends paid by the CFC during the tax year to other holders of the stock (or deemed dividends under Section 1248(a) on a sale of the stock by another holder), but not in excess of the product of (i) X% (the ownership percentage), (ii) the Subpart F income for the year, and (iii) the percentage of the year that the U.S. shareholder did not own the stock, *see* Section 951(a)(2)(B).

In other words, the *pro rata* share of the U.S. shareholder on the last CFC date is first determined as if the U.S. shareholder had held the stock for the entire period of the year through the last CFC date. That amount is then reduced by dividends to another holder of the same stock during the year, but only to the extent those dividends do not exceed the Subpart F income attributable on a *pro rata* basis to the period that the U.S. shareholder did not own the stock.

[107] The Tax Section is preparing a separate report on Section 245A.

[108] Section 951A(e)(1) and (2). This rule is also expressly stated in the Conference Report at 645.

[109] Section 951(a)(1).

[110] Section 951A(a), (b)(1)(A) and (c)(1)(A).

[111] Section 951A(e)(1). This section is written in a rather peculiar way because it refers separately to tested income, tested loss, and QBAI, but since these three items are in effect combined to determine the Section 951A inclusion, we assume it is intended to apply the *pro rata* rule to the Section 951A inclusion.

As will be seen below, these rules worked well under the prior law rules for Subpart F. However, they can now allow Subpart F income and tested income allocable to a U.S. shareholder for the portion of the taxable year before the shareholder sells its stock to avoid being a Subpart F or GILTI inclusion or ever being included in U.S. taxable income to anyone.

(b) Fact patterns and results

(i) *Sale of a CFC from one Section 958(a) U.S. Shareholder to another Section 958(a) U.S. Shareholder*

Consider first the case where a CFC is a CFC throughout the year and has 100% U.S. shareholders throughout the year that are subject to Subpart F or GILTI inclusions, *i.e.*, they are shareholders under Section 958(a) ("**Section 958(a) U.S. Shareholders**"). Assume in all cases that the relevant CFCs have no PTI as of the beginning of the year in question, there is no gain in the CFC stock on January 1 of the year in question, the U.S. shareholder's holding period for the CFC stock satisfies the Section 245A holding period requirement,[112] the U.S. shareholder holds no other CFCs and none of the relevant CFCs has any QBAI return.

> <u>Example 14(a) (CFC with Section 958(a) U.S. shareholders throughout the year)</u>: A U.S. shareholder (US1) owns the CFC. During the year, the CFC has $1000 of earnings. On June 30, the CFC pays a dividend of $500 to US1, and immediately thereafter US1 sells the stock to another Section 958(a) U.S. shareholder (US2) at no gain or loss. US2 continues to own the stock until the end of the year, so the last CFC date is December 31.

Consider first this fact pattern under prior law, and assume that the $1000 of earnings is all Subpart F income. US1 did not have any Subpart F inclusion because it was not a shareholder on the last CFC date. Thus, it did not have any PTI account, and the $500 dividend it received was taxable at ordinary rates. US2 had Subpart F income of $1000 under Section 951(a)(2)(A), but this was reduced by $500 under Section 951(a)(2)(B). Thus, the total inclusion was $1000, the full amount of Subpart F income for the year.

The same result would arise if there had been no dividend, but US1 had sold the stock of the CFC to US2 on June 30 for a gain of $500. Then, the gain would be a deemed dividend under Section 1248 subject to the same rules. Section 951(a)(2)(B) is essential in these cases to avoid double taxation of $500 of Subpart F income, since otherwise $500 would be taxed to US1 and $1000 would be taxed to US2.

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[112] *See* Section 246(c).

Consider now the same fact pattern under current law. Just as under prior law, US1 does not have a Subpart F inclusion or PTI account, US1 has dividend income of $500, and US2 has Subpart F income of $1000 minus $500, or $500. However, now the dividend of $500 received by US1 is eligible for the 100% dividends received deduction under Section 245A. Likewise, if US1 sold the stock at a $500 gain without taking out the dividend, new Section 1248(j) provides that the deemed dividend under Section 1248 is eligible for the Section 245A deduction.

In either of these cases, US2 would obtain a PTI account of $500 by the first day of the CFC's next taxable year and could withdraw that amount tax free under Sections 959(a) and (e). As a result, in both the dividend and Section 1248 cases, $500 of Subpart F income permanently goes untaxed. Section 951(a)(2)(B), which was originally intended and needed to avoid double taxation of Subpart F income, is now eliminating even a single level of taxation of Subpart F income.

Since the Section 951A rules incorporate the Subpart F rules, the same results arise if income of the CFC is tested income rather than Subpart F income. Again, since US1 is not a shareholder on the last CFC date, it does not have a Section 951A inclusion. US2's *pro rata* share of tested income is $1000 minus the distribution or deemed distribution to US1 of $500, or $500. US1 has a taxable dividend or deemed dividend of $500 and a Section 245A deduction of $500. The CFC has $1000 of tested income for the year, but only $500 of it is taxable (to US2).

These results arise even if US2 is related to US1 (assuming no Section 304 transaction). In addition, an even more taxpayer-favorable result arises if the sale is near the end of the taxable year of the CFC, and so there will be tax benefits to deferring a sale until that time of year. In some cases it might also be possible for US1 to change the taxable year of the CFC to be the 12-month period ending shortly after the sale, to fix the amount of income in the previous portion of the year that would not be taxed under Subpart F or Section 951A.

This elimination of tax on Subpart F income or GILTI inclusions arises because Section 951(a)(2)(B) reduces the Subpart F inclusion (and because of the cross-reference in Section 951A(e)(1) to Section 951(a)(2), the tested income) regardless of whether the dividends to prior shareholders are subject to U.S. tax. In particular, the elimination of tax arises because Section 951(a)(2)(B) applies to dividends paid in the year of sale even if the dividends are eligible for the Section 245A deduction to the shareholder.[113]

(ii) *Sale of CFC stock from a Section 958(a) U.S. Shareholder to a Non-U.S. Shareholder; CFC ceases to be a CFC*

We now consider how existing law applies when the CFC ceases to be a CFC on the sale date.

[113] If the distribution to US1 is not taxable because of a preexisting PTI account, such as on account of a prior Section 965 inclusion, it is not a dividend covered by Section 951(a)(2)(B).

> Example 14(b) (CFC for only part of year). A Section 958(a) U.S. shareholder (US1) owns the CFC on January 1. During the year, the CFC has $1000 of earnings. On June 30, the CFC pays a dividend of $500 to US1, and immediately thereafter US1 sells the stock to a non-U.S. shareholder (F1) at no gain or loss on the stock. F1 continues to own the stock until the end of the year. Assume no attribution rules apply, so the last CFC date is June 30.

In this case, US1 is a Section 958(a) U.S. shareholder on the last CFC date. As a result, US1 has Subpart F income or a Section 951A inclusion, and PTI, equal to the Subpart F income or tested income for the year, or $500, as well as a Section 250 deduction if the income is tested income. Section 951(a)(2)(B) never applies, since there is no prior shareholder of the relevant stock. The $500 dividend to US1 is out of PTI, and so there is a single inclusion of $500 of Subpart F income or a net Section 951A inclusion of $250. The statute reaches the correct result without regard to Section 951(a)(2)(B). The same result arises if there is no dividend on June 30, but instead the stock is sold at a gain of $500. There is still a Subpart F inclusion of $500 on June 30 and Section 1248(d)(1) excludes such amount from being taxed again under Section 1248.

However, there is one further issue. Section 951A(e)(3) states that for purposes of Section 951A, "a foreign corporation shall be treated as a controlled foreign corporation for any taxable year if such foreign corporation is a controlled foreign corporation at any time during such taxable year." This rule was apparently intended to conform the Section 951A rules to the repeal of the rule that had been in Section 951(a) and that had prevented the application of Subpart F to a corporation that was a CFC for less than 30 days during the year.

Yet it is possible to read this provision as stating that in Example 14(b), the CFC is treated as a CFC for the entire year even though it has no actual or constructive U.S. owners in the second half of the year. We do not think this result was intended, since it would make meaningless the rules in Section 951 that look to the last day of the year on which the CFC is a CFC. Such last day would always be the last day of the taxable year. We recommend that regulations clarify that this provision is merely stating that there is no minimum period of time for a CFC to qualify as a CFC in order for it to be a CFC during its qualification period.

(iii) *Sale of CFC Stock from a Section 958(a) U.S. Shareholder to a non-U.S. Shareholder; CFC remains a CFC*

We now turn to another case where, as in Example 14(a), the CFC remains a CFC until the end of its tax year.

> Example 14(c) (CFC for whole year, taxable Section 958(a) U.S. shareholder for only part of

> year). U.S. shareholder (US1) owns the CFC on January 1. During the year, the CFC has $1000 of earnings. On June 30, the CFC pays a dividend of $500 to US1, and immediately thereafter US1 sells the stock to a buyer (F1) at no gain or loss. Assume F1 continues to own the stock until the end of the year, and the CFC remains a CFC through the end of the year.

Suppose the prior Subpart F rules apply, the income was Subpart F income, and there was no Subpart F inclusion for the year to any U.S. taxpayer because there was no U.S. taxpayer with Section 958(a) ownership on December 31, the last CFC date. This fact pattern would have arisen, for example, if F1 was a U.S. partnership with all foreign partners.[114] While the partnership would have the Subpart F inclusion as a U.S. shareholder on the last CFC date, none of its partners would be subject to U.S. tax. Section 951(a)(2)(B) was irrelevant because it merely reduces a Subpart F inclusion. However, US1 had a taxable dividend of $500 on June 30, which was taxable because US1 had no PTI. The same is true if there was no dividend and US1 sold the stock on June 30 at a gain of $500, since Section 1248(a) would apply to the gain.

Now assume these facts arise in 2018, and the income is either Subpart F income or tested income. The CFC will remain a CFC following the sale to F1 far more often under current law than before the Act. The reason is that the Act repealed Section 958(b)(4), which prevented a U.S. corporation from being considered a U.S. shareholder by virtue of attribution from a related foreign person.[115] Now, the CFC will continue to be a CFC through the end of the year even if F1 is a foreign corporation, as long as F1 has at least one U.S. subsidiary, since the subsidiary will constructively own the CFC stock owned by F1.

As before, there is no Subpart F or Section 951A inclusion, because the last CFC date is December 31 and there is no Section 958(a) U.S. shareholder on that date.[116] Section 951(a)(2)(B) is irrelevant because it merely reduces a Subpart F (and now a Section 951A) inclusion. The dividend to US1 is included in its gross income since the CFC has e&p and there is no PTI. However, the dividend is eligible for the Section 245A deduction, so there is no net income inclusion. The same is true if there was no dividend and the stock

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[114] This fact pattern would also have arisen as to, say, 49% of the stock of the CFC if US1 sold 49% of the stock of the CFC to a foreign corporation and retained the rest. The CFC would have remained a CFC throughout the year with a 51% U.S. shareholder, but there would have been no Subpart F inclusion on December 31 as to the 49% purchased interest.

[115] The scope of the repeal of Section 958(b)(4) is discussed in Part IV.G.3.

[116] Even if the CFC remains a CFC because F1 has a U.S. subsidiary that is a U.S. shareholder for determining CFC status, the subsidiary is not a U.S. shareholder under Section 958(a) and therefore has neither a GILTI inclusion (Section 951A(e)(2)) nor a Subpart F inclusion (Section 951(a)(1)).

was sold at a gain of $500, since Section 1248(j) treats the Section 1248(a) gain as a dividend for purposes of Section 245A.

Thus, the Subpart F income or tested income allocable to US1, the selling U.S. shareholder of the CFC with Section 958(a) ownership, has permanently avoided U.S. tax by being converted into a tax-free dividend.[117] Moreover, no interpretation or amendment of Section 951(a)(2)(B) will change this result, since there is no inclusion of Subpart F or tested income that is being reduced by that provision. As before, the goal of US1 would be to sell the stock shortly before the end of the tax year of the CFC, and either take out a tax-free dividend shortly before the sale or else recognize a corresponding tax-free dividend under Section 1248.

As noted above, this permanent elimination of tax on Subpart F income and Section 951A inclusions will be more common in light of the repeal of Section 958(b)(4), since there will now be many more situations where a CFC remains a CFC even though it does not have a taxable Section 958(a) U.S. shareholder. However, the issue is conceptually distinct from such repeal, since the issue could arise even if Section 958(b)(4) were fully restored. For example, as in the discussion of prior law above, the same issue would arise (a) if the sale of 100% of the stock was to a U.S. partnership to the extent the partnership had foreign partners that would not be required to report their share of partnership income, or (b) as to 49% of the tested income of a CFC, if a 51% direct U.S. shareholder retained its stock for the entire year, and a 49% direct U.S. shareholder sold its stock in the middle of the year to a non-U.S. person.

(iv) *Sale of stock of second tier CFC where ownership of top CFC does not change*

Similar issues arise when a first tier CFC receives a dividend from, or sells the stock of, a second tier CFC during a taxable year, where the ownership of the first tier CFC does not change. This transaction is identical as an economic matter to the situation in Examples 14(a), (b), and (c) if the first tier CFC is a shell company, and if the buyer of the CFC stock is the same in each case. The result is in substance the same as in the previous situations.

The different fact patterns discussed above are now discussed in this lower-tier CFC context. In the examples, a U.S. shareholder ("**US1**") directly owns all the stock of a top tier CFC ("**CFC1**"), CFC1 directly owns all the stock of the lower tier CFC ("**CFC2**"), and CFC1 has no income or assets other than the stock of CFC2. As before, assume in all cases that the relevant CFCs have no PTI as of the beginning of the year in question, there is no gain in the CFC stock on January 1 of the year in question, the U.S. shareholder's holding

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[117] The converse situation would arise in Example 14(c) if F1 owned the stock in the first part of the year and sold it (without a distribution) to US1 on June 30. US1 would have a Subpart F or tested income inclusion on December 31 equal to the CFC's income for the entire year, and it is doubtful that an offset would be allowed under Section 951(a)(2)(B). The offset is only allowed for an amount included in gross income under Section 1248, and a non-U.S. person such as F1 would not have any gross income under Section 1248 or otherwise. A pre-sale dividend to F1 would avoid this problem.

period for the CFC stock satisfies the Section 245A holding period requirement,[118] the U.S. shareholder holds no other CFCs and none of the relevant CFCs has any QBAI return.

> Example 14(d) (Second Tier: CFC2 has Section 958(a) U.S. shareholders throughout the year): During the year, CFC2 has $1000 of earnings. On June 30, CFC2 pays a dividend of $500 to CFC1, and immediately thereafter CFC1 sells the stock of CFC2 to a Section 958(a) U.S. shareholder ("**US2**") at no gain or loss on the stock. US2 continues to own the stock until the end of the year, so the last CFC date for CFC2 is December 31.

Consider first this fact pattern under prior law, and assume that the $1000 of earnings is all Subpart F income. US1 did not have any Subpart F inclusion from CFC2 because it was not a shareholder on the last CFC date. US2 had Subpart F income of $1000 from CFC2 under Section 951(a)(2)(A), but this was reduced by $500 under Section 951(a)(2)(B). However, US1 would have an additional $500 of income either when CFC1 received the dividend as Subpart F income (*i.e.*, if the same country exception did not apply), or (if not Subpart F income initially) when CFC1 paid the cash to US1 or when US1 sold the stock of CFC1. Thus, the total inclusion was $1000, the full amount of Subpart F income for the year.

The same result would have arisen if there had been no dividend, but CFC1 had sold the stock of CFC2 to US2 on June 30 for a gain of $500. Under Section 964(e)(1), CFC1 would have a deemed dividend as if Section 1248(a) applied, and the foregoing results would be unchanged. Note that Section 951(a)(2)(B) is essential in these cases to reduce US2's Subpart F inclusion from $1000 to $500, since otherwise $500 would be taxed to US1 and $1000 would be taxed to US2.

Now consider the effects of the Act. The Act added new Section 964(e)(4), which provides that when CFC1 sells the stock of CFC2, the Section 1248(a) amount created by Section 964(e)(1) is Subpart F income to CFC1, is includible in the income of US1, and is eligible for the Section 245A deduction in the same manner as if the Subpart F income were a dividend from CFC1 to US1.

Return now to Example 14(d) under current law, and assume the $1000 of income of CFC2 is Subpart F income or tested income. The dividend to CFC1 would not be Subpart F income or tested income in CFC1's hands.[119] CFC1 could pass on the dividend

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[118] *See* Section 246(c).

[119] Under Section 951A(c)(2)(A)(i)(IV), a dividend from a related party is not tested income. The dividend might be exempt from Subpart F income to CFC1 under Section 954(c)(3) (same country exception) or Section 954(c)(6) (look-through rule). Note that the look-through rule does not apply if the underlying income is Subpart F income, but there is no exclusion if the underlying income is tested income. At least if the underlying income is Subpart F income and the same-country exception does not apply, CFC1 would apparently be entitled to the Section 245A deduction, *see* Conference Report at 599 n. 1486.

to US1, and US1 would be eligible for the Section 245A deduction. If instead CFC1 sells the CFC2 stock at a gain of $500, under Section 964(e)(4), US1 will have a deemed Subpart F inclusion that is eligible for the Section 245A deduction.[120] In addition, in either case, US2 will continue to have $1000 of Subpart F income or Section 951A inclusion that is reduced, under Section 951(a)(2)(B), by an actual dividend of $500 paid by CFC2 to CFC1, or by "any gain included in the gross income of any person as a dividend under section 1248". If CFC2 paid an actual dividend of $500, US2's CFC inclusion would be $500, and the clear intent is that the same result arises if CFC1 sold the stock for gain of $500.[121]

These results are similar to the results today under Example 14(a) when the stock of a first tier CFC is sold in the middle of the year to another U.S. shareholder. Here, if CFC2 has $1000 of tested income, the Section 951A inclusion reported for the year is $500. Likewise, if CFC2 has $1000 of Subpart F income, the Subpart F inclusion for the year is $500. In both the GILTI and Subpart F cases, the Act has conformed the results of the sale of stock of a second tier CFC to the results of a sale of a first tier CFC.

Next, consider the analog to Example 14(c), where CFC1 sells the stock of CFC2 to F1 and CFC2 continues as a CFC until the end of the year. Regardless of whether the $500 is paid up as a dividend or the stock is sold at a gain of $500, the results to CFC1 and US1 are the same as in the second preceding paragraph. Moreover, there is no U.S. shareholder that pays tax on any Subpart F income or Section 951A inclusions on the last CFC date. Just as in Example 14(c), $500 of Section 951A inclusion or Subpart F income attributable to US1 has avoided U.S. tax, and just as in that example, the reason has nothing to do with Section 951(a)(2)(B).

Finally, consider the results under the Act if the CFC2 income is either GILTI or Subpart F, CFC1 sells the stock of CFC2 to a non-U.S. person, and the CFC ceases to be a CFC. This is the analog to Example 14(b) but in the context of a sale of a second tier subsidiary. Now, US1 is a U.S. shareholder of CFC2 on the last CFC date. As a result, US1 has Subpart F income or a Section 951A inclusion of $500 on that date, regardless of whether the $500 is paid up as a dividend or the stock is sold at a gain of $500. The non-U.S. purchaser of CFC2 is not a U.S. shareholder and has no inclusion. As a result, the total inclusion is $500, just as in Example 14(b), and the result conforms to the amount of Subpart F income or GILTI allocable to the selling shareholder.

(c) Discussion

It is clear from the foregoing that on a sale of a first tier or second tier CFC in the middle of a taxable year, the Subpart F income or Section 951A inclusion attributable to the selling shareholder for the pre-sale portion of the taxable year of sale will now permanently avoid tax because of Section 245A.

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[120] Note that Section 964(e)(4) applies "notwithstanding any other provision of this title".

[121] Section 964(e)(4) does not say that CFC1's gain on the sale of the CFC2 stock is "included in the gross income of any person" as a Section 1248 dividend, but the intent is clear.

Absent a stock sale, it is clear that the payment of a dividend eligible for Section 245A does not reduce the amount of Subpart F income or Section 951A inclusion for the year. The policy question is whether a dividend eligible for Section 245A should reduce the amount of the inclusion if it occurs in the year the stock of a first-tier or second-tier CFC is sold.

On the one hand, it can be argued that Congress did not intend to allow for such an easy avoidance of Subpart F income or Section 951A inclusion. In addition, the fact that the Act conforms the treatment of a first and second tier subsidiary does not mean that it intended to allow such avoidance in either case. Moreover, such an avoidance of tax on a Section 951A inclusion is inconsistent with the theory that GILTI is a flat tax on foreign earnings. This result also allows for considerable tax planning to reduce the taxation of GILTI or Subpart F income. For example, a sale can occur near the end of the year to maximize the amount of excluded income, and the sale can be made to a U.S. or non-U.S. affiliate in a manner that avoids Section 304.

On the other hand, arguably Congress was not concerned about these results. The Act adds both Section 951A and Section 964(e)(4), and both sections refer to Section 951(a)(2). Moreover, the new rule in Section 964(e)(4), combined with new Section 245A, expands the scope of tax free treatment of GILTI and Subpart F income to second tier subsidiaries. Arguably Congress must have determined that the operation of Section 951(a)(2), in conjunction with Section 245A, was consistent with its intent or at least not important enough to fix. In addition, if Congress was satisfied with the operation of Section 951(a)(2) and Section 245A when the sale of stock was to a Section 958 U.S. shareholder, presumably it was satisfied with the equivalent result when the sale was to a non-Section 958 U.S. shareholder.

Moreover, Section 951(a)(2)(B) arguably allowed the elimination of Subpart F income in the year of a sale even before the Act. Return to Example 14(b), where the CFC ceased to be a CFC on June 30. Assume in addition that the CFC paid F1 a dividend of $500 on December 31. US1 is a U.S. shareholder on the last CFC date. Under a literal reading of Section 951(a)(2)(B), US1 has a Subpart F inclusion of (i) $500 (*pro rata* share of Subpart F income for the full taxable year of the CFC) minus (ii) $500 (distribution to F1 not in excess of F1's share of Subpart F income for the year), or $0. At least one Technical Advice Memorandum from 1995 confirms this result.[122] No legislative or regulatory action has been taken to change this result.

We take no position on whether these results should be changed by legislation or, if there is authority to do so, regulations. However, we point out some possible approaches if a change is desired.

First, Section 245A could be amended to provide that when stock of a CFC is sold during a taxable year, and the CFC continues to be a CFC after the sale, dividends paid on that stock out of Subpart F income or Section 951A inclusions for that year are not eligible

[122] TAM 9538002 (May 16, 1995).

for Section 245A. However, this would be a basic structural change to the Subpart F and GILTI rules, as well as Section 245A, and would create other complexities.

Second, Section 951(a)(2)(B) could be modified to reduce a Subpart F inclusion only for distributions not eligible for Section 245A. This approach would result in inclusion for the full amount of Subpart F income or GILTI for the year of the stock sale if the CFC continued to be a CFC with a continuing Section 958(a) U.S. shareholder. However, it would not result in full inclusion if the CFC continued as a CFC without a Section 958(a) U.S. shareholder. Moreover, it could be viewed as unfair to the Section 958(a) U.S. shareholder that buys the stock, since it would have a Section 951A inclusion of $1000 (without reduction for the $500 distribution to the seller eligible for Section 245A) even though it only held the stock for half the year. This is penalizing the buyer because of the under-taxation of the seller.

Third, a new rule could apply on any sale of stock by a U.S. shareholder where the tax year does not end and the CFC remains a CFC, regardless of the buyer. In that event, the taxable year of the CFC would be deemed to end, with respect to the sold stock only, on the sale date. This would result in full inclusion to the seller for the year of the sale, as in Example 14(b), regardless of whether the buyer was a Section 958(a) U.S. shareholder.

The notional ending of the tax year could, like today, result in a *pro rata* allocation of income for the full year to the periods before and after the sale date, as opposed to a factual determination of income before and after the sale date. However, if the closing of the tax year applied for all purposes, it would result in short tax years for the sold stock. This would exacerbate the tax detriments under GILTI that arise from tax years with tested losses, and the fact that FTCs do not carry over.

3. Relationship between Section 163(j) and Section 250

As indicated in Part III.E.3 of the Section 163(j) Report, regulations should address the relationship between Section 163(j) and Section 250. Notice 2018-28, relating to Section 163(j), is silent on this question. A taxpayer could first apply the Section 250(a)(1) deduction in determining “adjusted taxable income” under Section 163(j)(8), then determine allowed interest deductions under Section 163(j), and then apply the Section 250(a)(2) limitation of the Section 250 deduction to taxable income. However, a reduction in deductions under Section 250(a)(2) would “retroactively” increase “adjusted taxable income” under Section 163(j)(8), which would require re-calculating allowed interest deductions under Section 163(j), which, in turn, would require re-calculating the reduction in deductions under Section 250(a)(2), and so on and so forth. When Section 250(a)(2) applies, simultaneous equations might be required in order to replicate the effect of this iterative process.

4. Limit on Section 250 Deduction

Regulations should clarify that, for purposes of the limit on the Section 250 deduction under Section 250(a)(2), “taxable income of the domestic corporation” includes all income, including Subpart F, Section 951A, Section 78, and FDII inclusions, determined without regard to the Section 250(a)(1) deduction.

In addition, regulations should clarify whether the Section 250(a)(2) carve-back applies to the Section 78 gross-up amount for a Section 951A inclusion. For example, assume the U.S. shareholder has no income or loss except for a Section 951A inclusion of $50, a Section 78 gross-up amount of $20, and a current NOL of $60. Tentative taxable income before Section 250 is $10. Section 250(a)(2) might require the $70 base for the 50% Section 250(a)(1) deduction to be reduced to either:

(a) $10, *i.e.*, the total Section 951A and Section 78 inclusions of $70 are reduced by the excess of such inclusions ($70) over tentative taxable income ($10), a reduction of $60, resulting in a Section 250 deduction of $5, or

(b) $30, *i.e.*, the Section 951A inclusion of $50 is reduced by the excess of such inclusion ($50) over tentative taxable income ($10), a reduction of $40, to $10, but there is no reduction in the Section 78 amount of $20, resulting in a Section 250 deduction of $15.

Under alternative (a), the Section 250 deduction reduces the tentative taxable income by 50%, from $10 to $5. Under alternative (b), the Section 250 deduction eliminates all of the tentative taxable income and results in a loss of $5. Section 172(d)(9) would prevent this loss from being carried forward.

The two methods give the same result if the loss (after reduction for non-GILTI income) exceeds the sum of the Section 951A and Section 78 inclusions. In that case, any Section 250 deduction will only result in a loss that cannot be carried over because of Section 172(d)(9). The two methods also give the same result if the loss is no greater than the Section 951A inclusion, since the reduction of the Section 951A inclusion itself by the loss will give the same result as if both inclusions are reduced by the loss. The two methods only give different results if, as in the example, the loss is greater than the Section 951A inclusion but less than the sum of the two inclusions.

The uncertainty in the statute arises because under Section 250(a)(2)(A), the reduction in the GILTI amount taken into account under Section 250(a)(1) is equal to the excess of the GILTI amount "otherwise taken into account by the domestic corporation under [Section 250(a)(1)]" over the tentative taxable income of the corporation. Section 250(a)(1)(B) refers separately to the GILTI inclusion under Section 951A and the Section 78 gross-up attributable to such inclusion. It is not clear whether the reference in Section 250(a)(2)(A) is only to the Section 951A inclusion, or whether it is also intended to include the Section 78 gross-up. However, Section 250(a)(2)(B)(ii), which allocates the carve-back between GILTI and FDII, tracks the language of Section 250(a)(1)(B)(i) and implies that only the Section 951A inclusion and not the Section 78 gross-up can be cut back by Section 250(a)(2).

5. Allocation to Preferred Stock

We consider now the proper allocation of tested income to a U.S. shareholder that holds preferred stock of a CFC. Section 951A(e)(1) states that a U.S. shareholder's *pro rata* share of tested income of a CFC is determined under the rules of Section 951(a)(2). The regulations under Section 951(a)(2) determine how to allocate Subpart F income among classes of stock of a CFC.

Under those regulations, if preferred stock has a fixed term and all dividend arrearages accrue and compound at a rate at least equal to the applicable Federal rate at the time of issuance ("**fixed yield preferred stock**"), the stock is not allocated any Subpart F income in excess of accrued and unpaid dividends (referred to here as the "**fixed allocation method**").[123] However, stock that is subject to discretionary distributions, specifically including preferred stock that is perpetual or that does not provide for the compounding of dividend arrearages, is allocated Subpart F income under a different method (referred to here as the "**proportionate allocation method**").[124] Under that method, there is first an initial allocation to accrued and unpaid dividends, and any remaining Subpart F income is then allocated to each class of stock, including the preferred stock, in proportion to the fair market value of all classes of stock of the CFC.[125] The regulations do not contain any special rule for convertible preferred stock, although preferred stock with a participating dividend is subject to the proportionate allocation method.[126]

Regulations should determine the application of these rules to allocations of tested income to a U.S. shareholder holding preferred stock. If the stock is nonconvertible fixed yield preferred stock, we believe that the fixed allocation method that applies for Subpart F purposes should apply. Such stock is not entitled at any point in time to more income than its accrued dividends to date, and there is no logical reason to allocate to it a greater amount of tested income.

Contrary to the Subpart F regulations, the same logic applies to stock that would be nonconvertible fixed yield preferred stock except that it does not provide for compounding of dividend arrearages. If anything, this stock should be allocated *less* rather than more Subpart F income or tested income than fixed yield preferred stock, since the present value of its future fixed dividends will be lower than in the case of fixed yield preferred stock.[127]

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[123] Treas. Reg. §§ 1.951-1(e)(3)(i) (unless an exception applies, when there are multiple classes of stock, the *pro rata* share of each class for Subpart F purposes is based on proportion of the distributions that would be made to each class if all e&p for the year was distributed on the last day of the year); -1(e)(4)(ii) (an exception that applies the proportionate allocation method described below in the text does not apply to fixed yield preferred stock).

[124] *Id.*

[125] Treas. Reg. §§ 1.951-1(e)(3)(ii)(A); -1(e)(4)(ii).

[126] Treas. Reg. § 1.951-1(e)(6) Ex. 5.

[127] The Tax Section made the same point in commenting on the proposed regulations that led to these final regulations. See NYSBA Tax Section, Report No. 1079, *Report on Proposed Regulations Regarding*

As a result, we believe that in determining tested income allocable to nonparticipating, nonconvertible preferred stock that would be fixed yield preferred stock except for the lack of compounding of dividend arrearages, the allocation should at least not exceed the allocation under Subpart F for fixed yield preferred stock. We believe this change could be made by regulations, at least if the regulations under Subpart F are changed accordingly.

Turn now to convertible preferred stock that, absent the conversion feature, would be eligible for the fixed allocation method. It does not appear that the conversion feature causes it to be subject to the proportionate allocation method under the Subpart F regulations. Nevertheless, if the fixed allocation method applies to such stock, it would be possible to avoid Section 951A inclusions on tested income. The stock will be allocated tested income equal to the dividend paid or (apparently) accruing on the stock.[128] However, the dividend rate will be below the market rate on comparable nonconvertible preferred stock to reflect the conversion feature. In fact, assuming a purchase price at the face amount of the preferred stock, the greater the initial value of the conversion feature, the lower the dividend rate.

As a result, there may be no tested income allocated to any U.S. shareholder to reflect the “bargain” element of the dividend rate. In addition, when the stock is converted, it will represent a percentage interest in the CFC’s existing assets, including PTI for which the holder has never been allocated tested income.

Taxpayers could take advantage of these rules to defer or eliminate tax on tested income. For example, a U.S. shareholder could purchase convertible preferred stock of a CFC, or exchange its common stock for convertible preferred stock with the same value. The common stock might be held by an unrelated U.S. or non-U.S. person, or by the foreign parent of the U.S. shareholder.[129] An individual U.S. shareholder might also own convertible preferred stock, with a wholly owned corporation owning common stock.

It would be possible to treat convertible preferred stock as subject to the proportionate allocation method because of its conversion feature. Alternatively, at least when the stock is “in the money”, it could be treated as converted. However, any such rule could lead to widely varying results from year to year. In any event, regulations should clarify the result in these cases.

6. Interest Expense of CFC with Tested Loss

It is not clear whether the gross interest expense of a CFC with a tested loss reduces NDTIR of the shareholder. Section 951A(b)(2)(B) reduces NDTIR by interest expense

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The Determination of a Shareholder's “Pro Rata Share” Under Section 951 (Feb. 11, 2005), at 20-21 (expressing concern that an uneconomically high allocation of Subpart F income to such preferred stock could lead to abuse).

[128] Treas. Reg. § 1.951-1(e)(3)(i). *See also* Treas. Reg. § 1.951-1(e)(3)(ii) (clause (i) applies to preferred stock entitled to a fixed return).

[129] This assumes no previous inversion transaction. *See* Treas. Reg. § 1.7701(l)-4T.

taken into account under Section 951A(c)(2)(A)(ii) in determining net CFC tested income, and the tested loss of a CFC reduces net CFC tested income. However, while tested losses are calculated under Section 951A(c)(2)(B)(i) by taking into account expenses described in Section 951A(c)(2)(A)(ii), strictly speaking, the expense is taken into account under Section 951A(c)(2)(B)(i) rather than Section 951A(c)(2)(A)(ii) in reducing net CFC tested income.[130]

First, assume the CFC with the tested loss and interest expense does not have any notional QBAI return. For example, suppose CFC1 has $100 of tested income and $100 of QBAI return, so there is no Section 951A inclusion for income from CFC1 on a stand-alone basis. CFC2 has $100 of interest expense, $1 of tested loss, and no notional QBAI return. The question is whether the shareholder's NDTIR of $100 from CFC1 is offset by the interest expense in CFC2, so there is net CFC tested income of $99 and a Section 951A inclusion of $99.

Next, even if the interest expense in CFC2 reduces the shareholder's NDTIR in this situation, consider the above fact pattern where CFC2 also has $100 of notional QBAI return. The notional QBAI return of CFC2 does not increase the shareholder's NDTIR, because CFC2 has a tested loss. The question now is whether the shareholder's NDTIR of $100 from CFC1 is still offset by the interest expense in CFC2, even though the $100 of notional QBAI return in CFC2 is disregarded in determining the shareholder's NDTIR. If so, there would be a Section 951A inclusion of $99, the net CFC tested income from CFC1 and CFC2, with no NDTIR.

This would be a very anomalous result, and quite adverse to the taxpayer. Logically, even if interest expense in a CFC with tested losses such as CFC2 is generally required to offset NDTIR, the interest expense should *first* offset the notional QBAI return in CFC2 itself. After all, the purpose of the reduction of NDTIR for interest expense is a presumption that the debt on which the interest is paid was used to buy an asset generating QBAI return. If CFC2 has its own assets that generate notional QBAI return, there is no logical reason for that return to be ignored, and for the interest expense of CFC2 to offset the QBAI return of CFC1 without regard to the notional QBAI return of CFC2.

Regulations should clarify this point.

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[130] The House bill took account of all QBAI in determining NDTIR, without regard to whether a CFC had tested income or tested loss, and it was therefore logical to reduce NDTIR by interest expense of all CFCs. The Senate amendment took into account only QBAI used in the production of tested income but did not reduce NDTIR by any interest expense of CFCs. The conference agreement adopted the Senate amendment with modifications, including reducing QBAI for interest expense taken into account "under [section 951A(c)(2)(A)(ii)] in determining the shareholder's net CFC tested income....". However, because the Senate provision was not amended to also take into account QBAI in a CFC with tested loss, it is not clear whether the amendment was intended to only account for interest expense of a CFC with tested income.

7. Tax Basis and E&P Issues

A number of issues concerning tax basis and e&p are raised by the GILTI rules. We only mention these briefly, since many of these issues will be discussed in a more extensive report that the Tax Section will be submitting on the subject.

Outside of consolidation, suppose US1 owns all of CFC1 and other CFCs. Assume no NDTIR, and that in year 1, CFC1 has tested income and the other CFCs break even. US1's tax basis in CFC1 will increase by the Section 951A inclusion, which is CFC1's tested income. Now suppose that in year 2, CFC1 has a tested loss equal to its year 1 tested income, but US1 has another CFC with an equal amount of tested income, so there is no Section 951A inclusion in year 2.

Regulations should clarify whether US1 still has a PTI account of $100 in US1 based on the year 1 Section 951A inclusion, even though CFC1 has no net tested income over the two year period. The existence of such a PTI account would be consistent with the fact that US1's tax basis in CFC1 is apparently not reduced in year 2 notwithstanding the tested loss of CFC1 in year 2. There may be additional consequences arising from the fact that CFC1's loss in year 2 has saved US1 tax on the tested income of CFC2 in year 2.

Next, suppose US1 holds CFC1 and CFC2, CFC1 has tested income of $100, and CFC2 has a tested loss of $100. Section 951A(f)(2) states that if the Section 951A inclusion is less than the sum of the positive tested incomes of the shareholder's CFCs, the inclusion is allocated to the CFCs in proportion to the positive tested income of each CFC. Here, there is no Section 951A inclusion, no basis adjustment to the stock of CFC1 or CFC2, and no PTI is created. However, a dividend of $100 from CFC1 would apparently be eligible for the 100% deduction under Section 245A, and $100 of gain on the sale of the CFC1 stock would be exempt under Section 1248(a). Regulations should confirm these results.

Moreover, on this fact pattern, CFC2's loss has saved US1 $10.50 of GILTI tax, but there is apparently no adjustment to the tax basis of either CFC or to the e&p of the CFC with tested income. A similar issue arises if CFC2 has positive tested income but generates NDTIR in excess of that income, thereby offsetting tested income of CFC1 and causing US1 to save GILTI tax. The basis results in these examples can be uneconomic because the formula under Section 951A(f)(2) can cause a Section 951A inclusion to be allocated to a CFC that generated little or none of the actual Section 951A inclusion amount.

Finally, suppose that under our proposal in Part IV.C.3(a), the tested loss (and possibly QBAI return) of a CFC is shifted to the U.S. shareholder for carryover to future years of the shareholder. Logically there should be a basis decrease at the time of the shift, since the tested loss attribute has permanently left the CFC at that time. Regulations should clarify this point if the statute or regulations adopt this proposal for carryovers.

Many issues also arise under the consolidated return investment adjustment rules. Suppose one member (M1) owns the stock of another member (M2), and M2 has a Section 951A inclusion of $100 and a related Section 250 deduction of $50. Regulations should confirm that M1's stock basis in M2 increases by M2's Section 951A inclusion and is not reduced by M2's related Section 250 deduction. This result is supported by the rule for the dividends received deduction for dividends received by M2, by the analogous rule for partnerships discussed below that is contemplated by the Conference Report, and by the fact that the Section 250 deduction is intended as a rate reduction on GILTI inclusions rather than an economic deduction involving out of pocket costs.

Failure to give M1 a $100 basis increase in M2 would eliminate the benefit of the reduced GILTI tax rate when M1 sells the stock of M2, since M1 would then have a $50 capital gain on a sale attributable to the Section 250 deduction.

Additional issues arise under the investment adjustment regulations if, as we propose, members of a group are treated as a single corporation for purposes of GILTI inclusions and Section 250 deductions. As a result of such aggregation, members with Related CFCs may have different PTI accounts in those CFCs than in the absence of aggregation (although as discussed above, mismatches arise even in the absence of aggregation).

For example, suppose CFC1 and CFC2 are owned by different members M1 and M2, CFC1 has tested income, CFC2 has an equal amount of tested loss, and therefore there is no GILTI inclusion for the group.

For example, it is not clear if there is any tiering up or shifting of basis in the stock of M1 and M2, as there would be if CFC1 and CFC2 were domestic members of the group and the CFC2 losses were used to shelter CFC1 income. It is also not clear if any account is taken of the fact that CFC2's loss results in a loss of the Section 250 deduction for the group. The same issues arise if CFC1 has tested income, CFC2 has $1 of tested income and large QBAI return, and there is little or no GILTI inclusion as a result of the offset for NDTIR.

Finally, in a consolidated return context, the foregoing fact patterns raise questions as to how e&p is to be allocated among members of the group. Our forthcoming report will discuss both basis and e&p issues.

Additional issues also arise in the partnership context. As contemplated by the Conference Report, regulations should confirm that a corporate partner's outside basis in its partnership interest is increased by the GILTI inclusion of income to the partner, but not reduced by the Section 250 deduction. Such a reduction would mean that the deduction would represent a deferral, rather than a permanent decrease, in the tax rate on GILTI income to the corporate partner.

In addition, suppose a U.S. person is a partner in a partnership that owns a CFC, and the partner has a GILTI inclusion. Regulations should clarify whether there is an adjustment to the tax basis of the partnership in the CFC. Regulations should also address the more complex issues that can arise when interests in a CFC are held through tiered partnerships.

E. Foreign Tax Credit Issues

1. Determination of Allowed FTC

(a) Tracing versus proration

If a CFC has tested income, the foreign taxes paid by the CFC are entitled to the deemed paid FTC for GILTI purposes if they are "tested foreign income taxes". This means they must be "properly attributable to the tested income of such foreign corporation taken into account by such domestic corporation under Section 951A."[131] If the CFC has both tested income and other income, the Conference Report[132] indicates that regulations should apply principles from Treas. Reg. § 1.904-6. That regulation applies tracing if different categories of income are subject to foreign taxes imposed on different tax bases, but a *pro rata* rule based on net income if two categories of income are subject to the same foreign tax regime. We support regulations under GILTI that incorporate this aspect of the existing regulation.[133]

Once foreign taxes are determined to be attributable to tested income, regulations should clarify that it is not necessary to trace the taxes to particular dollars of tested income, as long as the items of tested income are included in the foreign tax base. For example, the CFC as a whole might have tested income, but foreign taxes might be paid by a branch or disregarded subsidiary that would have a tested loss on a stand-alone basis.

> <u>Example 15(a): Two divisions of a single CFC</u>. Assume a CFC has two divisions, A and B. Division A generates $100 of tested income, while division B generates $99 of tested loss in a business whose income would be tested income. As a result, the CFC has $1 of tested income. Assume that income of division B is subject to foreign income tax, notwithstanding the tested loss under U.S. tax principles.
>
> <u>Example 15(b): Disregarded subsidiary of a CFC</u>: Same facts as Example 15(a), but the CFC transfers division B to a newly-formed legal entity and "checks the box" to cause the entity to be disregarded.

[131] Section 960(d)(3).

[132] Conference Report at 628 (describing House bill), 630 (stating that conference agreement follows House bill).

[133] See Part IV.E.2(f), where we suggest modification of the regulation where tax is imposed on an item of income that is not included in the U.S. tax base.

As noted above, the FTC allowance is for FTCs "properly attributable" to tested income. As a result, it could be argued that in both of these cases, the foreign taxes borne by division B should not be eligible for the FTC. This position is arguably supported by the rule that if division B was a separate CFC, its foreign taxes would not be creditable to the U.S. shareholder.

We believe, however, that regulations should confirm that the FTC is available for foreign taxes borne by division B. The statute does not provide for any "tracing" of particular taxes to particular dollars of tested income. Rather, a CFC has a single specified amount of tested income, which is taken into account by the shareholder in determining its Section 951A inclusion. Income and loss of all the assets of the CFC that can generate tested income go into the calculation of its tested income, even if some groups of assets standing alone generate a loss for U.S. tax purposes. We therefore believe that all the foreign taxes of the CFC are attributable to "the tested income" of the CFC. This position is consistent with the fact that Section 960(d)(3) (requiring that the foreign taxes be "properly attributable to the tested income") is written in a broader fashion than the item-by-item approach of Section 960(a) (requiring that the foreign taxes be properly attributable to "any item of income under Section 951(a)").

Moreover, if a CFC has an overall tested loss, no tracing is *allowed* to *permit* FTCs for taxes paid on profitable activities of the CFC. Since tracing is disallowed in that case, tracing should not be *required* so as to *disallow* FTCs for unprofitable activities of a CFC that has overall tested income. This is a matter of policy rather than administrative convenience (although we note that item by item tracing would often be very burdensome and impracticable). Thus, we believe tracing should not be required even in Example 15(b), where tracing might be relatively simple.

(b) Timing differences

Tested income will often arise in the same taxable period as the foreign taxes that are attributable to that tested income. However, timing mismatches can arise in a number of situations, including (a) tested income arises in the current year under U.S. tax principles, but the corresponding income inclusion (and therefore tax accruals) occurs in an earlier or later year under foreign tax principles, *e.g.*, because of different depreciation schedules or different taxable years under U.S. and foreign tax law, or (b) audit adjustments.

The first question in these situations is whether foreign taxes can qualify as tested foreign income taxes if they accrue in a year that is different than the year that the underlying income is included in tested income for U.S. tax purposes. Timing differences do not disqualify a tax for the foreign tax credit for purpose of the non-GILTI baskets.[134]

[134] Treas. Reg. § 1.904-6(a)(1)(iv) (stating that timing differences do not change the basket in which a foreign tax is allocated); Rev. Rul. 74-310, 74-2 C.B. 205 (total foreign taxes of CFC imposed on profit on contract is eligible for Section 902 credit, even though timing of income was different under U.S. principles; requirement that foreign taxes be "attributable to" U.S. accumulated profits is satisfied).

As noted above, a tested foreign income tax must be "properly attributable to the tested income of such foreign corporation" taken into account by the U.S. shareholder under Section 951A. The concern is that the reference to "the tested income" means "the tested income" *for the year in which the foreign tax accrues*.

Regulations should confirm that the reference to "the tested income" of the CFC is not so narrow, and that a foreign tax is a tested foreign income tax as long as the underlying income giving rise to the foreign tax is included in the tested income of the CFC for *any* year.[135]

We believe this interpretation is fully consistent with the language of the statute. Moreover, a contrary rule would require the tracing of every item of tested income to every item of foreign tax, to make sure they arose in the same taxable year. This would not be administrable and would result in large amounts of foreign taxes being disqualified as tested foreign income taxes because of minor timing differences between U.S. and foreign law. As noted above, this would also be inconsistent with the law for foreign taxes allocable to non-GILTI baskets, where timing differences are disregarded.

Assume now that a foreign tax qualifies as a tested foreign income tax. Such a tax is creditable in the year it is paid or accrued by the CFC.[136] Normally this would be the taxable year that the liability arises under foreign law, namely the year that the underlying income is taken into account for foreign tax purposes. In the case of timing differences, this year would be different than the year that the CFC had the underlying tested income. This could result in loss of the benefit of the FTC altogether, because there is no carryover or carryback of GILTI credits, even to the year in which the underlying tested income arises.

Relief from this timing mismatch is provided under certain circumstances by Section 905(c)(2)(B), as amended by the Act. That section provides that if accrued foreign taxes are not paid within two years after the end of the taxable year to which the taxes relate, or are refunded after being paid, then they are taken into account in the taxable year to which they relate. Previously the section provided that taxes in this situation were taken into account when paid. The scope of the old provision was not clear,[137] and many of the uncertainties remain.

Nevertheless, the provision is directed primarily at the situation where an audit adjustment causes foreign taxes to accrue in an earlier year, but payment does not occur until the close of the audit. Regulations should confirm that Section 905(c)(2)(B) applies to audit adjustments relating to tested income under these circumstances, and clarify the

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[135] If a foreign corporation is a not a CFC in 2018 but is one in 2019, regulations should clarify whether a foreign tax payable in 2019 on 2018 income is a tested foreign income tax, given that the definition of tested income refers to income of CFCs. Section 951A(c)(2)(A).

[136] Section 960(d)(1)(B).

[137] *See* Alan Fischl, Elizabeth Nelson, and Anisa Afshar, *Section 905(c) Mysteries*, J. Int'l Tax, July 2017 at 22.

application of that provision. This is especially important because of the lack of carryovers and carrybacks of GILTI credits.

In cases where Section 905(c)(2)(B) does not apply, the Code does not provide relief from timing mismatches. Relief may not be needed for routine mismatches that cancel each other out from year to year, or even for routine annual audit adjustments that are settled quickly after a tax return is filed.

However, consider the case of an extraordinary item that involves a timing mismatch for U.S. and foreign income inclusion. Section 905(c)(2)(B) will not apply because the tax will accrue for U.S. tax purposes at the time the foreign tax accrues for foreign purposes and is paid, even though the tested income is reported for U.S. purposes in a different year.

Given the lack of carryovers and carrybacks of GILTI FTC, a disparity between the year the tested income is reported and the year that the FTC arises may give rise to significant amounts of FTCs that become unusable. We urge that the principles of Section 905(c)(2)(B) be extended to timing differences arising from the inclusion of items in the U.S. and foreign tax base in different years. The extension could be limited to non-routine items, although this would be difficult to define. An automatic rule that is as broad as possible would be preferable to a facts and circumstances test. In any event, regardless of the scope of the new rule, it should apply without regard to the two-year minimum deferral period in Section 905(c)(2)(B), because the lack of a carryover means that even a single-year timing difference could easily result in a loss of any benefit from FTCs.

We believe that this rule is justifiable because the restriction on carryovers and carrybacks of FTCs was presumably intended to prevent taxes paid in high-tax years from being used to shelter income earned in low-tax years. There is no indication it was intended to cause a loss of the benefit of FTCs as a result of inclusion of income in different years for U.S. and foreign tax purposes.

We recognize that applying an expanded version of Section 905(c)(2)(B) on an item-by-item basis will be administratively difficult. However, we do not see any alternative that would be consistent with the rule that there is no carryover of GILTI FTCs. We believe that the result after applying Section 905(c)(2)(B) should be the same, but no better and no worse, than if the tested income arose in the same year that the foreign tax was paid.

The proposed extension of the principles of Section 905(c)(2)(B) could be limited to GILTI, on the theory that GILTI is in effect a new world-wide tax system and so all preexisting rules should be reconsidered for GILTI. Alternatively, uniform rules under Section 960 could be considered for all foreign income. The reason is that the additional new baskets and lack of GILTI carryover mean that the use of FTCs and carryovers on an overall basis is now much more restricted than before.

(c) Withholding tax on distribution of PTI

Regulations should confirm that if there is withholding tax on a distribution of PTI arising from tested income, 100% rather than 80% of the withholding tax is allowed as a credit under Section 901, and that the FTC is not cut back by the inclusion percentage. Both limitations are imposed by Section 960(d)(1), which applies to tested foreign income taxes, *i.e.*, taxes paid by the CFC on the CFC's tested income. These taxes are imposed on the U.S. shareholder rather than the CFC.[138]

2. Section 904 Issues

(a) Expense allocation

Section 904(d) creates a separate limitation basket for GILTI. As illustrated in Examples 5(a) through 5(c) above, if expenses of the U.S. shareholder are treated as foreign source expenses allocated to the GILTI basket, and if the foreign tax rate is at least 13.125%, expenses of this type cause U.S. tax to be payable on a Section 951A inclusion no matter how far above 13.125% the foreign tax rate is. As shown in Example 5(c), for every $1 of such allocated expenses, foreign source income is reduced by $1, and this reduces the FTC limit by $.21. This in turn increases the U.S. tax liability by $.21, no matter how much the foreign tax rate exceeds 13.125%. If the foreign tax rate is less than 13.125%, any allocated expenses will first increase the effective foreign tax rate (determined under U.S. principles taking the expense allocations into account) to 13.125%, and thereafter any additional $1 of allocated expenses will result in the same $.21 increase in U.S. tax liability.

This section discusses the statutory basis for the allocation of expenses, the ability of Treasury not to allocate any expenses to GILTI, the policy issues concerning allocating or not allocating expenses to GILTI, and possible modification of existing regulations for allocating expenses to GILTI.

Section 904(d)(1)(A) states that Section 904(a) and certain other sections shall be applied separately to Section 951A inclusions. Section 904(a) limits foreign tax credits based on taxable income from foreign sources, so the Section 951A limitation is based on taxable income in the Section 951A basket. Under Sections 861(b), 862(b), and 863(a), taxable income in a category is based on gross income in the category reduced by expenses "properly apportioned or allocated" to such gross income under regulations. Moreover, under existing regulations, the expenses of the U.S. shareholder must be divided between US-source and foreign-source, and then the foreign-source expenses are further divided among the applicable limitation baskets.[139]

In light of this statutory structure, if Treasury determines that no expenses of the U.S. shareholder are "properly allocable" to income in the GILTI basket, Treasury could

[138] Logically the same rule should apply to withholding tax on a distribution from a subsidiary CFC to a parent CFC, since the U.S. shareholder takes account of tested income of the lower tier CFC, and the distribution to the upper tier CFC creates PTI rather than tested income to the upper tier CFC.

[139] *See generally* Section 861 and Treasury Regulations thereunder.

issue regulations that no allocation of expenses to that basket should be made. Presumably such a determination would be based on the flat-rate theory of GILTI discussed above that the rules are intended as a flat tax of 13.125% on foreign income. As noted above, the Conference Report seems to contemplate no GILTI tax if the foreign tax rate is at least 13.125%. This statement is correct only if there are no allocations of U.S. deductions to the GILTI basket for purposes of determining FTC limitations. Moreover, there are other situations where the usual rules for allocating expenses are modified.[140]

On the other hand, arguments can be made that such an interpretation by Treasury would be inconsistent with the structure and purpose of the statute. First, such an interpretation is inconsistent with the notion that the statement in the legislative history is illustrative rather stating a definitive rule. Arguably the allocation of deductions to foreign income is integral to the structure of the FTC rules, and it should take more than this ambiguous statement in the legislative history to override that basic structure.

Second, the statute is most logically read to require that every expense should be allocable to some item of gross income. Therefore, Treasury would have to conclude that expenses otherwise allocable to Section 951A inclusions under the principles of the existing regulations are instead allocable as a matter of law to domestic income or other foreign source income. It is difficult to see how such expenses become "properly allocable" to such other income solely as a result of the enactment of the Act, since there is no more connection between such expenses and such other income after the Act than there was before. Such a nonallocation to Section 951A inclusions is in contrast to other situations where regulations create an exception to allocations of expenses to foreign income, since such exceptions are based on specific fact patterns where an allocation is likely not "proper" as a factual matter.

Third, the statute clearly contemplates a loss of GILTI FTCs in other situations,[141] so perhaps Congress was not concerned about a loss of FTCs in the context of expense allocations. In fact, when Congress desired to change the normal rules for allocations of expenses to categories of income, it has stated so explicitly.

- Section 864(e) contemplates an allocation of interest expense among assets, with a specific exception in Section 864(e)(3) that prevents an allocation of expenses to tax exempt assets (and the income they produce) and the deductible portion of dividends eligible for the DRD.

- New Section 904(b)(4), discussed below, is a special rule for allocating expenses when dividends from a CFC are eligible for Section 245A.

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[140] *See, e.g.*, Treas. Reg. § 1.861-10T, relating to special rules for allocating interest expense.

[141] For example, FTCs are lost if the foreign taxes are paid by a CFC without tested income, and tested losses of one CFC (or NDTIR of the shareholder) can reduce the shareholder's resulting FTC allocation percentage for FTCs paid by a CFC with tested income.

- New Section 965(h)(6) turns off allocation of deductions attributable to dividends from a CFC in determining the net tax liability under Section 965.

There is no comparable special rule for the GILTI basket, arguably indicating an intent by Congress that no special expense allocation rules were intended for the GILTI basket. In fact, Section 904(b)(4) by its terms disregards deductions allocable to income from stock of a CFC other than amounts includible in income under Sections 951(a)(1) or 951A(a). This exception clearly implies an understanding that deductions might be allocable to Section 951A inclusions. Similarly, since shareholder level deductions clearly reduce FDII, to the extent FDII and GILTI are considered parallel systems, shareholder deductions should likewise be allocable to GILTI.

In any event, we do not believe as a policy matter that there should be a complete exclusion of shareholder expenses from the GILTI basket.

Such a complete exclusion means that expenses that would be properly allocable to Section 951A inclusions under existing principles should instead *automatically* be treated as properly allocable to other foreign or domestic source income. Yet such expenses reduce U.S. taxable income no matter how they are allocated for FTC purposes. To the extent expenses that are properly allocable to foreign income are in fact allocated to domestic income for FTC purposes, the overall effect is that FTCs are allowed to shelter U.S. tax on U.S. income. This effect also arises if these expenses are not allocated to any basket (a questionable interpretation of the statute in any event), because the full FTC is allowed as long as there is no reduction in foreign source income.

Section 904 was intended to prevent the FTC from having this effect. In addition, this reallocation of deductions encourages foreign countries to raise their tax rates at the expense of the U.S. fisc, because until the Section 904 limits are reached, 80% of the additional foreign tax is creditable.

If the taxpayer had non-GILTI foreign income, it would be possible to avoid all or part of this result by allocating the GILTI-related expenses to other baskets of foreign income, rather than to U.S. income. This may be taxpayer-favorable because it could allow GILTI FTCs to be used currently instead of being permanently lost, and FTCs in other baskets to be carried forward or backward instead of being used currently. However, it could be taxpayer-unfavorable if the taxpayer has, say, high-taxed foreign branch income and low-taxed GILTI, since there would be no effect on GILTI FTCs but the branch FTCs would have to be carried forward or backward rather than being used currently. In either case, it is difficult to see a logical reason for the reallocation of expenses to other baskets.

Moreover, there would be no justification for reallocating GILTI expenses to FDII of the shareholder. The argument for a flat rate of tax based on the Conference Report applies equally to FDII, and so it would be inconsistent with the flat rate theory to increase the effective tax rate on FDII in order to obtain a flat rate on GILTI.

Finally, allocation of GILTI expenses to other baskets of foreign income (with or without FDII) would have no effect if the taxpayer did not have any foreign income in other baskets, and no material effect if the taxpayer did have foreign income in the other baskets but such income was not subject to a material amount of foreign tax. Also, once the allocation eliminated all foreign source income in non-GILTI baskets, any additional expenses otherwise allocable to GILTI would have to be reallocated to GILTI or to U.S. source income.[142] This leads back to the original issue.

Despite these policy arguments against allocating *no* expenses to the GILTI basket, it is important to note that there are significant differences between the GILTI regime and the historic regime for taxing income of CFCs. For example, foreign tax credits in the GILTI basket cannot be carried forward or backward,[143] so the impact on taxpayers of limiting GILTI FTCs is much more severe than limiting non-GILTI FTCs. These limits on GILTI FTCs seem to undercut both theories of the nature of GILTI, since they cause worse results for taxpayers than either the Subpart F rules or the result under a flat rate of tax (at least if the flat rate of tax is intended to be based on true economic income over a period of years).

As a result, we believe that in light of these differences between GILTI and the preexisting tax rules for FTCs, even if expense allocations continue to apply to the GILTI basket under Section 904, the existing Section 861 statutory and regulatory framework should not necessarily be applied wholesale. Moreover, in light of the flat rate theory of GILTI, regulations should modify existing rules to minimize allocations to GILTI inclusions that are not economically justified. In fact, reconsideration might also be given to certain of the allocation rules for Subpart F income allocated to the general and passive FTC baskets.

For example, research expenses of a U.S. corporation are allocated to U.S. and foreign sources under various methods based on sales or gross income.[144] To the extent that gross income is the test, there was little allocation to CFCs in the past because most income of CFCs was not currently included in U.S. gross income. This result seems appropriate because research expenses of the U.S. shareholder increase the royalty or sales income of the shareholder, but the CFC does not benefit. In fact, the CFC would only have increased its income if the resulting intangibles were transferred to the CFC, which could

[142] Section 904(a) and (f)(5); Treas. Reg. § 1.904-4(c)(2)(ii). Allocations to U.S. source income would also create an overall domestic loss ("**ODL**") to the extent they exceeded U.S. source income.

[143] This means, for example, that if a U.S. shareholder has an NOL or NDTIR that offsets its GILTI inclusion for the year, the NOL or NDTIR is absorbed in the current year and the FTC on the GILTI inclusion provides no benefit in the current year and cannot be carried to a future year.

[144] *See* Treas. Reg. § 1.861-17.

not occur without gain recognition or Section 367(d) royalty income to the U.S. parent corporation.[145]

Now, CFCs will generate a significant amount of gross income to the U.S. shareholder as a result of GILTI inclusions. Moreover, the research expenses of the U.S. shareholder will not generally give rise to tested income to the CFC or GILTI inclusions to the shareholder for the reasons stated above.[146] Nevertheless, absent a change in regulations, the GILTI inclusions will result in an allocation of research expenses to the GILTI basket for purposes of Section 904. These allocations do not seem justified as a result of the enactment of the GILTI rules, and we believe these rules should be reconsidered by Treasury.

Likewise, interest expense of the U.S. shareholder is generally allocated to stock of a CFC based on the tax basis of the stock and the accumulated earnings of the CFC.[147] However, under Section 864(e)(3), no expenses may be allocated to stock that gives rise to income that is exempt, excluded, or eliminated from tax, including the portion of stock attributable to the dividends received deduction available under Section 243 or 245 for dividends on that stock.[148] It appears that this rule does not apply to stock of a CFC that gives rise to dividends eligible for the Section 245A deduction, because such dividends are initially included in gross income and the deduction is under a section not specified in Section 864(e)(3). Rather, stock giving rise to such dividends is apparently subject solely to Section 904(b)(4), discussed below. Regulations should confirm this conclusion.

Other allocation questions also arise. Allocations of some expenses such as interest are based on the tax basis of stock of a CFC. The stock may give rise to GILTI inclusions, dividends eligible for Section 245A, or Section 956 inclusions. The allocation each year could be based on the actual GILTI inclusions, Section 956 inclusions, and Section 245A eligible dividends paid during the year. Alternatively, the allocation could be based on GILTI inclusions, Section 956 inclusions, and QBAI return whether or not paid out as dividends during the year. Section 904(b)(4), discussed below, is inconclusive on this question because it contemplates that expenses might be allocable both to stock of a CFC and to exempt dividends paid by a CFC.

We note that the timing of Section 245A dividends is entirely discretionary and could be adjusted to achieve desired allocations each year. As a result, an annual allocation based on Section 245A dividends paid during the year would have little or no economic

[145] For intangibles developed by cost sharing, each of the U.S. shareholder and the CFC bore its own expenses, so this issue does not arise.

[146] An exception would be if royalty income from the CFC was considered a GILTI inclusion to the U.S. shareholder. We believe this should not be the case, as discussed in Part IV.E.2(e), but if this is the case, an expense allocation to such income would be appropriate.

[147] Section 864(e)(4); Treas. Reg. § § 1.861-9T(g), -12(c)(2); new Section 864(e)(2) (requiring use of tax basis rather than fair market value for allocating interest expense).

[148] *See also* Treas. Reg. § 1.861-8T(d)(2)(ii).

substance and would create considerable opportunity for tax planning. On the other hand, an allocation based on QBAI return could not take into account the possibility that such return could be paid out in the future as either Section 245A eligible dividends or as Section 956 inclusions. Regulations should clarify this question. In the examples that follow, we assume an allocation based on QBAI return rather than actual cash dividends, but the results would be the same in substance in either case.

Finally, in many situations the allocation of expenses is based on gross income, including in the preceding paragraph where the allocation to categories of income in the CFC is based on different types of income of the CFC. Consideration should be given as to whether these allocations should be based on net GILTI rather than gross GILTI. It can be argued that expenses give rise proportionately to gross income regardless of the different tax rates that might apply to different items of income. However, if the CFC has $100 of passive Subpart F income and $100 of gross GILTI income, an equal allocation of expenses to both items will have a far more adverse effect on the GILTI basket than on the passive basket. This result would exacerbate the negative effect of interest allocations on the GILTI basket. Consequently, it can be argued that a *pro rata* rule based on gross GILTI is unjustified in light of the flat-rate theory of GILTI.

(b) Section 904(b)(4)

Regulations should clarify the application of new Section 904(b)(4).

As background, FTCs are not available for dividends giving rise to a Section 245A deduction.[149] As a result, deductions allocable to such dividends, or to stock giving rise to such dividends, do not cause a tax detriment to the U.S. shareholder of a CFC, since a reduction in foreign source income under Section 904 does not matter when no FTCs are available anyway. It can logically be argued that deductions allocated to such dividends should remain so allocated, as opposed to being reallocated to other baskets, and other aspects of the Section 904 calculations should be unchanged.

After all, the logic that led to the initial allocation of expenses to each FTC basket is not changed as a result of the enactment of Section 245A. For example, if a U.S. shareholder borrows to buy stock in a corporation, the interest expense would logically be allocated to the stock (or not) regardless of whether the stock happens to give rise to taxable or tax-exempt dividends. This result would also be consistent with the general approach of Section 265 , which disallows deductions for expenses allocable to exempt income, and thereby increases taxable income for all purposes of the Code, but does not reallocate any deductions to or from exempt income (the "**no-reallocation approach**").

By contrast, Section 864(e)(3), discussed above, reallocates all expenses initially allocable to tax-exempt income and assets to other income and assets for FTC purposes. This reduces foreign source income in the baskets giving rise to taxable income, and therefore reduces the ability to utilize FTCs arising on taxable income. This approach might be based on the theory that in this situation, unlike under Section 265, the expenses

[149] Section 245A(d).

in question are still allowed to the U.S. shareholder as deductible expenses and therefore should still be allocated against taxable income.

Section 904(b)(4) was added by the Act as Section 904(b)(5) and later renumbered in a technical correction bill.[150] The heading is "Treatment of Dividends for which Deduction is Allowed Under Section 245A." Since the provision is within Section 904, the purpose is clearly to adopt a rule to deal with the allocation of deductions to dividends that are in substance exempt from tax.

The provision states that for purposes of the Section 904 limitations, the shareholder's foreign source income and entire net income are calculated without regard to (A) the foreign source portion of all dividends from the CFC ("**clause A**"), (B)(i) deductions allocable to non-GILTI, non-Subpart F income from stock of a CFC ("**clause B(i)**"), or (B)(ii) deductions allocable to stock of a CFC to the extent income from the CFC is non-GILTI, non-Subpart F ("**clause B(ii)**"). The identification of these clauses reflects the clause references in Section 904(b)(4).

This provision is similar to Section 864(e)(3) in that it does not deny a deduction for expenses at the shareholder level. On the other hand, on its face, it does not reallocate any expenses to other baskets, as does Section 864(e)(3). Rather, it provides a formula for calculating foreign source income and entire net income for purposes of the Section 904 limitations. As is discussed below, the formula appears to achieve the same result as the no-allocation approach.

Turning to the specifics of the formula, recall that the ratio of foreign source income in a basket to entire net income is multiplied by U.S. tax liability to obtain the FTC limit for the basket. Clause A disregards all foreign source dividends from a CFC. This rule is likely based on the fact that all dividends from a CFC will either be nontaxable PTI from GILTI or Subpart F, and taken into account previously for expense allocation purposes, or else from CFC exempt income and eligible for Section 245A.

Clauses B(i) and B(ii) require the disregard of all expenses allocable to the CFC in baskets other than GILTI and Subpart F. Since a CFC will never give rise to branch income to its U.S. shareholder, the reference can only be to the general basket. However, once those expenses are disregarded, the determination of foreign source income and entire taxable income must be recalculated for purposes of all baskets, including GILTI and Subpart F.

Since the formula disregards both exempt dividend income and expenses allocable to such income, the result is the no-reallocation approach. This increases the ability of the U.S. shareholder to use FTCs when the only foreign income of the U.S. shareholder is (1) dividends from a CFC eligible for Section 245A, and (2) Subpart F income or GILTI inclusions from a CFC.

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[150] Pub. Law. 115-141, § 401(d)(1)(D)(xiii) repealed former Section 904(b)(4) as deadwood and renumbered Section 904(b)(5), added by the Act, as Section 904(b)(4), effective March 23, 2018.

Example 16(a) (Shareholder has no foreign income except CFC income). U.S. shareholder has:

- $700 of U.S. income offset by $500 of allocable expenses, for U.S. taxable income of $200
- $300 of net GILTI income from a CFC offset by $100 of allocable expenses, for GILTI basket income of $200
- $100 of expenses allocable to QBAI return of the CFC (general basket expenses).

World-wide taxable income is $300. Absent Section 904(b)(4), the foreign tax credit fraction for the GILTI basket would initially be $200 (GILTI income) divided by $300 (worldwide taxable income). However, since there is a $100 loss in the general basket, the GILTI fraction is reduced to $100/$300.[151]

Now applying Section 904(b)(4), clause A says to ignore dividends from the CFC. Regardless of whether any such dividends are paid, they would not be in taxable income (either because they are non-taxable distributions of PTI or because they are fully offset by Section 245A deductions) and so this condition is satisfied. Clauses B(i) and B(ii) say to disregard the $100 of expenses in the general basket in determining foreign source income and entire taxable income (because these expenses are allocable to QBAI return that will give rise to exempt dividends). In calculating the new GILTI limitation, those expenses are ignored in the numerator, meaning that they no longer reduce the $200 of net GILTI income to $100. Moreover, absent those expenses, entire taxable income increases from $300 to $400. As a result, the GILTI FTC fraction becomes $200 (net GILTI income) divided by $400 (entire taxable income with addback of expenses allocable to exempt dividends).

This $200/$400 FTC fraction is an improvement over the $100/$300 fraction that arises in the absence of Section 904(b)(4). In fact, this is the same result that would arise if the expense of $100 had simply not been incurred. Consequently, this result is the same as under the no-reallocation approach.

We now consider a case where the U.S. shareholder has other foreign source income in the general basket at least equal to the expenses in that basket that are allocable to exempt income. In that case, there is no negative balance in the general basket that would reduce the balances in the GILTI or Subpart F baskets. Section 904(b)(4) still reaches the same result as the no-reallocation approach. However, in this case the application of Section 904(b)(4) increases the limitation in the general basket, and

[151] Section 904(f)(5); Treas. Reg. § 1.904-4(c)(2)(ii).

decreases the limitations in the GILTI and Subpart F baskets. The following example illustrates these results.[152]

Example 16(b) (shareholder has other general basket income). A U.S. shareholder has:

- $100 of domestic source business income offset by $40 of allocable expenses,
- $600 of gross GILTI inclusion, offset by $300 of Section 250 deduction and $60 of allocable expenses,
- $50 of foreign source business income in the general basket, offset by $10 of allocable expenses, and
- $40 of expenses allocable to exempt CFC return of the CFC giving rise to dividends eligible for Section 245A.

On these facts, before applying Section 904(b)(4), the U.S. shareholder has:

- taxable income of $300 ($150 operating income, $300 net GILTI inclusion, $150 expense),
- U.S. source income of $60 ($100 of business income and $40 of expense),
- foreign source GILTI basket income of $240 ($300 inclusion minus $60 expense),
- foreign source general basket income of $0 ($50 of business income, $10 of expense allocated to such income, and $40 of expense allocated to exempt CFC return),
- tentative U.S. tax liability of 21% of $300, or $63.00, and
- a GILTI FTC limit of $63.00 (tentative U.S. tax) times $240 (foreign source GILTI inclusion) divided by $300 (world-wide taxable income), or $50.40.

These results would not change if income from the CFC was distributed, since the GILTI inclusion would be PTI, the exempt CFC return would give rise to gross income eligible for the Section 245A deduction, and as noted above Section 864(e)(3) would not apply. As a result, no taxable income or foreign source income would be created.

[152] Appendix 1 contains a table illustrating this example.

In this case, the expense of $40 that is allocated to QBAI return reduces the U.S. shareholder's foreign source income in the general basket from $40 to $0. As a result, unlike in Example 16(a), there is no "negative" balance in the general basket that reduces the GILTI fraction. However, the general basket fraction is reduced from $40 (general basket income outside the CFC) divided by $300 (worldwide income) to $0 divided by $300, or $0. Therefore, no FTCs on the direct foreign source income of $50 are available.

Consider now Section 904(b)(4). It requires disregarding the expenses of $40 allocable to QBAI return in calculating the shareholder's foreign source income and entire taxable income. Therefore, similar to the result in Example 16(a), general basket expenses are calculated without regard to the $40 deduction, so general basket income is increased from $0 to $40. Stopping there, the general basket FTC fraction is $40 (foreign source income) divided by $300 (world-wide income), and the GILTI basket is unaffected.

However, Section 904(b)(4) also requires that the shareholder's "entire taxable income" be determined without regard to the $40 of expense. As a result, the foreign source GILTI inclusion remains at $240. However, the denominator of the general basket fraction and the GILTI fraction, namely world-wide taxable income, is increased by the $40 of lost deductions, to $340.

The general basket FTC fraction is then $40/$340, which is higher than the $0/$300 result absent Section 904(b)(4). The GILTI FTC fraction is then $240/$340, or .71, which is lower than the initial fraction of $240/$300, or .80. The reason for the increase in the general basket fraction is that the increase in the numerator of that fraction by the $40 of exempt expense more than makes up for the increase in the denominator by the same amount. On the other hand, there is no increase in the numerator of the GILTI fraction, only a $40 increase in the denominator. This is in contrast to Example 16(a), where the increase in the numerator of the GILTI fraction (as a result of preventing the income in the basket from being offset by the exempt loss) more than made up for the increase in the denominator of the fraction by the same amount.

In both cases, the result is the same as under the no-reallocation approach. If the U.S. shareholder had not incurred the $40 of expense allocated to the exempt dividend income, entire taxable income would be $340 and the above results would follow.

It can be argued that the initial GILTI fraction of $240/$300 is the "correct" fraction, and that the reduction in the fraction to $240/$340 has the same substantive effect as reallocating part of the $40 of exempt expenses to the GILTI basket to reduce the GILTI fraction. However, if the GILTI fraction remains at $240/$300, the U.S. shareholder has a higher limitation in the GILTI basket than if there had not been any exempt income or expense. This is not consistent with the no-reallocation approach, with the principles of Section 265 or with the statutory directive to disregard the exempt expenses.

We also note that the maximum allowed GILTI FTC is the GILTI fraction multiplied by the tentative U.S. tax liability on world-wide income, and the latter number is reduced as a result of the tax deduction of $40 that was allocated to Section 245A dividends. As a result, the GILTI FTC basket is less than if the $40 had not been incurred and additional U.S. tax had been paid. However, this is a consequence of the allowance of the deduction, unlike the disallowance of deductions allocable to exempt income under Section 265. The deduction reduces the effective U.S. tax rate on worldwide income, and the result under Section 904(b)(4) is consistent with the purpose of Section 904 to limit the credit for FTCs to the effective U.S. tax rate on worldwide income.

Treasury should clarify in regulations whether the above results are correct, and if not, how Section 904(b)(4) should be applied instead.

(c) The Section 250 deduction

Regulations should confirm that the portion of the Section 250 deduction that is allocable to the GILTI inclusion is allocated and apportioned to the GILTI basket.[153] That portion of the deduction is clearly attributable to the foreign-source GILTI inclusion, since the deduction is a percentage of the gross income inclusion and is clearly intended merely to reduce the U.S. tax rate on that income.

If this portion of the Section 250 deduction was allocated and apportioned to the general limitation basket, foreign taxes on tested income at a rate in excess of 13.125% could in effect be used to shelter U.S. tax on U.S. income. Likewise, the allocation might cause a foreign tax on general basket income such as FDII income not to be fully creditable. These results are clearly at odds with Congressional intent.

(d) Section 78 gross-up

We recommend that regulations specify that the Section 78 gross-up for foreign taxes deemed paid under Section 960(d) is in the GILTI basket.

The issue arises for the following reason. Section 78 treats the gross-up amount as a dividend to the U.S. shareholder. However, the amount of foreign tax reduces the tested income of the CFC, and therefore neither the tax nor the gross-up gives rise to a Section 951A inclusion (which is based solely on tested income and QBAI return). Consistent with this, Section 250(a)(1)(B) specifically includes, in the amount eligible for the 50% Section 250 deduction, both the Section 951A inclusion and the Section 78 gross-up of the Section 951A inclusion. Moreover, while the Senate bill explicitly provided that the Section 78 gross-up was in the GILTI basket,[154] this provision was removed in the final bill. The foregoing could potentially indicate a conscious choice by Congress not to include the gross-up as an inclusion in the GILTI basket and to reach the "right" amount of the Section 250 deduction through a separately identified deduction.

[153] Likewise, the portion of the Section 250 deduction that is allocable to FDII is clearly attributable to FDII and should be allocated solely to the general basket or passive income basket. If the carve-back applies, the deduction should be allocated between GILTI and FDII based on the reduced amounts of each.

[154] *See* Conference Report at 644, describing the Senate Bill ("[T]he taxes deemed to have been paid [under new Section 78] are treated as an increase in GILTI for purposes of section 78...").

However, explicitly providing that the gross-up belongs in the GILTI basket might also have been deemed unnecessary. Section 78 does not specify the appropriate basket for gross-ups on other income, and regulations could address this point in the same manner that it is addressed under Subpart F.[155]

Moreover, it is not logical for the Section 78 gross-up to be in any basket other than the GILTI basket when the underlying income giving rise to the grossed-up taxes was tested income giving rise to an inclusion in the GILTI basket. If the Section 78 amount is not in the GILTI basket, this would reduce foreign source income in the GILTI basket and thus the FTCs allowed in that basket. In fact, reducing foreign source GILTI inclusion by excluding the Section 78 gross-up has a similar effect as reducing foreign source GILTI inclusion by allocating expenses of the U.S. shareholder to GILTI inclusion.

Unless some other items were also shifted out of the GILTI basket (see below), the result is that a blended foreign tax rate of 13.125% on pre-foreign tax tested income would not itself be sufficient to eliminate U.S. tax on such income even after taking the Section 78 gross-up into account. This is so even if no expenses of the U.S. shareholder were allocated to the GILTI basket. Even stranger, the higher the foreign taxes paid, the more pronounced this effect would be because more pre-foreign tax tested income would be shifted out of the GILTI basket. This seems inconsistent with the intent of Congress.

We assume that if a Section 78 gross-up is not included in the GILTI basket, it would be in the general basket.[156] In that case, other adjustments would logically follow.[157] In particular, since the foreign tax reduces tested income, we believe that regulations should provide that the portion of the FTC allocable to the Section 78 gross-up amount (a non-tested income amount) is also in the general basket. For example, suppose the CFC has $100 of income and pays $10 of foreign tax. This results in $90 of tested income, a Section 951A inclusion of $90, a Section 78 gross-up of $10, an FTC under Section 960(d) of $8 and a Section 250 deduction of $50. If the $10 of Section 78 gross-up is in the general basket, then an allocable portion of the Section 250 deduction and shareholder expenses should logically also be allocable to the general basket rather than the GILTI basket. Moreover, the portion of the FTC allocable to the Section 78 gross-up, *i.e.*, 80% of the tax

[155] Section 904(d)(3)(G), implemented by Treas. Reg. § 1.904-6(b)(3), specifies that amounts included in gross income under Section 78 and attributable to Subpart F income are treated as Subpart F income for purposes of the foreign tax credit limitations. Although the statute addresses only Subpart F income, Section 904(d)(7) delegates broad regulatory authority and the principles of the regulation could be extended to Section 78 amounts attributable to GILTI.

[156] Since tested income excludes Subpart F income, if there were no GILTI basket, all tested income (except for passive income that is not Subpart F income) would be in the general basket.

[157] *See discussion in* Elizabeth J. Stevens and H. David Rosenbloom, GILTI Pleasures, Tax Notes Int'l, Feb. 12, 2018, at 615.

imposed on $10 of general basket income, or $0.80, would logically also be in the general basket.[158]

However, when all of the underlying income of the CFC is tested income included under Section 951A, it would be extremely peculiar for the GILTI rules to give rise to two separate and parallel tax calculations and limitations, one in the GILTI basket and one in the general basket. Illogical pro-taxpayer and pro-government mismatches could arise. On the pro-taxpayer side, excess general basket FTCs could offset a low-taxed Section 78 gross-up of the Section 951A inclusion. In addition, excess FTCs could be created in the general basket that could carry over. On the pro-government side, excess GILTI FTCs from other CFCs could not offset a low-taxed Section 78 gross-up amount. In that case, GILTI FTCs could be wasted, and tax would be owed on the gross-up amount unless the taxpayer had excess FTCs in the general basket. This issue would be exacerbated if the FTCs proportionately allocated to the Section 78 gross-up income were not placed in the general basket. We do not believe that these results were intended by Congress.

(e) Interest, rent and royalty payments from a CFC to its U.S. shareholder

Regulations should confirm that interest, rent and royalties received by a U.S. shareholder from its Related CFC are not in the GILTI basket for Section 904(d) purposes.

We acknowledge that Section 904(d)(3)(C) states that interest, rents, and royalties paid by a CFC to a U.S. shareholder out of passive category income of the CFC retains its character as passive category income in the hands of the shareholder for Section 904 purposes. By analogy, this could allow these amounts paid out of tested income of a CFC to be in the GILTI basket for Section 904 purposes.

However, for the following reasons, we believe that these payments should not be in the GILTI basket.[159]

First, as a statutory matter, only Section 951A inclusions can give rise to taxes in the GILTI basket, and nothing in Section 951A turns these payments into Section 951A inclusions. Likewise, Section 904(d)(3) was not amended to include GILTI inclusions, and Congress did not include Section 904(d)(3) in the rather long list of sections for which GILTI was to be treated in the same manner as Subpart F income.[160]

[158] Under principles analogous to Treas. Reg. § 1.904-6(b)(3), the Section 78 gross-up would be in the GILTI basket if the underlying taxes were paid on income in the GILTI basket. Since tested income is only $90, logically only $9 of the foreign taxes were paid on that income, and the other $1 of foreign tax was paid on the $10 of pre-tax foreign income that was paid out in foreign taxes and thereby reduced tested income from $100 to $90. Of that $9 and $1 respectively, $7.20 and $0.80 are allowed as FTCs under Section 960(d) (assuming the inclusion percentage is 100%).

[159] Assuming these payments are not in the GILTI basket, foreign withholding taxes on these payments should likewise not be GILTI taxes and should not be subject to the 80% limit on GILTI credits.

[160] *See* Section 951A(f)(1)(A).

Second, rent or royalty income from a CFC to its U.S. shareholder would often be eligible for the FDII deduction. This is inconsistent with those payments being treated as GILTI inclusions.

Third, these payments are deductible for U.S. tax purposes. They reduce the tested income of the CFC, and reduce the U.S. shareholder's Section 951A inclusion in the same manner as payments made by the CFC to third parties. In addition, unlike dividends, these payments are normally deductible for foreign tax purposes and therefore reduce foreign tax liability. Increasing the GILTI basket by an expense that reduces foreign taxes is arguably contrary to the purpose of the FTC baskets.

Fourth, if these payments are in the GILTI basket, the U.S. shareholder of a CFC with high taxed income could use otherwise unusable FTCs to shelter these payments from U.S. tax.

> <u>Example 17 (Royalty income and FTC baskets).</u> Assume a CFC has $200 of gross income, a royalty deduction of $100 to the U.S. shareholder, tested income of $100 before foreign taxes, and foreign tax of $40 (40%). Assume the shareholder has no income other than this royalty income. Then, the shareholder has $100 of GILTI inclusion (including Section 78 gross-up), $50 of Section 250 deduction, and $100 of royalty income. Its tentative U.S. tax is $31.50 ($100 of royalty income, plus $50 of net GILTI, all multiplied by 21%).

If the royalty income is not in the GILTI basket, the Section 904(d) limit on GILTI credits is $10.50 ($50 GILTI inclusion, divided by $150 worldwide income, multiplied by $31.50 tentative U.S. tax). Therefore, the U.S. tax is $21 ($31.50 of tentative tax, less the allowed FTC of $10.50). This $21 is the full U.S. tax on $100 of royalty income.

If the royalty income is a GILTI inclusion for purposes of Section 904(d), the available FTC is 80% of $40, or $32. The Section 904(d) limit is $31.50 ($150 GILTI, divided by $150 worldwide income, multiplied by $31.50 tentative U.S. tax). Therefore, the shareholder can use $31.50 of its FTC to entirely eliminate the tentative U.S. tax of $31.50. As a result, no U.S. tax is owed on receipt of the royalty payment.

The CFC has effectively received the benefit in the foreign jurisdiction of having made a deductible royalty payment while, for U.S. FTC purposes, the U.S. shareholder has been able to treat the payment more like a non-deductible dividend payment. By adding the income to the GILTI basket it has offset the effect of the deduction taken into account in the calculation of tested income. While not actually a hybrid payment, this treatment appears to violate the principles behind anti-hybrid rules.

Finally, if these payments are in the GILTI basket, a U.S. shareholder with U.S. source income and with a high-taxed CFC would be incentivized to "sop up" the excess FTCs by converting its U.S. income into interest, rents or royalties from the CFC.[161] The result would be the conversion of U.S. taxable income to tax-free interest, rent or royalty income from the CFC.

(f) Basket for base differences

Current law, as amended by the Act, treats foreign taxes on items that are not income for U.S. tax purposes as in the basket for branch income.[162] This rule is the result of a technical error in the Act,[163] and if our suggestion below is not adopted, a statutory amendment should be adopted to restore the prior rule that such taxes are allocated to the general basket.

Allocation of residual taxes to the general basket made sense when the general basket contained most types of non-passive income. However, GILTI inclusions, and FTCs allocable to GILTI inclusions, are very significant today. The same is true for branch income.[164] An allocation of all these foreign taxes to the general basket could therefore have very unjustifiable and adverse results on taxpayers. As a result, we urge that legislation be adopted to provide for an allocation to one or more baskets based on a facts and circumstances test, *i.e.*, based on the basket that the item would be in if it were subject to U.S. tax. If this question was still unanswerable, the allocation could be made to the general basket as today.

For example, the GILTI basket should apply to a foreign income tax imposed on a particular item that is part of an ordinary business that generates tested income, but that is not viewed as income for U.S. tax purposes. In the same situation, the branch basket should apply if the item relates to an underlying business that is operated in a branch. Likewise, withholding tax on exempt PTI from GILTI inclusions could logically be placed in the GILTI basket (see discussion in Part IV.E.2(g)).

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[161] For example, if the U.S. shareholder had assets earning $100 of U.S. source income, the shareholder could sell the assets to a third party and loan the proceeds to the CFC for debt paying interest of $100 per year. If the CFC could invest the proceeds and earn $100 on the purchased assets, just as the shareholder did, the foreign taxable income and tax would be unchanged. However, if the interest income to the parent was in the GILTI basket, then just as in Example 17, a sufficiently high foreign tax on the CFC would mean that the interest income would be tax-free to the parent.

[162] Section 904(d)(2)(H)(i).

[163] When Section 904(d)(2)(H)(i) was enacted, its cross reference to Section 904(d)(1)(B) was to general limitation income. The Act amended Section 904(d)(1)(B) to refer to the branch basket, but inadvertently neglected to change the cross-reference.

[164] Section 904(d)(1)(B).

We acknowledge that our proposal is arguably inconsistent with language in the Conference Report[165] indicating an expectation that taxes on items excluded from the U.S. tax base would be allocated to the general basket. However, this language is describing the current Code, and we are proposing legislation. Moreover, it is not clear that the drafters of the Conference Report were aware of the severe adverse consequences under the Act from base differences.

Finally, our position is supported by Section 951A(c)(2)(A)(ii), which allows a reduction in tested income for expenses (including taxes) properly allocable to gross income in the tested income category, or "to which such deductions would be allocable if there were such gross income". This language appears to contemplate a reduction in tested income for foreign taxes imposed on an item relating to tested income even if it is not in the U.S. tax base. It would be most logical for the amount of the deduction for foreign taxes attributable to tested income to be the same amount as the gross-up and FTC for foreign taxes attributable to tested income.

(g) Basket for withholding tax on PTI

If withholding tax applies to the distribution of previously taxed Subpart F income, the withholding tax appears to be in the same basket as the underlying income.[166] Regulations should provide that this treatment applies to withholding tax imposed on distributions by a CFC of previously taxed tested income attributable to GILTI inclusions.

Section 960(c)(1) increases the Section 904 limitation for the applicable FTC basket to account for such withholding tax in the taxable year in which a PTI distribution is made, to the extent there is excess limitation that was not used in prior years. However, Section 951A(f)(1)(A) does not incorporate the principles of Section 960. As a result, under existing regulations, the GILTI limitation for the year would not be increased by excess limitation from prior years.

We believe this "increase by excess limitation" rule should be extended to GILTI by regulations or a statutory amendment. Absent such a rule for GILTI, the FTCs from the GILTI withholding tax would often be unusable because of the lack of income inclusion from the distribution, and the lack of a carryback of FTCs to the year of the GILTI inclusion. Absent this rule, the FTC could only be used if the U.S. shareholder happened to have other low-taxed GILTI inclusions in the year of the PTI distribution.

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[165] Conference Report at 628, describing the House Bill ("It is anticipated that the Secretary would provide regulations with rules for allocating taxes similar to rules in place [under Treas. Reg. § 1.904-6(a)] for purposes of determining the allocation of taxes to specific foreign tax credit baskets. Under such rules, taxes are not attributable to an item of subpart F income if the base upon which the tax was imposed does not include the item of subpart F income. For example, if foreign law exempts a certain type of income from its tax base, no deemed-paid credit results from the inclusion of such income as subpart F. Tax imposed on income that is not included in subpart F income, is not considered attributable to subpart F income." [footnote omitted])

[166] Treas. Reg. § 1.904-6(a)(1)(iv).

Even in a GILTI system without a general carryover of FTCs, if the tax on the underlying income is low enough to create excess limitation in the years that income is earned, there is no logical reason that the excess limitation should not be carried forward and made usable against withholding tax on GILTI inclusion when it is distributed. The Section 960(c)(1) rule applies to Subpart F income even though there is also a rule allowing FTC carryovers for Subpart F. There is no logical reason that the same rule should not apply to GILTI even in the absence of GILTI FTC carryovers.

On the other hand, existing Section 960(c)(1) involves the creation of a single cumulative excess limitation account that is drawn upon when needed. That approach appears to be inconsistent with the lack of carryover of GILTI FTCs, since it can put a GILTI taxpayer in a better position by receiving a PTI distribution in a later taxable year than in the year the tested income was earned. As a result, in applying Section 960(c)(1) to GILTI, logically the U.S. shareholder would be required to trace a particular distribution of PTI to particular tested income for a prior taxable year and excess limitation for the same year. Then, only excess limitation from that year would be allowed to shelter withholding taxes on the PTI distribution. We acknowledge that such a rule would be administratively burdensome.

(h) 2017 overall foreign or domestic loss

Regulations should clarify issues that arise under Section 904(f), relating to recapture of overall foreign loss ("**OFL**"), and Section 904(g), relating to recharacterization of ODL, where the respective loss occurred in 2017 or prior years. The question is how recapture or recharacterization of pre-2018 OFLs and ODLs, respectively, should be applied in 2018 and subsequent years. The issue arises because the calculations are done separately for each FTC basket,[167] and most or all income items that were in the pre-2018 general basket may now be in the GILTI and foreign branch baskets that did not exist pre-2018. Also, these sections were designed to reach a proper aggregate result for FTC limits across different tax years, and did not contemplate that a significant portion of FTCs taken into account in 2017 would be eliminated under Section 965(g).

(i) FTC transition issues

Regulations should clarify transition issues involving foreign tax credits that arise because the concept of tested income did not exist before 2018.[168] For example, should foreign taxes payable in 2018 for income of a CFC that accrued under foreign law in 2018 but accrued under U.S. law in 2017 be tested foreign income taxes? What if the foreign tax was payable in 2017 but the tested income accrued under U.S. law in 2018? How should a foreign tax deficiency or refund in 2018 for a foreign tax payable in 2017 or earlier

[167] Treas. Reg. § 1.904(f)-7; Section 904(g)(3).

[168] While not a GILTI question, regulations should also clarify whether excess foreign branch FTCs for 2018 can be carried back under Section 904(c) to 2017 (presumably to the general limitation basket), given that there was no foreign branch basket for 2017.

years be treated? The Tax Section expects to prepare a Report on FTC issues arising under the Act that will cover these and other topics.

F. U.S. Partnership as a U.S. Shareholder in a CFC

1. Possible Approaches for Applying GILTI

Suppose a U.S. partnership is a U.S. shareholder of a CFC.[169] It is not clear whether the GILTI calculations are to be made at the partnership level or the partner level. We believe the most logical alternatives are the following.

Under the "**Partnership Level Approach**":

(1) A partnership that is a U.S. shareholder of a CFC calculates its Section 951A inclusion just as any U.S. shareholder. The inclusion is based only on stock in the CFCs owned directly or indirectly under Section 958(a) by the partnership, but the rule applies even if the partnership owns less than 10% directly or indirectly and is a U.S. shareholder solely by reason of owning additional stock by attribution from its partners under Section 958(b).

(2) The partnership notionally calculates a Section 250 deduction equal to the specified percentage of the Section 951A inclusion, but without regard to the nature of its partners or the taxable income limit in Section 250(a)(2). The deduction has no substantial economic effect, and must be allocated to partners in the same manner as the inclusion.

(3) Each partner, whether or not it is itself a U.S. shareholder, includes its share of the Section 951A amount in gross income. Each partner claims the corresponding share of the Section 250 deduction to the extent it is eligible at the partner level. In particular, noncorporate partners do not get the deduction, and corporate partners are subject to the Section 250(a)(2) limit based on their own taxable income, other Section 250 deductions, and FDII deductions.

(4) Section 960(d) by its terms is applied at the level of a domestic corporation. As a result, tested foreign income taxes paid by CFCs owned by the partnership would flow through to each domestic corporate partner based on the Section 951A inclusion of each such partner, whether or not the partner is a U.S.

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[169] A domestic partnership can be a U.S. shareholder of a CFC. Section 7701(a)(30); Treas. Reg. § 1.701-2(f) Example (3). This position was recently reaffirmed in Section 3.05(b) of Notice 2018-26, which treats a U.S. partnership that is a U.S. shareholder of a deferred foreign income corporation as the shareholder required to report the Section 965(a) inclusion amount, with partners in the partnership required to report their share regardless of whether they themselves are U.S. shareholders. If this rule was changed to apply look-through treatment to domestic partnerships in the same way it applies to foreign partnerships, many of the issues in this Report involving partnerships would be avoided. However, that proposal is beyond the scope of this Report.

shareholder.[170] The partner calculates its own inclusion percentage, Section 78 gross-up, and Section 904 limitations. A partner can use credits in the GILTI basket not only against the GILTI inclusion passed through from the partnership, but also against other GILTI inclusions from the same or other CFCs or from other partnerships owning CFCs, and *vice versa*.

Alternatively, under the "**Partner Level Approach**":

(1) If the partnership is a U.S. shareholder, tested income, tested loss, QBAI and interest expense of a CFC flow through the partnership directly to the partners and are treated as the partners' *pro rata* shares of such items for purposes of applying Sections 951A(c)(1)(A) and (B) and 951A(b)(2). The flow-through applies whether or not the particular partner is itself a U.S. shareholder.

(2) Each partner combines these items with its own partner-level items in determining its own GILTI inclusion under Section 951A and Section 250 deduction.

(3) The tested foreign income taxes of the CFC also flow through the partnership to the partner. The partner calculates its own inclusion percentage, taking into account items from the partnership as well as its own partner-level items. The partner then determines its FTCs under Section 960(d) and its Section 78 gross-up. The Section 904 limits are determined at the partner level.

2. Discussion

The statute and legislative history are not conclusive on which approach should be adopted. In contrast to new Section 163(j), there is no statutory provision stating that either Section 951A or Section 250 should be determined at the partnership level. As a literal matter, Section 951A requires the U.S. shareholder of the CFC to include GILTI in income. If the partnership is a U.S. shareholder, this seems to require the GILTI inclusion to be at the partnership level.

By contrast, Section 250(a)(1) allows a deduction "to a domestic corporation" for a percentage of the amount included in its gross income under Section 951A. Similarly, Section 250(a)(2) limits the GILTI/FDII combined deduction to "the taxable income of the domestic corporation" determined without regard to this section. These provisions seem to require the Section 250 deduction to be at the level of the corporate partner of a partnership. Confusing matters further, the legislative history implies in two places that Section 250 applies at the partnership level.[171]

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[170] Section 960(d) allows an FTC to a domestic corporation with a Section 951A inclusion, and does not require that the corporation be a U.S. shareholder.

[171] Conference Report at 623 n. 1517, describing the Senate Bill ("The Committee intends that the deduction allowed by new Code section 250 be treated as exempting the deducted income from tax. Thus, for example, the deduction for global intangible low-taxed income could give rise to an increase in a domestic corporate partner's basis in a domestic partnership under section 705(a)(1)(B)."); and at 626 n. 1525, describing the Final Bill ("Due to the reduction in the effective U.S. tax rate resulting from the

We believe that there are a number of advantages of the Partner Level Approach. First, it taxes a U.S. shareholder on its share of the net CFC tested income minus NDTIR determined by reference to all the CFCs in which it has an interest, regardless of whether the interest is held directly or through a partnership. In particular, this approach allows tested income from all CFCs in which the U.S. shareholder has an interest to be offset by tested loss, NDTIR and FTCs from other CFCs in which it has an interest. We believe this is the proper result.

Second, by contrast, the Partnership Level Approach would encourage tax planning to achieve very different tax results with very little change in economic position. This issue is the same as that for consolidated groups if members are not aggregated, where aggregation can then be achieved electively by restructuring. The Partnership Level Approach is comparable to nonaggregation in the consolidated return context, and the Partner Level Approach is comparable to aggregation in that context.

As discussed in Part IV.B.4(a) in the context of a consolidated group, sometimes aggregation of CFCs helps the taxpayer and sometimes it hurts the taxpayer. For example, the Partnership Level Approach would be adverse to a partner with a GILTI inclusion from a partnership with no ability to offset the inclusion with tested loss or NDTIR from CFCs held directly or through other partnerships. Likewise, a U.S. shareholder could have a GILTI inclusion from CFCs held directly with no offset for such items allocated from one or more partnerships.

In other cases, the Partnership Level Approach is more favorable for taxpayers than the Partner Level Approach. For example, a U.S. shareholder might hold a CFC with high-taxed income through a partnership, and directly hold a low-taxed CFC that generates NDTIR. Assuming the Partnership Level Approach results in a separate inclusion percentage to the corporate partner for Section 951A items from the partnership (*see* discussion below), that approach will prevent the NDTIR from reducing the inclusion percentage for the FTC on the high-taxed income from the partnership. *See* Example 9(b) for the consolidated return analog to this example.

The Partnership Level Approach in effect makes aggregation elective, except possibly for FTCs, since a U.S. shareholder with multiple CFCs could transfer some of them to (say) a 99% owned partnership and achieve very different results. Likewise, it would often be advantageous for a partnership to transfer its interest in one or more CFCs to its partners. There is no logical reason that the GILTI results should differ in these situations.

Third, the Partnership Level Approach can give rise to very counter-intuitive results. Suppose a U.S. partner directly holds 10% of the equity in a CFC and indirectly holds the same or a different class of equity in the same CFC through a U.S. partnership that is a U.S. shareholder. The partner could then have both GILTI inclusions and tested

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deduction for FDII and GILTI, the conferees expect the Secretary to provide, as appropriate, regulations or other guidance similar to that under amended section 965 with respect to the determination of basis adjustments under section 705(a)(1) and the determination of gain or loss under section 986(c).")

income from the same CFC, with the latter but not the former being offset by tested losses and NDTIR of other CFCs owned by the partner. This is a very peculiar result.

Fourth, the Partnership Level Approach could not apply to a foreign partnership, since it cannot be a "U.S. shareholder" of a CFC. As a result, the Partnership Level Approach results in large differences in tax treatment of tested income depending upon whether the shareholder partnership is a U.S. or foreign partnership. While this is already true to some extent today, there is no good policy reason to increase these differences even further.

Fifth, the Partnership Level Approach is necessarily a hybrid of the two approaches, because under Section 960(d), the calculation of the inclusion percentage must be made at the level of the corporate partner. This in effect requires the entire FTC calculation to be made at the level of the corporate partner.

In fact, Section 960(d)(2) is unclear as to whether any corporation can only have a single inclusion percentage or can have multiple inclusion percentages. Under the former interpretation, all partnership level items must be aggregated with all nonpartnership items of the corporation to determine a single inclusion percentage. Under the latter interpretation, a corporate partner has a separate inclusion percentage for its share of a Section 951A inclusion passed through from any particular partnership, and another inclusion percentage for any nonpartnership Section 951A inclusion. Under either interpretation, however, the Partnership Level Approach has the disadvantage of being a rather complex hybrid approach.

Finally, the Partner Level Approach is supported by analogy to other situations where regulations apply that approach. The so-called "Brown Group" regulations look through partnerships for various purposes in applying Subpart F.[172] Under the portfolio interest rules,[173] the status of being a 10% shareholder of the issuer (and thus ineligible for the portfolio interest exception to withholding tax) applies at the partner level, rather than the partnership level, when the partnership holds debt of the issuer.[174]

On the other hand, the Partnership Level Approach is consistent with Section 3.05(b) of Notice 2018-26. This section states that if a partnership is a U.S. shareholder of a deferred foreign income corporation, the Section 965 calculations are made at the partnership level. U.S. partners are required to report their share of the partnership's inclusion amount, regardless of whether they themselves are U.S. shareholders.

However, applying Section 965 at the partnership level does not involve inter-relationships with partner level items comparable to the issues in applying GILTI at the partnership level. Moreover, Section 965 is a one-time provision. As a result, we do not

[172] T.D. 9008, July 22, 2002.

[173] Sections 871(h), 881(c).

[174] Treas. Reg. § 1.871-14(g)(3)(i).

believe the rules under that section should control the rules that will apply permanently under GILTI.

A benefit of the Partnership Level Approach is that, in contrast to the Partner Level Approach, it does *not* provide a U.S. shareholder in a CFC with a greater Section 163(j) limitation if the U.S. shareholder holds a CFC inside rather than outside a partnership. There is no policy justification for this distinction that arises under the Partner Level Approach. Moreover, the increased Section 163(j) limitation that arises under the Partner Level Approach is inconsistent with applying the Section 250 deduction before the Section 163(j) limitation. *See* Part IV.D.3.

To illustrate, assume that outside a partnership, the Section 250 deduction applies before the Section 163(j) limitation. The same result would arise under the Partnership Level Approach, since all calculations under both GILTI and Section 163(j) are made at the partnership level. Yet under the Partner Level Approach, Section 163(j) is still required by statute to be applied first at the partnership level, and then Section 951A and Section 250 are applied at the partner level. This allows a larger Section 163(j) limitation because the partnership taxable income is computed without taking into account the Section 250 deduction.

> <u>Example 18(a): Partner directly holds CFC and has Section 163(j) limitation.</u> Assume a corporation is engaged in business and directly owns a CFC, the CFC gives rise to $100 of Section 951A inclusion, and the corporation has $50 of interest expense and $50 of net profit (aside from the inclusion) before taking account of this interest expense. The corporation has a Section 250(a)(1) deduction of $50, leaving it with taxable income of $100 before interest expense. Under Section 163(j), the interest deduction is limited to $30, so net taxable income is $70. Section 250(a)(2) does not apply because taxable income before the Section 250(a)(1) deduction is $120.
>
> <u>Example 18(b): The business, the CFC and Section 163(j) interest are at partnership level</u>. Same facts as Example 18(a), except the business, the CFC and the debt are held through a partnership.

In Example 18(b), under the Partnership Level Approach, the partnership has $100 of Section 951A inclusion and $50 of Section 250 deduction, leaving taxable income before interest expense of $100 and a Section 163(j) limit on interest of $30. The partnership passes through $70 of taxable income to the partner, the same result as in Example 18(a).

In Example 18(b), under the Partner Level Approach, the partnership has $100 of tested income, no Section 250 deduction, and $50 of business income. The Section 163(j) limit must be applied at the partnership level and is $45. The partnership passes through $100 of tested income, $50 of business income and a $45 interest deduction to the partner. The partner has a Section 951A inclusion of $100, a Section 250 deduction of $50, and an interest deduction of $45, and business income of $50. Taxable income is $55, as compared to $70 in the other cases.

In summary, under the Partner Level Approach, Section 163(j) applied at the partnership level before Section 250 applied at the partner level. The result is that the interest allowed was 30% of $150, rather than 30% of $100, for a reduction in taxable income of $15. If this ordering rule is not allowed outside a partnership, there is no policy reason for it to be allowed merely because the CFC and debt are held by a partnership engaged in a trade or business.

3. Conclusions

We believe that regulations or legislation should adopt the Partner Level Approach. In general, this involves applying aggregate rather than entity principles to partnerships for GILTI purposes. Aggregate principles generally reach results that are more economically correct than if a partnership is treated as an entity. Here, in particular, the results make sense by avoiding arbitrary effects of the entity approach, and by preventing taxpayers from selectively grouping and ungrouping CFCs under partnerships to maximize tax benefits.

The results under Section 163(j) do not make sense under this approach, but we are reluctant to change our recommended approach to solve this narrow issue. Rather, we believe it is important to adopt, along with the Partner Level Approach, one of the approaches to Section 163(j) described below to avoid the undue benefit from applying Section 163(j) at the partnership level and Section 250 at the partner level.[175]

One way to reach a sensible result under Section 163(j) under the Partner Level Approach would be a rule that solely for purposes of applying that section at the partnership level, a notional Section 250 deduction must be applied before Section 163(j), based on the hypothetical Section 951A inclusion and resulting Section 250 deduction that the partnership would have if it was a corporation. This would limit the ability of taxpayers to

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[175] In the Report on Section 163(j), we accepted as a policy matter the fact that if a partnership receives dividends, the DRD applies at the level of a corporate partner, yet the Section 163(j) deduction is calculated at the partnership level without regard to the deduction. We stated this result was a "direct consequence" of the decision by Congress to apply Section 163(j) at the partnership level.

There, the mismatch between DRD and Section 163(j) was clearly mandated by the statute. Here, although only corporations obtain the benefit of the Section 250 deduction, the statute does not state whether the Section 250 deduction should be at the partner or partnership level. In fact, as noted in the text, the Conference Report implies that the Section 250 deduction will be taken at the partnership level, and we can speculate that the reason was to avoid an undue benefit under Section 163(j) that would arise if the Section 250 deduction were at the partner level. We believe that in the GILTI context, the proposal in the text best carries out the intent of Congress.

increase the Section 163(j) limit merely by putting the CFC and the debt into a partnership rather than holding the CFC and being liable for the debt directly.

If Treasury does not believe it has the authority to adopt these positions in regulations, it should request a statutory amendment. We note, however, that there is no provision in the statute mandating the Section 951A inclusion or the Section 250 deduction be at the partnership level. While the Conference Report assumes the deduction is taken at the partnership level, it does not say so directly, and the notional deduction under Section 250 at the partnership level that we propose could be viewed as a partial implementation of that legislative history.

This approach appears to us to be a reasonable way to accommodate the policies of GILTI and Section 163(j). We also note that Section 7 of Notice 2018-28 requires certain aspects of the partnership-level calculation under Section 163(j) to be taken into account by the partner in doing its own Section 163(j) calculation, to avoid a double benefit from partnership interest income. That result does not go as far as our proposal for a notional Section 250 deduction at the partnership level. However, it indicates a view that elements of a particular calculation may be relevant at both the partner and partnership levels in order to avoid unjustified results.

Another way to reach a sensible result for Section 163(j) and Section 250 under the Partner Level Approach would start with a rule that the Section 951A inclusion and the Section 250 deduction are taken entirely at the partner level. Then, a rule would be adopted that if a partnership is a shareholder owning 10% or more of the stock of a corporation, that stock would automatically be considered as held for investment rather than as a business asset, and no interest expense of the partnership on debt allocable to that stock would be considered business interest expense under Section 163(j). As a result, if the partnership was a U.S. shareholder of a CFC, any inclusion by the partnership of tested income from the CFC would be investment income, and any interest expense of the partnership allocable to stock of the CFC would not be business interest expense. As a result, Section 163(j) would apply at the partnership level without regard to either such item.

Tested income and interest expense would then presumably pass through to a corporate partner as business income and business interest expense, respectively, and would be subject to Section 163(j) at the partner level. As a result, both Section 250 and Section 163(j) would apply at the partner level, with the same result as if the partner held the CFC stock directly.[176]

This approach requires treating all 10% shareholdings by partnerships as investment assets under Section 163(j). This would be difficult to justify as a factual matter in many circumstances. As a result, a *per se* rule would be necessary to achieve the desired

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[176] *See* the Report on Section 163(j), at 41-42, for a discussion of the consequences under Section 163(j) when a partnership holds investment assets. This approach would also reach a similar result under the Partnership Level Approach. In that case, the Section 250 deduction would be taken at the partnership level and pass through to the partner, and Section 163(j) would also apply at the partner level because the interest expense would not be business interest expense at the partnership level.

coordination with Section 250 in all cases. Lack of a *per se* rule would also allow considerable electivity by taxpayers who could combine or disaggregate partnership business activity and ownership of subsidiaries. In addition, there is no logical reason for the *per se* rule to apply only to 10% holdings in CFCs as opposed to holdings in any domestic or foreign corporation. Consequently, this proposal would have significance in the domestic context well beyond GILTI, and would require further consideration that is beyond the scope of this Report.

4. Related Issues

If (contrary to our proposal) the Partnership Level Approach is adopted, regulations should clarify how it is applied in certain ownership situations described below. In that connection, note that under Sections 958(b) and 318(a)(3)(A), in testing whether a U.S. partnership is a U.S. shareholder of a CFC, and in testing for CFC status, a partnership is deemed to own the stock in a foreign corporation owned by the partners in the partnership. We believe regulations should confirm the following:

(1) If a U.S. partnership owns directly (or indirectly under Section 958(a)) 10% of a CFC, then the partnership is a U.S. shareholder and its GILTI calculation should be based on such ownership in the CFC.

(2) Suppose a U.S. partnership owns directly (or indirectly under Section 958(a)) less than 10% of a CFC, but owns 10% after taking into account constructive ownership of CFC stock owned by its partners under Section 958(b). The partnership is a U.S. shareholder, but its inclusion under Section 951A is limited to its *pro rata* share of the tested income of the CFC based on its direct and Section 958(a) indirect ownership.

(3) Suppose a partnership owns 100% of a CFC, and it has two 50% U.S. partners. The partnership and each partner are U.S. shareholders of the CFC. However, as in (2), the income inclusion is at the partnership level, so the calculations should still be made at the partnership level rather than the partner level.

(4) In all of these cases, the Section 250 deduction would be available even to a corporate partner that was not itself a U.S. shareholder of the CFC. Section 250 is triggered by a Section 951A inclusion by a domestic corporation, regardless of the status of the corporation as a U.S. shareholder.

Regulations should also state whether, under the Partnership Level Approach, the Section 250(a)(2) limit is determined at the partnership level or the partner level. If it is determined at the partnership level, the partnership might obtain a Section 250 deduction and pass it through to a partner that did not itself have sufficient taxable income to be entitled to the deduction directly. In this situation, regulations should also state whether Section 172(d)(9) would apply to limit the partner from using the passed-through Section 250 deduction in calculating its own NOL carryover.

Moreover, as discussed above, under the Partnership Level Approach, regulations should clarify whether under Section 960(d), a domestic corporation with Section 951A inclusions from more than one partnership, or from one or more partnerships and from any directly held CFCs, will have a single or multiple inclusion percentages. Also, even if a corporation has only a single Section 951A inclusion from a single partnership, regulations should also clarify how the inclusion percentage is determined under the Partnership Level Approach. The Section 951A inclusion at the partnership level is based on items that go into the calculation of the inclusion percentage (*e.g.*, NDTIR, interest expense, tested income and tested losses of each CFC). Regulations should clarify whether there is a "look-through" of some or all of these items directly to the corporate partner, or whether there is a netting of any of these items (*e.g.*, tested income and tested loss) at the partnership level before the net amount is passed through to the corporate partner.

In addition, regulations should confirm certain additional aspects of the relationship between the Section 250 deduction and the Section 163(j) limit. Under our proposal for both the Partnership Level Approach and the Partner Level Approach, the Section 250 deduction would be calculated either actually or notionally at the partnership level before the Section 163(j) deduction is determined at the partnership level. However, individuals and non-U.S. corporations are not eligible for the Section 250 deduction. As a result, presumably only the usable portion of the Section 250 deduction should be taken into account in calculating the Section 163(j) limit. To illustrate, if all the partners are individuals, it would not make sense for the Section 163(j) limit to assume a 50% deduction to all partners, when none in fact are entitled to the deduction.

The partnership should therefore obtain an "extra" Section 163(j) deduction on account of its individual partners who are not entitled to a Section 250 deduction. Presumably such extra deduction would be required to be allocated to the individual partners. This would reduce the partnership's carryforward of Section 163(j) deductions.

Regulations should clarify that the partnership must limit the extra allocation of interest deduction to a partner to the interest deductions that are allowable to the partnership under Section 163(j) only because the partner's share of partnership income is not reduced by the Section 250 deduction at the partnership level with respect to that partner. The extra allocation should reduce the portion of the carryover that is allocated to the partner. Absent such a rule, a partnership could allocate a disproportionate amount of its total interest deductions to partners that could not use a Section 250 deduction, and there would not be substantial economic effect to such an allocation. Such a special allocation also seems inconsistent with the statutory requirement that the Section 163(j) limit be determined at the partnership level.

Logically, the same approach of an increased Section 163(j) allocation should apply for a corporate partner that could not use its entire Section 250 deduction because of the taxable income limit in Section 250(a)(2). However, partners of a partnership might not be willing to inform the partnership about whether their Section 250 deduction would be so limited. As to partners such as direct non-U.S. partners who would not obtain a Section 250 deduction, presumably the Section 163(j) deduction would be determined without regard to an actual or notional Section 250 deduction at the partnership level, although it would be necessary to look through a partner that is a partnership to determine the nature of the ultimate partners.

Finally, Part IV.D.7 discusses certain issues concerning tax basis in a partnership interest.

G. Other Issues

1. Section 962 Election

If an individual U.S. shareholder directly holds stock in a CFC, the individual has an income inclusion under Section 951A without a deduction under Section 250. As a result, the maximum tax rate on the GILTI inclusion is 37%. No foreign tax credit is allowed, although foreign taxes reduce tested income and therefore the GILTI inclusion. In the past, the shareholder was not taxed on current earnings except for Subpart F income, and if the CFC was in a treaty country, a dividend was QDI taxed at the rate of 20% (disregarding Medicare tax).[177] As a result, the Act imposes a significant tax increase on a U.S. shareholder in this situation.

Section 962 is designed to allow an individual U.S. shareholder of a CFC to elect to be placed in approximately the same position for Subpart F inclusions as if the CFC stock was held through a domestic corporation. Moreover, Section 951A(f)(1)(A) states that for purposes of Section 962, the Section 951A inclusion is to be included in income in the same manner as a Section 951(a) inclusion under Subpart F. Therefore, Congress clearly contemplated that an individual could obtain relief from the GILTI consequences above by making the Section 962 election.

Section 962(a) imposes tax on the electing individual shareholder at the corporate rate on the "amounts which are included in his gross income under section 951(a)" if the shareholder were a corporation. The gross income inclusion for GILTI is the Section 951A inclusion (including the Section 78 gross-up if an FTC is being claimed) without regard to the Section 250 deduction. Moreover, the regulations make clear that the corporate tax is imposed on Subpart F income without the allowance of any deductions.[178]

The no-deduction rule makes sense for purposes of Subpart F, since the tax is being imposed as if the CFC was held by a hypothetical domestic corporation having no assets other than CFC stock. However, this rationale does not apply to the Section 250 deduction, and it seems doubtful that Congress intended to require that Section 962 apply without the deduction. The deduction is intended to create a reduced effective tax rate, rather than operate as a typical deduction that involves an outlay of funds.[179] The fact that Congress chose to achieve a reduced tax rate on foreign earnings by means of a gross income

[177] Section 1(h)(11).

[178] Treas. Reg. § 1.962-1(b)(1)(i).

[179] *See, e.g.*, Conference Report at 623 n. 1517 ("The Committee intends that the deduction allowed by new Code section 250 be treated as exempting the deducted income from tax.").

inclusion and a deduction, rather than a reduced tax rate, should have no effect on the policy of Section 962 of treating the shareholder as owning the CFC stock through a corporation.

To be sure, the language of Section 951A(f)(1)(A) does not itself seem broad enough to authorize the Section 250 deduction. In addition, Section 5 of Notice 2018-26 allows a shareholder making a Section 962 election to obtain the Section 965(c) deduction at the shareholder level. However, the Notice is expressly limited to Section 965 and relies in part on the fact that individuals are themselves eligible for the Section 965 deduction for dividends received directly.

Nevertheless, we believe that Treasury should issue regulations confirming that the Section 250 deduction is available for a Section 962 election. If Treasury does not believe it has the authority to do so, we recommend an amendment to the statute.

Next, when the CFC distributes PTI to the U.S. shareholder, the distribution is included in the shareholder's income under Section 962(d). Treasury should clarify whether the income is QDI. Allowing treatment as QDI is necessary to achieve the purpose of Section 962 of treating an individual shareholder of a CFC approximately the same as if the CFC stock had been held by a domestic corporation owned by the U.S. shareholder. Under this construct, the CFC's distribution of PTI to the U.S. shareholder is treated as a distribution by the CFC of PTI to the domestic corporation, followed by a dividend from the domestic corporation to the U.S. shareholder.[180] We note that resolution of this issue has broader implications than GILTI.

Finally, the statute and regulation[181] state that only an individual U.S. shareholder (*i.e.*, with 10% ownership in the CFC) can make the election. Section 5 of Notice 2018-26 states that for purposes of Section 951, only an individual that is a U.S. shareholder of a CFC, whether by virtue of directly held stock, stock held through a partnership, or both, can make the Section 962 election. In such case, the election applies both to directly owned stock in the CFC as well as the individual's share of partnership income earned through the CFC. If a U.S. partnership is a U.S. shareholder of a CFC but an individual partner is not, the individual cannot make the election. These rules automatically apply to Section 951A by cross-reference.

We believe these positions are reasonable. We note that an individual partner in a foreign partnership clearly looks through the foreign partnership under the usual rules, in determining whether the individual is a U.S. shareholder of the CFC eligible for the election.[182]

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[180] Treas. Reg. § 1.962-3(b)(4) achieves similar parity by treating a redemption of stock by the CFC as eligible for capital gain treatment to the U.S. shareholder, rather than being considered a partial taxable distribution of earnings and profits.

[181] Treas. Reg. § 1.962-2(a).

[182] *See* Treas. Reg. § 1.962-2(b)(1), requiring the reporting of any intermediate partnership through which the individual holds the interest in the CFC.

2. Fiscal Transition Year 2017-2018

If a CFC has a fiscal year, income earned in the 2017-2018 fiscal year is exempt from GILTI.[183] This gives rise to opportunities for avoiding Section 951A inclusions in subsequent taxable years. For example, a CFC might sell an appreciated asset to an affiliate during this period, in which case the affiliate can take depreciation or amortization deductions in future periods to reduce its tested income in those years. If the asset is a depreciable tangible asset, this transaction may also increase the overall QBAI in the system, which will increase future NDTIR. If the affiliate has a calendar year tax year, it can also take a current deduction from tested income for interest expense, royalties, etc. paid during this period to a fiscal year affiliate.

The statute[184] contemplates a broad delegation of authority to Treasury to adopt anti-abuse rules for transactions intended to increase QBAI, including during the transition period. The legislative history[185] contemplates a much broader delegation of authority to disregard all noneconomic transactions intended to minimize tax under the GILTI rules, not only during the transition period. We have been asked by government representatives to consider the possible scope of regulations to exercise this authority.

Suppose a transaction during the transition period between affiliates gives rise to exempt income in the current year, and a deduction from tested income in the current year or a future year (*e.g.*, through use of tax basis created in the transition year). Possible tests for disallowance of the deduction from tested income are the following, from the most permissive to the most restrictive:

(1) No disallowance.

(2) Presumptive allowance overcome by government showing of a bad purpose.

(3) Presumptive disallowance overcome with a showing of a good business purpose.

(4) Disallowance if "the principal purpose" of the transaction was to obtain exempt income and a deduction from tested income.

(5) Disallowance if "a principal purpose" of the transaction was to obtain exempt income and a deduction from tested income.

(6) Automatic disallowance.

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[183] Section 951A applies to taxable years of a foreign corporation beginning after December 31, 2017.

[184] Section 951A(d)(4).

[185] Conference Report at 645.

Any of these standards could be enforced in the case of an asset sale by mandating a carryover basis for calculating tested income. Moreover, similar standards might apply to acceleration of income into the transition period, such as prepayments from customers or sale/leasebacks of property with third parties, or to deferral of deductions until after the transition period.

We note that in the context of transactions that reduce Section 965 tax liability, Section 3.04(a) of Notice 2018-26 adopts alternative (5) as a general matter, with several of the other alternatives applying in the case of various specified categories of transactions. In addition, Section 3.04(b) of the Notice disregards any change in method of accounting on or after November 2, 2017 for purposes of Section 965, regardless of the purpose of the change. It is not clear whether Treasury will adopt similar anti-abuse rules for GILTI, although we note that the statutory basis for anti-abuse rules under Section 951A is narrower than the broad grant of authority for anti-abuse rules under Section 965(o).

If Treasury does not believe that the statute and the Conference Report give it the authority to issue regulations of the type described in the Conference Report and that it believes are necessary to eliminate abuses during or after the transition period, it should request an amendment to the statute to conform its authority to that described in the Conference Report.

3. Effect of Section 958(b)(4) Repeal

The Act repealed Section 958(b)(4), which prohibited the "downward attribution" rules from treating stock that is owned by a non-U.S. person as being owned by a U.S. person.[186] While the repeal is unconditional, a colloquy (the "**colloquy**") on the Senate floor states that the repeal was not intended to apply to a U.S. shareholder of a CFC if the CFC qualifies as such only because of downward attribution to a U.S. person that is not related to the U.S. shareholder.[187] It further states that Treasury Regulations should interpret the provision accordingly.[188] The Senate Finance Committee's explanation of the corresponding provision in the Senate Bill is to the same effect,[189] and there is no indication that Congress intended repeal to have broader consequences.

[186] Act § 14213.

[187] 163 Cong. Rec. No. 207 (Dec. 19, 2017) at p. S8110 (colloquy between Senator Hatch, Chairman of the Senate Finance Committee and Senator Perdue).

[188] *Id.*

[189] "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)." Committee Print, *Reconciliation Recommendations Pursuant to H. Con. Res. 71*, S. Prt. 115–20, (December 2017), p. 378, as reprinted on the website of the Senate Budget Committee, available at *https://www.budget.senate.gov/taxreform*.

The unconditional repeal of Section 958(b)(4) could create Section 951A inclusions in the following situations. According to the colloquy, such inclusions were not intended to be created by such repeal.

- A U.S. corporation or partnership (D1) owns 10% of the stock of foreign corporation (F1), and the other 90% of F1 is owned by an unrelated foreign corporation with no U.S. shareholders but with a U.S. subsidiary (D2). Then, D2 constructively owns 90% of F1, F1 would be a CFC, and D1 would have a Section 951A (and Subpart F) inclusion from F1. If D1 was a partnership, its partners would have a Section 951A inclusion and its individual partners would not have a Section 250 deduction.

- D1 owns 10% of F1, and F1 owns 100% of both a domestic subsidiary D2 and a foreign subsidiary F2. Then, D2 constructively owns 100% of F2, F2 is a CFC, and D1 has a Section 951A inclusion from F2.

We do not believe that these results should arise. There is no logic to a U.S. person being treated as a U.S. shareholder of a CFC merely because an unrelated foreign shareholder of the purported CFC happens to have a U.S. subsidiary with no direct ownership interest in the CFC.

We therefore believe that the consequences of the repeal of Section 958(b)(4) should be limited to conform to the apparent Congressional intent as expressed in the colloquy, either by regulations or an amendment to the statute. Section 3.01 of Notice 2018-26 gives very limited relief from the repeal of Section 958(b)(4) in applying the constructive ownership rules to partnerships for purposes of Section 965. This may indicate that Treasury does not believe it has the authority to further limit the consequences of repeal, in which case we recommend requesting an amendment to the statute.

Of course, limiting the consequences of the repeal would have significance well beyond GILTI. Thus, any regulations or statutory amendment should take into account the intended results not just for GILTI, but also for other Code sections that were affected by the repeal.

In addition, even as to GILTI, the colloquy does not deal with the case where the tax treatment of a U.S. shareholder depends upon the status of a corporation as a CFC (or not) before or after the U.S. shareholder became a U.S. shareholder. Return to two cases discussed in Part IV.D.2.

- Similar to footnote 117: A foreign corporation (F) has a foreign subsidiary (F1) and a U.S. subsidiary (US1). U.S. corporation (P) buys the stock of F1 from F in the middle of the year. Then, US1 constructively owned all of F1 for the period before the sale, so F1 is a CFC for the entire year. P apparently has a Section 951A or Subpart F inclusion for the entire year rather than only for the post-sale portion of the year.

- Same as Example 14(c): A U.S. shareholder (US1) of a CFC sells stock in the

> CFC to a non-U.S. person F, but F has a U.S. subsidiary (FSub) so the CFC remains a CFC for the entire year. As a result, there is no Section 951A inclusion or Subpart F income reported for the year of the sale.

In the first case, the overinclusion in income to P does not arise because F1 was a CFC *as to P* during the first part of the year, but rather because it was a CFC at all in the first part of the year (when P was not a shareholder). Likewise, in the second case, the underinclusion arises because the CFC remained a CFC during the second half of the year, at a time when US1 was not a shareholder. As a result, additional changes beyond the colloquy would be necessary if the intent was to change the result in these situations.

4. Overlap Between Section 250(a)(2) and Section 172(d)(9)

Section 172(d)(9) states that the Section 250 deduction is not allowed in calculating a net operating loss. Regulations should clarify the situations where this provision becomes relevant in light of Section 250(a)(2), which limits the combined GILTI/FDII deduction to a percentage of taxable income determined without regard to Section 250. On its face, Section 172(d)(9) could never become applicable, since limiting the Section 250 deduction to a percentage of taxable income (otherwise determined) would by itself prevent the Section 250 deduction from creating or increasing a net operating loss that would be limited under Section 172(d)(9). Moreover, Section 250(a)(2) must apply before Section 172(d)(9), since the former affects deductions allowed in the current year and the latter only affects carryovers to future years.

However, in Part IV.D.4, we discuss the possibility that the Section 250(a)(2) carve-back does not limit the Section 250(a)(1) deduction for the Section 78 gross-up amount, in which case the Section 250(a)(1) deduction might create a taxable loss for the year. Moreover, in Part IV.F.4, we propose a possible occasion for Section 172(d)(9) to apply in the partnership context. It is not clear whether the drafters had either of these situation in mind, so it would be helpful for regulations to clarify cases in which Section 172(d)(9) would be applicable.

5. Medicare Tax (Section 1411)

Regulations should clarify whether GILTI inclusions are investment income under Section 1411.

6. REIT Income

Regulations should clarify the extent to which GILTI inclusions are qualified income for REIT purposes.[190] There is clear statutory authority for such regulations.[191] The current Treasury/IRS Priority Guidance Plan already includes a project to determine

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[190] Section 856(c).

[191] Section 856(c)(5)(J).

whether Subpart F income is qualifying income under Section 856(c),[192] and this project should logically be extended to GILTI inclusions. Some PLRs have applied look-through treatment for passive income of a CFC that is Subpart F income.[193]

7. RIC Income

Section 951A(f)(1)(A) treats GILTI inclusions as Subpart F income for purposes of Section 851(b). Section 851(b) (flush language) states that Subpart F inclusions are not treated as qualifying dividends unless there is an actual distribution that corresponds to the inclusion. Proposed regulations state that Subpart F inclusions do not qualify as other income derived with respect to the business of investing in stock.[194] In a prior Report, we stated our disagreement with this aspect of the proposed regulations.[195] Regulations should clarify the rules for a RIC that has a GILTI inclusion.

8. UBTI

We believe that GILTI inclusions are not unrelated business taxable income to tax-exempt U.S. shareholders under the terms of Section 512. Nevertheless, we believe that published guidance to confirm this would be helpful because of the importance of the issue to tax-exempts and the lack of published guidance in analogous areas such as Subpart F. The Tax Section is preparing a broader Report on tax-exempt issues that will address this issue in greater detail.

H. Proposed Aggregation of CFCs held by a U.S. Shareholder

This section proposes legislation to treat all Related CFCs of a particular U.S. shareholder as a single corporation for purposes of the GILTI calculations. We believe that the existing rules that treat each CFC separately are unjustified as a policy matter, are very unfair to taxpayers, and invite restructurings solely for tax purposes. We acknowledge that the existing rules are clear and are supported by the legislative history of the Act. Nevertheless, we urge the Congress to reconsider these provisions and for Treasury to support such reconsideration.

Under Sections 951A and 250, if a single U.S. corporation is a U.S. shareholder in more than one Related CFC, several uneconomic results arise from the separate treatment of each CFC.

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[192] Department of the Treasury, 2017-2018 Priority Guidance Plan, as updated February 7, 2018.

[193] *See, e.g.*, PLRs 201605005 (addressing REIT qualification), 201430017 (addressing UBTI for a tax-exempt organization), and 201043041 (addressing UBTI for a charitable remainder unitrust).

[194] REG-123600-16, Sept. 28, 2016.

[195] NYSBA Tax Section Report Number 1359, *Report on Proposed Regulations under Section 851 Dealing with Imputations from CFCs and PFICs,* Nov. 29, 2016.

First, QBAI can create NDTIR only to the extent the underlying property is "tangible properly used in the production of tested income".[196] A CFC with a tested loss does not literally have tested income, and so QBAI of any CFC with a tested loss can never create NDTIR. This QBAI is "wasted" and never provides any tax benefit to a U.S. shareholder.

The mere possibility of wasted QBAI could have a significant effect on supply chain planning. For example, a business model might contemplate manufacturing in one CFC and sales by another CFC. All the QBAI is in the first CFC. If there is a risk that the first CFC will have a tested loss, this model becomes uneconomic and the taxpayer is forced to combine both CFCs, either in actuality or through check the box. It is doubtful that Congress intended this to be a result of the GILTI rules.

The statute might be read broadly to say that QBAI qualifies if it produces income that *would be* tested income if the corporation in question had positive tested income. However, the legislative history is clear that this is not the intended interpretation of the statute.[197]

Second, foreign taxes are taken into account to the extent they are "properly attributable" to tested income.[198] The legislative history is clear that this prevents the U.S. shareholder from receiving an FTC for taxes paid by a CFC with a tested loss.[199] As a result, even if a CFC has income that is treated as income for both U.S. and foreign tax purposes, and is subject to foreign tax, an offsetting loss in the CFC that produces an overall tested loss in the CFC precludes an FTC.

This result may be particularly unfair to taxpayers when a CFC has an overall tested loss, but a branch or a disregarded subsidiary has, on a stand-alone basis, tested income and pays foreign taxes. The branch income reduces the shareholder's tested loss from the CFC, which may increase the shareholder's net CFC tested income and Section 951A inclusion. The foreign taxes paid by the branch are a real cost of the increase in tested income, but no FTCs are available.

As noted above, the legislative history makes clear that the lack of FTCs for a CFC with no tested income was intended by Congress. Therefore, we do not suggest that Treasury should change this result by regulation. However, we urge Congress to reconsider

[196] Section 951A(d)(2)(A).

[197] Conference Report at 642 n. 1536 ("Specified tangible property does not include property used in the production of tested loss, so that a CFC that has a tested loss in a taxable year does not have QBAI for the taxable year".).

[198] Section 960(d)(3).

[199] Conference Report at 643 n. 1538 ("Tested foreign income taxes do not include any foreign income tax paid or accrued by a CFC that is properly attributable to the CFC's tested loss (if any)").

these rules since they give very arbitrary results and invite restructurings solely to minimize tax liability.

Moreover, these rules give extremely arbitrary results that can be very unfair to taxpayers. Consider a U.S. shareholder that holds two CFCs, CFC1 and CFC2. If CFC1 has tested income for a year and CFC2 has a tested loss, the tested loss will reduce the net CFC tested income of the U.S. shareholder. However, the U.S. shareholder will obtain no benefit from any FTCs or notional QBAI return of CFC2. This is true whether CFC2's tested loss is $1 or $1 billion.

On the other hand, if CFC2 has $1 of tested income, all of its FTCs and QBAI return would be taken into account by the U.S. shareholder. It is difficult to understand why there should be such a vastly different outcome depending on whether CFC2 has income or loss under U.S. tax principles – a distinction that could turn on less than $1.

These rules also cause very formalistic results. Turn back to Example 15(a), where CFC1 has two divisions, division 1 generates tested income, division 2 generates tested loss, there is overall net positive tested income, and division 2 bears a foreign tax. We conclude that there should not be a tracing of FTC to particular dollars of tested income, so the FTC should be allowed for division 2 even though it generates a tested loss on a stand-alone basis. Moreover, we reach the same conclusion in Example 15(b), where division 2 is transferred to a disregarded subsidiary.

Assume now that CFC1 transfers division 2 to a subsidiary entity, CFC2, that is a corporation for U.S. tax purposes. Now, CFC2 has a tested loss and bears a foreign tax. However, since it is a separate corporation, the U.S. shareholder does not receive any FTC for that foreign tax.

There is no logical reason for this distinction. Moreover, the same distinction arises if division 2 has QBAI return rather than FTC. As in Examples 15(a) and 15(b), it is clear that if a particular CFC has any tested income, the QBAI return of that CFC is not limited to the return on particular assets that generate positive tested income. Rather, the deduction for NDTIR under Section 951A(b)(1)(B) aggregates all QBAI returns of all CFCs with positive tested income, without any tracing of QBAI return of a CFC to particular tested income of the same CFC.

Similarly, suppose CFC1 has a tested loss, interest expense, and notional QBAI return, and CFC2 has tested income and QBAI return. The notional QBAI return of CFC1 is disregarded, yet it is unclear whether the interest expense of CFC1 reduces the NDTIR generated by CFC2's QBAI (*see* discussion in Part IV.D.6). If this interest expense did reduce the NDTIR, all the notional QBAI return of CFC1, and the QBAI return of CFC2 up to CFC1's interest expense, would both be "wasted". This result would make no sense at all.

Finally, suppose CFC1 has $100 of tested income and pays foreign taxes, and CFC2 has a tested loss. If CFC2's tested loss is less than $100, the U.S. shareholder will have net CFC tested income, but the inclusion percentage for the FTC will be reduced on account of the tested loss. If instead CFC2 was a branch of CFC1, the net CFC tested income would be the same, but the inclusion percentage would be 100% (assume no NDTIR), so there would be no cutback on the FTC. On the other hand, if the CFC2 tested loss was $100 or more, the U.S. shareholder would be worse off if CFC2 was a branch of CFC1 than a separate CFC, because as a branch, the disadvantages of a CFC without tested income would then encompass CFC1 as well as CFC2.

These results are arbitrary and counter-intuitive, and encourage restructuring of business organizations purely for tax reasons. In particular, Related CFCs of a U.S. shareholder will be separated or combined (including by using "check-the-box" elections) to distribute tested income among CFCs in a manner so as to minimize the likelihood that CFCs with meaningful QBAI and/or FTCs will have tested losses. It might also become desirable to artificially accelerate income at year end in particular CFCs to prevent the existence of a tax loss for the year. Taxpayers will also attempt to rely on the administrative relief to make retroactive check the box elections, if events do not turn out as expected.

The need for such tax planning would be reduced or eliminated if all Related CFCs of a particular U.S. shareholder were treated as a single corporation for purposes of the GILTI calculations. The rule would apply regardless of whether the CFCs were each directly held by the shareholder or if they were in chains of ownership. Then, the tested income or tested loss of a particular CFC would not matter, and FTCs and QBAI return of all CFCs would be available as long as there was overall tested income. This result would not be unduly favorable to taxpayers, since it can be created by self-help today if the U.S. shareholder puts all its CFCs under a single CFC holding company and checks the box on all the subsidiary CFCs. In fact, mandatory aggregation can be viewed as anti-taxpayer, because the well-advised taxpayer today has the choice of aggregation or nonaggregation by simple tax planning, and nonaggregation is often more favorable.

Such aggregation is clearly at odds with Congressional intent in drafting Section 951A. However, it is not clear that Congress realized the anomalous results created by nonaggregation and how self-help could achieve results similar to aggregation.

If this proposal was enacted, and regulations were adopted to treat all members of a consolidated group as a single corporation for purposes of Section 951A,[200] the result would be the aggregation of all Related CFCs of all members of a consolidated group. We believe this would greatly simplify the GILTI rules, be much fairer to taxpayers, and avoid the need for uneconomic tax planning by taxpayers.

We are not suggesting, however, that all Related CFCs owned by a single U.S. shareholder (or members of a single consolidated group) should be treated as a single corporation for all purposes, so that all transactions between them should be disregarded in calculating tested income. This would, for example, eliminate tested income when one CFC sells an asset to another CFC at a gain. While elements of such a rule apply under

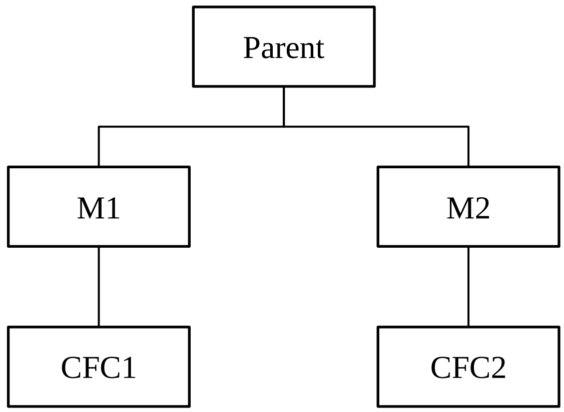
[200] *See* Part IV.B.4.

Subpart F for transactions between CFCs, such a rule would require considerably more analysis.

APPENDIX 1

The charts and calculations on the following pages illustrate certain of the examples in the Report.

Example 6(a)



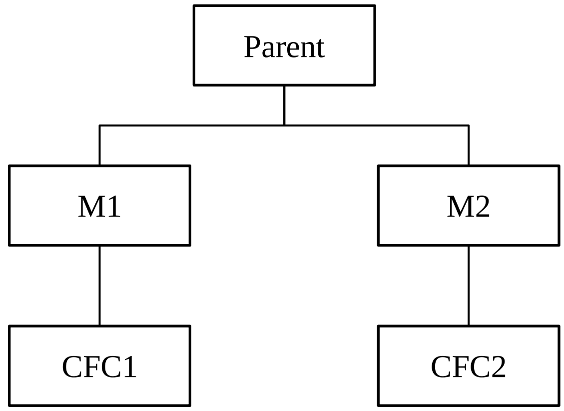
Tested income / (loss) = 100
QBAI return = 0
Foreign tax rate = 0%
Foreign taxes = 0

Tested income / (loss) = (100)
QBAI return = 0
Foreign tax rate = 0%
Foreign taxes = 0

	Nonaggregation		**Aggregation**
	M1	**M2**	**M**
Net CFC tested income	100	0	0
NDTIR	0	0	0
Section 951A inclusion	100	0	0
Aggregate of Related CFCs’ tested income	100	0	100
Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income)	100%	0%	0%
Foreign tax paid by Related CFCs with tested income	0	0	0
FTCs (80% * Inclusion percentage * Foreign tax)	0	0	0
Section 78 amount (Inclusion percentage * Foreign tax)	0	0	0
GILTI inclusion (Section 951A inclusion + Section 78 amount)	100	0	0
US tax before FTCs (GILTI inclusion * 50%[201] * 21%)	10.50	0	0
Incremental US tax, taking into account FTCs (US tax before FTCs - FTCs)	10.50	0	0
Aggregate tax (Foreign tax + Incremental US tax)	10.50	0	0
Aggregate tax for consolidated group	**10.50**		**0**

[201] Assumes full Section 250 deduction for GILTI is available.

Example 6(b)[202]



Tested income / (loss) = 100
QBAI return = 100
Foreign tax rate = 0%
Foreign taxes = 0

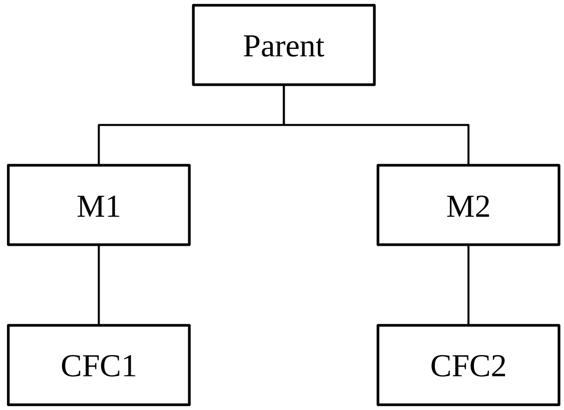
Tested income / (loss) = (50)
Interest expense = (100)
QBAI return = 0
Foreign tax rate = 0%
Foreign taxes = 0

	Nonaggregation		**Aggregation**
	M1	**M2**	**M**
Net CFC tested income	100	0	50
NDTIR	100	0	0
Section 951A inclusion	0	0	50
Aggregate of Related CFCs' tested income	100	0	100
Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income)	0%	0%	50%
Foreign tax paid by Related CFCs with tested income	0	0	0
FTCs (80% * Inclusion percentage * Foreign tax)	0	0	0
Section 78 amount (Inclusion percentage * Foreign tax)	0	0	0
GILTI inclusion (Section 951A inclusion + Section 78 amount)	0	0	50
US tax before FTCs (GILTI inclusion * 50%[203] * 21%)	0	0	5.25
Incremental US tax, taking into account FTCs (US tax before FTCs - FTCs)	0	0	5.25
Aggregate tax (Foreign tax + Incremental US tax)	0	0	5.25
Aggregate tax for consolidated group	**0**		**5.25**

[202] This example assumes that interest expense in a Related CFC with tested losses reduces the U.S. shareholder's NDTIR from other CFCs with QBAI return. See discussion in Part IV.D.6.

[203] Assumes full Section 250 deduction for GILTI is available.

Example 7



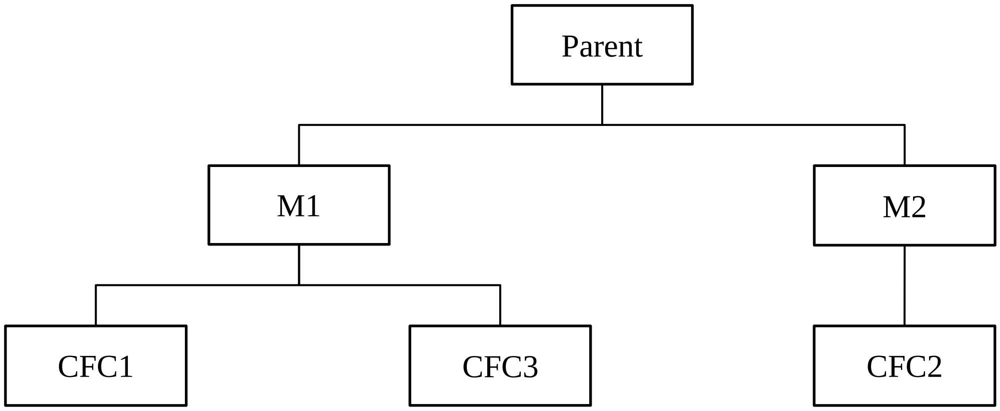
Tested income / (loss) = 100
QBAI return = 0
Foreign tax rate = 0%
Foreign taxes = 0

Tested income / (loss) = 10
QBAI return = 100
Foreign tax rate = 0%
Foreign taxes = 0

	Nonaggregation		**Aggregation**
	M1	**M2**	**M**
Net CFC tested income	100	10	110
NDTIR	0	100	100
Section 951A inclusion	100	0	10
Aggregate of Related CFCs' tested income	100	10	110
Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income)	100%	0%	9%
Foreign tax paid by Related CFCs with tested income	0	0	0
FTCs (80% * Inclusion percentage * Foreign tax)	0	0	0
Section 78 amount (Inclusion percentage * Foreign tax)	0	0	0
GILTI inclusion (Section 951A inclusion + Section 78 amount)	100	0	10
US tax before FTCs (GILTI inclusion * 50%[204] * 21%)	10.50	0	1.05
Incremental US tax, taking into account FTCs (US tax before FTCs - FTCs)	10.50	0	1.05
Aggregate tax (Foreign tax + Incremental US tax)	10.50	0	1.05
Aggregate tax for consolidated group	**10.50**		**1.05**

[204] Assumes full Section 250 deduction for GILTI is available.

Example 8(b)



Tested income / (loss) = 100
QBAI return = 0
Foreign tax rate = 13.125%
Foreign taxes = 15.11

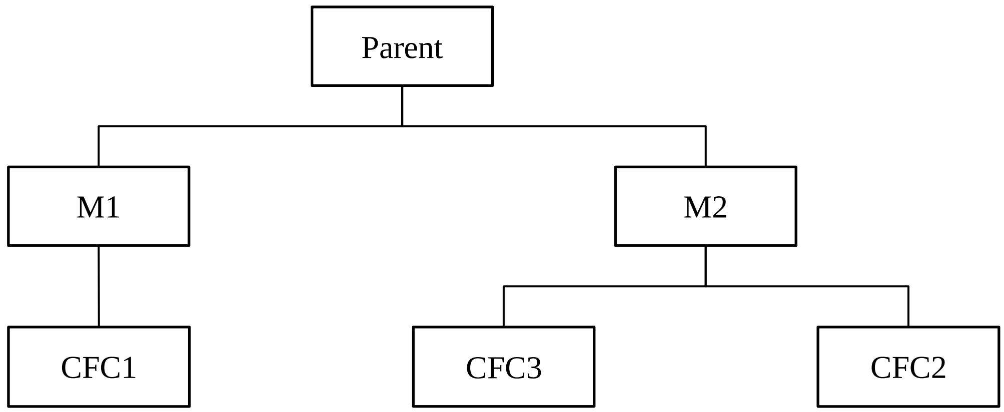
Tested income / (loss) = (100)
QBAI return = 0
Foreign tax rate = 0%
Foreign taxes = 0

Tested income / (loss) = 100
QBAI return = 0
Foreign tax rate = 0%
Foreign taxes = 0

	Nonaggregation		**Aggregation**
	M1	**M2**	**M**
Net CFC tested income	0	100	100
NDTIR	0	0	0
Section 951A inclusion	0	100	100
Aggregate of Related CFCs' tested income	100	100	200
Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income)	0%	100%	50%
Foreign tax paid by Related CFCs with tested income	15.11	0	15.11
FTCs (80% * Inclusion percentage * Foreign tax)	0	0	6.04
Section 78 amount (Inclusion percentage * Foreign tax)	0	0	7.55
GILTI inclusion (Section 951A inclusion + Section 78 amount)	0	100	107.55
US tax before FTCs (GILTI inclusion * 50%[205] * 21%)	0	10.50	11.29
Incremental US tax, taking into account FTCs (US tax before FTCs - FTCs)	0	10.50	5.25
Aggregate tax (Foreign tax + Incremental US tax)	15.11	10.50	20.36
Aggregate tax for consolidated group	**25.61**		**20.36**

[205] Assumes full Section 250 deduction for GILTI is available.

Example 8(c)



Tested income / (loss) = 100
QBAI return = 0
Foreign tax rate = 13.125%
Foreign taxes = 15.11

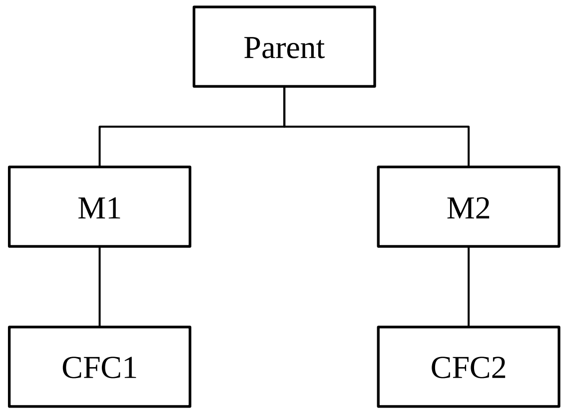
Tested income / (loss) = (100)
QBAI return = 0
Foreign tax rate = 0%
Foreign taxes = 0

Tested income / (loss) = 100
QBAI return = 0
Foreign tax rate = 0%
Foreign taxes = 0

	Nonaggregation		**Aggregation**
	M1	**M2**	**M**
Net CFC tested income	100	0	100
NDTIR	0	0	0
Section 951A inclusion	100	0	100
Aggregate of Related CFCs' tested income	100	100	200
Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income)	100%	0%	50%
Foreign tax paid by Related CFCs with tested income	15.11	0	15.11
FTCs (80% * Inclusion percentage * Foreign tax)	12.09	0	6.04
Section 78 amount (Inclusion percentage * Foreign tax)	15.11	0	7.55
GILTI inclusion (Section 951A inclusion + Section 78 amount)	115.11	0	107.55
US tax before FTCs (GILTI inclusion * 50%[206] * 21%)	12.09	0	11.29
Incremental US tax, taking into account FTCs (US tax before FTCs - FTCs)	0	0	5.25
Aggregate tax (Foreign tax + Incremental US tax)	15.11	0	20.36
Aggregate tax for consolidated group	**15.11**		**20.36**

[206] Assumes full Section 250 deduction for GILTI is available.

Example 9(b)



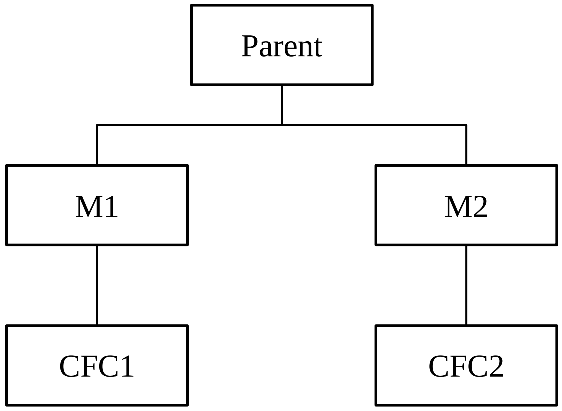
Tested income / (loss) = 100
QBAI return = 0
Foreign tax rate = 13.125%
Foreign taxes = 15.11

Tested income / (loss) = 100
QBAI return = 100
Foreign tax rate = 0%
Foreign taxes = 0

	Nonaggregation		**Aggregation**
	M1	**M2**	**M**
Net CFC tested income	100	100	200
NDTIR	0	100	100
Section 951A inclusion	100	0	100
Aggregate of Related CFCs' tested income	100	100	200
Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income)	100%	0%	50%
Foreign tax paid by Related CFCs with tested income	15.11	0	15.11
FTCs (80% * Inclusion percentage * Foreign tax)	12.09	0	6.04
Section 78 amount (Inclusion percentage * Foreign tax)	15.11	0	7.55
GILTI inclusion (Section 951A inclusion + Section 78 amount)	115.11	0	107.55
US tax before FTCs (GILTI inclusion * 50%[207] * 21%)	12.09	0	11.29
Incremental US tax, taking into account FTCs (US tax before FTCs - FTCs)	0	0	5.25
Aggregate tax (Foreign tax + Incremental US tax)	15.11	0	20.36
Aggregate tax for consolidated group	**15.11**		**20.36**

[207] Assumes full Section 250 deduction for GILTI is available.

Example 9(c)



CFC1	CFC2
Tested income / (loss) = 100	Tested income / (loss) = 100
QBAI return = 0	QBAI return = 100
Foreign tax rate = 0%	Foreign tax rate = 13.125%
Foreign taxes = 0	Foreign taxes = 15.11

	Nonaggregation		**Aggregation**
	M1	**M2**	**M**
Net CFC tested income	100	100	200
NDTIR	0	100	100
Section 951A inclusion	100	0	100
Aggregate of Related CFCs' tested income	100	100	200
Inclusion percentage (Section 951A incl. / Agg. Rel. CFCs' tested income)	100%	0%	50%
Foreign tax paid by Related CFCs with tested income	0	15.11	15.11
FTCs (80% * Inclusion percentage * Foreign tax)	0	0	6.04
Section 78 amount (Inclusion percentage * Foreign tax)	0	0	7.55
GILTI inclusion (Section 951A inclusion + Section 78 amount)	100	0	107.55
US tax before FTCs (GILTI inclusion * 50%[208] * 21%)	10.50	0	11.29
Incremental US tax, taking into account FTCs (US tax before FTCs - FTCs)	10.50	0	5.25
Aggregate tax (Foreign tax + Incremental US tax)	10.50	15.11	20.36
Aggregate tax for consolidated group	**25.61**		**20.36**

[208] Assumes full Section 250 deduction for GILTI is available.

Example 16(a)

	Taxable income	U.S. source basket	GILTI basket	Foreign source general basket		
				Exempt CFC income	**Direct income**	**Basket total**
Business income	700	700	0	0	0	0
Expenses	(700)	(500)	(100)	(100)	0	(100)
GILTI gross	600	0	600	0	0	0
GILTI deduction	(300)	0	(300)	0	0	0
Total	**300**	**200**	**200**	**(100)**	**0**	**(100)**

Calculate GILTI fraction without taking into account Section 904(b)(4), and by re-allocating $100 loss from foreign source general basket to GILTI basket

$$\text{GILTI fraction} = \frac{\text{GILTI basket income} - \text{Foreign source general basket loss}}{\text{Worldwide income}}$$

$$\text{GILTI fraction} = \frac{100}{300} = 0.33$$

Apply Section 904(b)(4) to disregard $100 of expenses allocable to exempt CFC income

	Taxable income	U.S. source basket	GILTI basket	Foreign source general basket		
				Exempt CFC income	**Direct income**	**Basket total**
Business income	700	700	0	0	0	0
Expenses	(600)	(500)	(100)	0	0	0
GILTI gross	600	0	600	0	0	0
GILTI deduction	(300)	0	(300)	0	0	0
Total	**400**	**200**	**200**	**0**	**0**	**0**

$$\text{GILTI fraction} = \frac{\text{GILTI basket income}}{\text{Worldwide income}}$$

$$\text{GILTI fraction} = \frac{200}{400} = 0.50$$

Example 16(b)

	Taxable income	U.S. source basket	GILTI basket	Foreign source general basket		
				Exempt CFC income	**Direct income**	**Basket total**
Business income	150	100	0	0	50	50
Expenses	(150)	(40)	(60)	(40)	(10)	(50)
GILTI gross	600	0	600	0	0	0
GILTI deduction	(300)	0	(300)	0	0	0
Total	**300**	**60**	**240**	**(40)**	**40**	**0**

Calculate GILTI and foreign source general basket fractions without taking into account Section 904(b)(4)

$$\text{GILTI fraction} = \frac{\text{GILTI basket income}}{\text{Worldwide income}} = \frac{240}{300} = 0.80$$

$$\text{Foreign general basket fraction} = \frac{\text{Foreign general basket income}}{\text{Worldwide income}} = \frac{0}{300} = 0$$

Apply Section 904(b)(4) to disregard \$40 of expenses allocable to exempt CFC income

	Taxable income	U.S. source basket	GILTI basket	Foreign source general basket		
				Exempt CFC income	**Direct income**	**Basket total**
Business income	150	100	0	0	50	50
Expenses	(110)	(40)	(60)	0	(10)	(10)
GILTI gross	600	0	600	0	0	0
GILTI deduction	(300)	0	(300)	0	0	0
Total	**340**	**60**	**240**	**0**	**40**	**40**

$$\text{GILTI fraction} = \frac{\text{GILTI basket income}}{\text{Worldwide income}} = \frac{240}{340} = 0.71$$

$$\text{Foreign general basket fraction} = \frac{\text{Foreign general basket income}}{\text{Worldwide income}} = \frac{40}{340} = 0.12$$

Revenue Procedures

Rev. Proc. 2018-53, 2018-43 IRB 667, 10/03/2018, IRC Sec(s). 355

Distribution of stock and securities of controlled corp.-letter rulings.

Headnote:

As IRS continues to study issues surrounding assumption and satisfaction of distributing's obligations in divisive reorgs. for purposes of issuing private letter rulings, taxpayers have been provided with updated list of representations, information, and analysis that should be submitted along with ruling request, or else explain inability to do so and demonstrate that modified representations still satisfy stated requirements. Rev. Proc. 2018-1,2018-1 IRB 1 is modified. Rev. Proc. 2017-52,2017-41 IRB 283 is amplified and modified.

Reference(s): ¶ 3555.01(3); Code Sec. 355;

Full Text:

1. Purpose

This revenue procedure provides procedures for taxpayers requesting private letter rulings regarding certain issues pertaining to reorganizations under § 368(a)(1)(D) and § 355 of the Internal Revenue Code of 1986 (Divisive Reorganizations), including representations, information, and analysis that taxpayers requesting these rulings should submit.

2. Background

In a Divisive Reorganization, a corporation (Distributing) transfers property to a corporation it controls (within the meaning of § 368(c)) immediately thereafter (Controlled), in exchange for consideration. The consideration received by Distributing (§ 361 Consideration) includes Controlled stock and also may include money, securities or other debt obligations of which Controlled is the obligor, and other property. Controlled may also assume liabilities of Distributing. To complete the Divisive Reorganization, Distributing distributes the Controlled stock, and possibly other § 361 Consideration, to its shareholders and may also distribute § 361 Consideration in satisfaction of its obligations to holders of its securities or to other creditors.

In section 5.01(10) of Rev. Proc. 2013-3, 2013-1 I.R.B. 113, the Internal Revenue Service (Service) modified its prior practice and stated that it would no longer rule on whether § 355 or § 361 applied to Distributing's distribution of Controlled stock or securities in exchange for, and in retirement of, putative Distributing debt if such Distributing debt was issued in anticipation of the distribution. The Service set forth this no-rule position most recently in section 5.01(4) of Rev. Proc. 2017-3, 2017-1 I.R.B 130. In Rev. Proc. 2017-38, 2017-22 I.R.B. 1258, the Service modified Rev. Proc. 2017-3 to remove this no-rule position.

In Rev. Proc. 2017-52, 2017-41 I.R.B. 283, the Service introduced a pilot program to allow rulings on the overall federal income tax consequences of Divisive Reorganizations and other distributions under § 355, provided procedures for taxpayers requesting these rulings, and clarified procedures for taxpayers requesting rulings on significant issues (defined in section 3.01(53) of Rev. Proc. 2018-3, 2018-1 I.R.B. 130).

On October 13, 2017, the Service released a statement to inform taxpayers and their advisers of changes relating to requests for private letter rulings on certain corporate transactions. This statement provides, in part, the following:

If, in connection with a section 355 distribution, a distribution of stock, securities or other property to the distributing corporation's shareholders or creditors is substantially delayed, IRS will continue to rule on whether the delayed distribution is tax-free under section 355 or section 361. However, rulings on such issues will not be based solely on the length of the delay. Instead, IRS will rule on this issue only based on substantial scrutiny of the facts and circumstances (including the circumstances of the delay) and full consideration of the legal issues and the effects of a ruling on federal tax administration.

The Department of the Treasury and the Service continue to study the issues relating to assumption and satisfaction of Distributing's obligations in Divisive Reorganizations. The Service has determined, however, that taxpayers requesting rulings on certain of these issues should follow specified procedures and submit specified representations and related information and analysis.

3. Application And Procedures

.01. Ruling requests to which procedures apply

A taxpayer engaging in a Divisive Reorganization may request rulings that no gain or loss will be recognized to Distributing (i) upon Controlled's assumption of liability for an obligation of Distributing (§ 357(a)), and (ii) upon Distributing's receipt of § 361 Consideration and its distribution of the § 361 Consideration to a creditor in satisfaction of Distributing's debt obligation (§§ 361(b) and (c)). Each such ruling may be a Significant Issue Ruling, described in section 6.03(2) of Rev. Proc. 2018-1, 2018-1 I.R.B. 1, or it may be included in a Transactional Ruling, defined in section 2.03(1)(c) of Rev. Proc. 2017-52.

The procedures described in section 3.03 of this revenue procedure apply to a request for a Significant Issue Ruling or a Transactional Ruling, as appropriate, to the extent that a subject of the request is an assumption by Controlled of liability for Distributing Debt or the satisfaction of Distributing Debt with § 361 Consideration. For purposes of this revenue procedure, an obligation is Distributing Debt if (a) Distributing is the obligor, and (b) the obligation (i) is evidenced by a debt instrument (defined in § 1.1275-1(d)) that is not a contingent payment debt instrument subject to § 1.1275-4 (Non-contingent Debt Instrument) and (ii) by its terms is payable only in money. (For example, Distributing Debt does not include an obligation that, by its terms, can be satisfied with § 361 Consideration at Distributing's option.)

.02. Ruling requests on similar or related transactions

The Service will continue to rule on transactions that are not described in section 3.01 of this revenue procedure but are similar to such transactions. These transactions include assumption or satisfaction of Distributing's obligations that are not Distributing Debt (for example, contingent liabilities) and distributions of § 361 Consideration to Distributing's shareholders. However, this revenue procedure does not describe procedures for requesting such rulings or the representations, information, or analysis that taxpayers requesting such rulings should submit. See generallyRev. Proc. 2018-1 and Rev. Proc. 2017-52.

A taxpayer may request rulings regarding assumption or satisfaction of some obligations that are, and of other obligations that are not, Distributing Debt. In this situation, the taxpayer should follow the procedures described in section 3.03 of this revenue procedure with respect to the Distributing Debt and should follow the procedures described in Rev. Proc. 2018-1 and Rev. Proc. 2017-52 with respect to the other obligations. Additional representations, information, and analysis may be required.

.03. Procedures

In a request for rulings described in section 3.01 of this revenue procedure, the taxpayer should submit (in addition to the representations, information, and analysis described in Rev. Proc. 2018-1 and Rev. Proc. 2017-52) information that describes (1) the Distributing Debt that will be assumed or satisfied (including the relevant terms of the Non-contingent Debt Instruments that evidence the Distributing Debt and the date or dates on which the Distributing Debt was incurred), (2) the § 361 Consideration that will be distributed to creditors in satisfaction of the Distributing Debt, and (3) the transactions that will implement Controlled's assumption of liability for Distributing Debt or Distributing's receipt of § 361 Consideration and its distribution of § 361 Consideration to creditors in satisfaction of Distributing Debt.

The taxpayer should also submit information and analysis to establish that (1) any assumption of Distributing Debt by Controlled will be consideration received by Distributing in the Divisive Reorganization, and (2) any distribution of § 361 Consideration by Distributing to its creditors in satisfaction of Distributing Debt will be in connection with the plan of reorganization.

If, at the time of the first distribution of Controlled stock to Distributing shareholders, the assumption or satisfaction of Distributing Debt is subject to any contingency, the taxpayer should (1) describe each contingency and any alternative transactions and (2) establish that there are one or more substantial business reasons for the plan not being fixed and determined at that time. Documentation of such business reasons should be submitted only if requested.

In addition, the taxpayer should submit the representations, information, and analysis set forth in section 3.04 of this revenue procedure.

.04. Representations, information, and analysis

The representations, information, and analysis described in paragraphs (1) through (8) of this section 3.04 should be submitted. With respect to these representations, the taxpayer should not follow the procedures in section 3.04 of Rev. Proc. 2017-52. Instead, the taxpayer should set forth each applicable representation and the additional information and analysis described in this section 3.04. If the taxpayer believes that any of the representations is not applicable, the taxpayer should explain its rationale for this belief.

If the taxpayer is unable to submit an applicable representation in the form set forth in this section 3.04 (<u>Standard Representation</u>), the taxpayer should submit (1) an explanation for its inability to provide the Standard Representation and (2) the rationale supporting the issuance of each relevant requested ruling in the absence of the Standard Representation. If appropriate, the taxpayer should submit (1) a modified representation that addresses the same matter, (2) an explanation of the modification, and (3) the rationale supporting the issuance of each relevant requested ruling, taking into account the modified Standard Representation.

The representations in this section 3.04 use terms defined in this revenue procedure. The taxpayer should include in its request either (1) definitions of these terms that are consistent with the definitions in this revenue procedure or (2) a statement to the effect that these terms have the meanings set forth in this revenue procedure.

(1) <u>Distributing as obligor in substance</u>. Submit the following REPRESENTATION:*Distributing is in substance the obligor of each Distributing Debt that will be assumed or satisfied.* With respect to any such Distributing Debt, the taxpayer should submit information regarding any co-obligation, guarantee, indemnity, surety, make-well, keep-well, or similar arrangement, including security provided by any person other than Distributing. The taxpayer should also submit information and

analysis to establish that, taking into account any such arrangement, Distributing is in substance the obligor of such Distributing Debt.

(2) Holder not a Related Person. Submit the following REPRESENTATION: No holder of Distributing Debt that will be assumed or satisfied is a person related to Distributing or Controlled within the meaning of § 267(b) or § 707(b)(1) (Related Person) If a holder is a Related Person, the taxpayer should establish that the § 361 Consideration received by the Related Person will be used to satisfy an obligation that is evidenced by a Non-contingent Debt Instrument and is held by a person other than a Related Person. The taxpayer should also submit information and analysis to address any potential application of the consolidated return regulations, including § 1.1502-13(g).

(3) Holder of Distributing Debt. Submit the following REPRESENTATION:*The holder of Distributing Debt that will be assumed or satisfied will not hold the debt for the benefit of Distributing, Controlled, or any Related Person.* A collateral benefit received by Distributing from an arrangement with an intermediary (for example, facilitation of exchanges of § 361 Consideration for Distributing Debt) will not be treated as the intermediary holding Distributing Debt for the benefit of Distributing, Controlled, or a Related Person. If an intermediary will acquire pre-existing Distributing Debt from any person, and such Distributing Debt will be satisfied with § 361 Consideration, submit the following additional REPRESENTATIONS:*[Name of intermediary] will not acquire Distributing Debt from Distributing, Controlled, or any Related Person. Neither Distributing, nor Controlled, nor any Related Person will participate in any profit gained by [name of intermediary] upon an exchange of § 361 Consideration; nor will any such profit be limited by agreement or other arrangement. The value of the § 361 Consideration received by [name of intermediary] in satisfaction of the Distributing Debt will not exceed the amount to which the holder is entitled under the terms of the Distributing Debt.* The taxpayer should describe any co-obligation, guarantee, indemnity, surety, make-well, keep-well, or similar arrangement, including additional security, provided to the intermediary by Distributing, Controlled, or any Related Person for risk of loss with respect to the Distributing Debt.

(4) Distributing Debt as historic debt. Submit the following REPRESENTATION:*Distributing incurred the Distributing Debt that will be assumed or satisfied (a) before the request for any relevant ruling is submitted and (b) no later than 60 days before the earliest of the following dates: (i) the date of the first public announcement (as defined in § 1.355-7(h)(10)) of the Divisive Reorganization or a similar transaction, (ii) the date of the entry by Distributing into a binding*

agreement to engage in the Divisive Reorganization or a similar transaction, and (iii) the date of approval of the Divisive Reorganization or a similar transaction by the board of directors of Distributing. A transaction is a similar transaction if it would have effected a direct or indirect separation of all, or a significant portion of, the same assets as the Divisive Reorganization that is the subject of the taxpayer's ruling request (cf. § 1.355-7(h)(12) and (13) (describing the terms "similar acquisition (not involving a public offering)" and "similar acquisition involving a public offering," respectively). If Distributing incurred or will incur any of the Distributing Debt that will be assumed or satisfied at a later time, the taxpayer should establish that, based on all the facts and circumstances, the borrowing and the assumption or satisfaction of such Distributing Debt will result in an allocation of historic Distributing Debt between Distributing and Controlled or an exchange of historic Distributing Debt for Controlled stock. As one example, the taxpayer may establish that the proceeds of the more-recently incurred Distributing Debt were used to satisfy other Distributing Debt that was incurred no later than the time described in the representation in this section 3.04(4) (cf. Rev. Rul. 79-258, 1979-2 C.B. 143 (in connection with a Divisive Reorganization, Controlled's assumption of liability for debt newly issued by Distributing to replace historic debt incurred in connection with the business to be transferred to Controlled did not cause § 357(b) to apply to the assumption)). As another example, the taxpayer may establish that the proceeds of the Distributing Debt assumed or satisfied were or will be used in Controlled's business.

(5) Historic average. Submit the following REPRESENTATION:*The total adjusted issue price (determined under § 1.1275-1(b)) of Distributing Debt that will be assumed or satisfied does not exceed the historic average of the total adjusted issue price of (a) Distributing Debt owed to persons other than Related Persons and (b) obligations that are evidenced by Non-contingent Debt Instruments and are owed by other members of Distributing's separate affiliated group (within the meaning of § 355(b)(3)(B)) to persons other than Related Persons.* The historic average of total adjusted issue price should be determined based on debt outstanding as of the close of the eight fiscal quarters that ended or will end immediately before the date of approval of the Divisive Reorganization by the board of directors of Distributing.

(6) Delayed satisfaction of Distributing Debt. If applicable, submit the following REPRESENTATIONS:*There are one or more substantial business reasons for any delay in satisfying Distributing Debt with § 361 Consideration beyond 30 days after the date of the first distribution of Controlled stock to Distributing's shareholders. All the Distributing Debt that will be*

satisfied with § 361 Consideration will be satisfied no later than 180 days after such distribution. The taxpayer should submit information and analysis to establish the substantial business reasons for any delay in satisfying Distributing Debt after the 30-day period beginning on the date of the first distribution of Controlled stock to Distributing's shareholders. If satisfaction of any Distributing Debt with § 361 Consideration will occur more than 180 days after the date of such first distribution, the taxpayer should submit information and analysis to establish that, based on all the facts and circumstances, the satisfaction will be in connection with the plan of reorganization. Documentation of the matters described in this section 3.04(6) should be submitted only if requested.

(7) No replacement of Distributing Debt. Submit the following REPRESENTATION:*Distributing will not replace any Distributing Debt that will be assumed or satisfied with previously committed borrowing, other than borrowing in the ordinary course of business pursuant to a revolving credit agreement or similar arrangement*. The purpose of this representation is to establish that the application of § 361 to the proposed transactions is consistent with the purposes of § 361. If Distributing is a prospective borrower under a revolving credit agreement or similar arrangement, the taxpayer should submit information and analysis to establish that the agreement or arrangement was not entered into, and amounts of borrowing provided for therein were not increased, in a transaction related to the Divisive Reorganization.

(8) General information and analysis. Submit information and analysis to establish that, under general principles of tax law, the transactions (including any exchange facilitated by an intermediary) should not be recast, recharacterized, or otherwise treated as one or more transactions that would not qualify under the relevant provisions of the Internal Revenue Code of 1986.

4. Miscellaneous

Taxpayers and their advisers are encouraged to contact the Office of Associate Chief Counsel (Corporate) with questions and comments regarding these matters. Taxpayers seeking rulings described in section 3.01 of this revenue procedure are encouraged to request pre-submission conferences. Seesection 10.07 of Rev. Proc. 2018-1.

5. Effect On Other Documents

.01. Section 6.03(3)(d) of Rev. Proc. 2018-1 is modified by deleting the second paragraph and adding the following text in its place:

The taxpayer should consult other published authorities (see, for example, Appendix G of this revenue procedure, which identifies certain checklist and guideline revenue procedures, including Rev. Proc. 2017-52 and Rev. Proc. 2018-53, to identify information or representations but only to the extent that they relate to the issue).

.02. Section 7.01(2)(a) of Rev. Proc. 2018-1 is modified by deleting the text of the second sentence of the first paragraph and adding the following text in its place:

But seesection 3.02 and section 4 of Rev. Proc. 2017-52, 2017-41 I.R.B. 283, for requirements relating to ruling requests under § 355, and section 3.04 of Rev. Proc. 2018-53, 2018-43 I.R.B. XXX, for requirements relating to ruling requests involving assumption or satisfaction of the distributing corporation's debt in connection with § 355 distributions.

.03. Section .01 of Appendix G to Rev. Proc. 2018-1 is modified as follows:

(1) In the column titled REVENUE PROCEDURE AND NOTICE, in the text corresponding to "Subchapter C-Corporate Distributions, Adjustments, Transfers, and Reorganizations" found in the column CODE OR REGULATION SECTION, by deleting the text and adding the following text in its place: Rev. Proc. 77-37, 1977-2 C.B. 568, as modified by Rev. Proc. 89-30, 1989-1 C.B. 895, and as amplified by Rev. Proc. 77-41, 1977-2 C.B. 574, Rev. Proc. 83-81, 1983-2 C.B. 598 (see alsoRev. Proc. 2018-3), Rev. Proc. 84-42, 1984-1 C.B. 521 (superseded, in part, as to no-rule areas by Rev. Proc. 2018-3), Rev. Proc. 86-42, 1986-2 C.B. 722, Rev. Proc. 89-50, 1989-2 C.B. 631, Rev. Proc. 2017-52, 2017-41 I.R.B. 283 (relating to Transactional Rulings for Covered Transactions), and Rev. Proc. 2018-53, 2018-43 I.R.B. XXX. But seesection 3.01(53) of Rev. Proc. 2018-3, which states that the Service will not issue a letter ruling as to whether a transaction constitutes a reorganization within the meaning of § 368 (except as provided in section 6.03(2)(b) of this revenue procedure). However, the Service will issue a letter ruling addressing significant issues (within the meaning of section 3.01(53) of Rev. Proc. 2018-3) presented in a reorganization within the meaning of § 368. The information and representations described in these revenue procedures should be included in a letter ruling request only to the extent that they relate to the significant issues with respect to which the letter ruling is requested. Seesection 6.03(2) of this revenue procedure.

(2) In the column titled REVENUE PROCEDURE AND NOTICE, in the text corresponding to "355 Checklist questionnaire" found in the column CODE OR REGULATION SECTION, by deleting the text and adding the following text in its place:

Rev. Proc. 2017-52, 2017-41 I.R.B. 283, and Rev. Proc. 2018-53, 2018-43 I.R.B. XXX. See alsosection 6.03(2) of this revenue procedure.

.04. Rev. Proc. 2017-52 is amplified and modified.

6. Effective Date

This revenue procedure will apply to all ruling requests postmarked or, if not mailed, received by the Service after October 3, 2018. If a ruling request described in section 3.01 of this revenue procedure is pending on such date, the taxpayer should consider a supplemental submission with the representations, information, and analysis described in section 3.03 and section 3.04 of this revenue procedure (to the extent this material has not been submitted).

7. Paperwork Reduction Act

The collections of information in this revenue procedure have been reviewed and approved by the Office of Management and Budget (OMB) in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1522.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collections of information in this revenue procedure are in section 3. This information is required to determine whether a taxpayer would qualify for tax-free treatment to the extent allowed under § 357 and § 361. The collections of information are required to obtain a benefit. The likely respondents are corporations that control another corporation, as well as the management of the corporation the stock of which is distributed or that controls the corporation the stock of which is being distributed.

The estimated total annual reporting burden for Rev. Proc. 2018-1 is 326,436 hours.

The estimated annual burden per respondent for Rev. Proc. 2018-1 varies from 1 to 200 hours, depending on individual circumstances, with an estimated average of 82 hours. The estimated number of respondents is 3,956.

The estimated total annual reporting burden for this revenue procedure adds 955 hours to the burden imposed by Rev. Proc. 2018-1.

The estimated annual burden per respondent for this revenue procedure varies from 5 to 50 hours, depending on individual circumstances, with an estimated average of 15 hours. The estimated number of additional respondents added to Rev. Proc. 2018-1 by this revenue procedure is 2, increasing the estimated number of respondents to Rev. Proc. 2018-1 to 3,958.

The estimated average burden for Rev. Proc. 2018-1, as increased by this revenue procedure, is 82 hours.

The estimated annual frequency of responses is on occasion.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue tax law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

8. Drafting Information

The principal author of this revenue procedure is J.P. Stemwedel of the Office of Associate Chief Counsel (Corporate). For further information regarding this revenue procedure, please contact Mr. Stemwedel at (202) 317-5024.

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